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Outreach and Sustainability of Rural Microfinance in Asia:

Observations and Recommendations

by

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Outreach and sustainability of rural microfinance in Asia: Observations and recommendations[1]

1. Is Banking with the Poor Poor Banking?

Outreach vs. viability

We in the community of microfinance specialists want to help alleviate poverty. We think microfinance is a useful tool. Yet, by bringing these two concerns together, we might be mixing up two diverging ends: one is poverty reduction; the other one the development of a healthy microfinance industry. If poverty reduction is our objective, then microfinance is likely to be only one of several instruments; in fact it might turn out to be of minor importance. If viable microfinance institutions are our chief concern, they may benefit, and profit, from a variety of market segments, which may or may not include the poor. In this case, banking with only the poor might turn out to be poor banking, and the poor, and particularly the very poor, might even be left out. It might also be that in the long run only healthy microfinance institutions have a chance of effectively serving the poor.

Learning from experience

During the *Bank Poor '96 Workshop* in Kuala Lumpur, December 1996, which served as a pre-Microcredit Summit, David Gibbons as one of the chief organizers and contributors described the following learning experience:

> "Project Dungganon of the Negros Women for Tomorrow Foundation, the largest Grameen Bank replication/adaptation in the Philippines serving over 10,000 poor women, has lurched form financial crisis to repayment crisis to financial crisis again, because of a financially imprudent expansion plan that encouraged: Don't worry about the money; if you reach and benefit large numbers of the poor, the money will be forthcoming. No more! We have learned to make existing and new branches viable. This has slowed down our outreach to the poor, but it is being made more sustainable. The latter is of course essential for lasting poverty-reduction."

From outreach...

It took us, members of a diverse team[2] working on microfinance in Asia, a while to arrive at that conclusion. We started asking ourselves whether and how microfinance can help alleviate poverty. We ended asking ourselves whether and how microfinance institutions may become self-reliant and viable. Outreach to the poor was thus our first concern. In the context of this question, we examined the issue of resource mobilization from a purely instrumental viewpoint: where to find the resources for poverty lending. It appeared to go without asking that most of these sources had to found externally, namely in the form of donor money. There seemed to be little chance that commercial banks would engage in poverty lending. This was in line with the view expounded by the Microcredit Summit of February 1997: where to find the billions of dollars needed to extend credit to the poor.

... to sustainable institutions

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[1] This paper is based on the results of a research program of the Asian and Pacific Development Centre (APDC) in eleven countries on *Micro Finance for the Poor in Asia-Pacific,* supported by UNDP. Preliminary results were published in: I. Getubig, J. Remenyi & B. Quiñones, eds.: Creating the Vision: Microfinancing the Poor in Asia-Pacific Issues, Constraints and Capacity-building. Asian and Pacific Development Centre, Kuala Lumpur, 1997

[2] The internationa team comprised I. Getubig, D. Gibbons, B. Quiñones, J. Remenyi and H. D. Seibel. The studies were carried out by national teams in each country.

However, funds given by governments and donors are not hard-earned by the beneficiaries. Easy money is not taken seriously, ie., it is frequently not paid back, or not repaid on time. This, we realized, had distrastrous consequences for outreach. MFIs which fail to mobilize their own resources and whose capital base is eroded by heavy losses will decrease, rather than increase, their outreach, until they eventually go out of business altogether. Wasting precious resources, they contribute to financial shallowing rather than deepening, and financial narrowing rather than widening. Savings are a pillar of sustainability. A sustainable institution is one which is viable and does not depend on donors but its own resources. A viable institution is able to cover its costs and perhaps make a profit from its own business operations. Finally, we realized that the effectiveness of a microfinance institution does not only depend on its own activities, but to a large extent on the policy and legal environment, which may be facilitating or constraining.

The evidence

There are thus four major issues we examined: outreach, viability and sustainability, resource mobilization, and policies, and we did so in China, Fiji, India, Indonesia, Malaysia, Nepal, Papua New Guinea, Philippines, Solomon Islands, Sri Lanka, Tonga. China and Malaysia were left out of this book for reasons of space restrictions. Of 54 case studies, 39 were found to be adequate in terms of the quality of information gathered. This is our empirical base.

2. How to increase outreach

To target...

Thirty years of subsidized agricultural credit have tought us that targeting the poor has failed to substantially increase outreach. We are now being told that microfinance is to succeed where agricultural credit failed. We are also being told that the target clients of MFIs are those persons identified as living below nationally defined income-based poverty lines; and that MFI should restrict their clientele to that target group. But do MFIs with a non-poor clientele inevitably divert resources from outreach to poor persons as is surmised? The opposite might be true: Non-poor clients, with their larger equity shares, savings and loan sizes may raise the resources and generate the profits needed to provide financial services to the poor which might otherwise be much more restricted. Targeting the poor thus raises several questions: Do the non-poor have to be excluded, be it as borrowers or equity-contributors and savers? What about those clients who, as a result of benefits derived from microfinance services, have crossed the poverty line? Should they be excluded, to be perhaps included again if, as a result of that exclusion, they fall back below the poverty line? If the owners of some institutions decide to limit their membership or clientele to women, the poor or poor women, does that mean that all such institutions have to do so if they want to qualify as MFIs? And finally, who should decide?

... or not to target the poor

In many an organization and project examined in our study, much effort has gone into the identification of the poor, P4K in Indonesia being an example. In fact, we have excluded one prominent microfinance provider in Indonesia from our study on the grounds that he does not employ a poverty targeting test: Bank Rakyat Indonesia (BRI). BRI, a government-owned national bank with a rural mandate, is an interesting case. After the introduction of interest rate deregulation in 1983, BRI turned from one of the biggest losers of subsidized targeted funds to a profitable bank by mobilizing resources from 16.2 million rural savers and granting small loans to 2.49 million rural borrowers (Dec. 1996, subbranch level only) at commercial rates of interest: a multiple of the borrowers served with subsidized credit. BRI has no exact figures on the percentage of poor and very poor clients reached through its rural banking network of about 3600 subbranches, and does not care to monitor this. Should it? BRI says no, its branches are open to the poor – they are free to deposit their savings and apply for a loan. With loans starting as low as Rp. 25,000 (US$ 11 before the 1997/98 devaluation, but

most are above Rp 500,000 = $217), there is a sizeable number of poor people among its clients: certainly a much larger number than in many pampered institutions which rely on donor money. BRI's services are profitable; they are sustainable; and they have expanded since their inception at a rapid rate. BRI defends its policy arguing that any deviation from its current approach would confuse the staff in its subbranches. Through the profits from this nontargeted program, BRI is also able to finance other programs which are more directly geared to the poor, but it does so through its branches rather than subbranches. There are two major programs, each working through self-help groups as a mechanism to keep transaction and information costs low. One is a national program, *Linking Banks and Self-Help Groups (PHBK)* under the auspices of Bank Indonesia in which BRI is a major and Bank Shinta Daya, one of our cases in this study, one of the smaller participants. The other one is P4K in which BRI is the sole bank involved. The former, PHBK, works through previously existing self-help groups; the latter, P4K, first identifies the poor and the very poor and then helps to organize in newly groups. In both cases, BRI insists on market rates of interest, timely repayment, and a profit margin. PHBK uses only existing bank funds within the national economy to refinance self-help groups. P4K, with a much weaker savings component, originally relied for its funding on IFAD, which is now being gradually replaced by BRI's own funds. These funds are not allocated by the government, but are mobilized and earned through at the subbranch level. BRI is also the major participant in the recent massive drive of providing microcredit from special presidential allocations to all villages identified as poor.

Reaching the poor through both targeted and non-targeted technologies

Another example is Bank Shinta Daya (BSD), a small rural bank in Indonesia, which is privately owned and funded and his financed its expansion since 1970 from its profits. Without targeting, BSD has reached substantial numbers of poor people: 22,940 individual depositors, 71.3% of them classified as poor; and 6,456 individual borrowers, 29.4 % classified as poor. Its profits have enabled it to participate in Bank Indonesia's linkage banking project PHBK and reach out to another 7,400 poor people through the group approach. These are substantial numbers for an institution which by its rural banking charter is authorized to do business only within a single sub-district. Compare this to donor-funded MKEJ in Indonesia, which has 1,125 clients, all poor and all women, with little potential for viability and growth of outreach.

Is targeting a donor concern?

Our conclusion is that outreach ultimately depends on governance and source of funds. Fifteen of the 39 MFIs in our study, most of them NGOs, depend on grants and softloans, leaving the saying to donors; their total outreach is 24,337. Fourteen of our MFIs rely on savings and commercial borrowings; their total outreach is 686,923. If BRI were included, the discrepancy would even be wider. If the loanable funds are provided by a donor or the government, it is their right to attach strings. If they use taxpayer money to subsidize the program, poverty targeting may be the justification. If resources are static of declining, leakage may be an issue.

Let the poor decide!

The situation is entirely different if the resources are generated locally and grow rapidly, which is easily done once an institution starts mobilizing savings vigorously from the poor and the non-poor. In this case it is the local owners or members who decide whether to restrict services to the poor or not. This is the governance issue: those who own the institution decide! This issue become murky if an MFI is locally owned and thus on principle in a position to make its own decisions; but at the same time receives donor funds for the poor only. Donors employ consultants to examine the amount of "leakage." Nobody can prevent a donor from attaching its own strings. But some donors might think twice if they learn what they are doing: supporting nonviable institutions with nonsustainable services for a non-growing number of poor people. Perhaps we should stop telling MFIs, or the poor themselves, that financial services MUST be targeted to the poor – and only on the poor or the very poor, and instead leave the decision to those concerned. Specialized *banks for the poor*, as recently

established in Vietnam with government money, and in Nepal with donor funding, may ultimately prevent, rather than promote, the growth of outreach to low-income people.

Two ways of increasing outreach

At a first glance, our MFIs from Nepal appear to present a different case: donor-funded Purbanchal Grameen Bikas Bank had 26,297 clients in December 1995, while the locally funded Navajiban Cooperative Society had only 1661 clients. However, comparing single cases of MFIs may be misleading. There are five Grameen Bikas Banks in Nepal with a total membership of poor women of 32,119 in mid-95 and 48,392 in mid-96 – compared to 12,000 registered and unregistered savings and credit organizations and cooperatives with a total of 792,000 members. It has been argued that MFIs should strive for a minimum outreach of *20,000 poor beneficiaries*. This would leave no place for village-based institutions (such as the famous Raiffeisen banks in Germany, the renowned BKK in Central Java, and the cooperatives in Nepal). These size requirements are donor concerns! What is wrong with a small informal institution owned and controlled by its 30 members, or a cooperative of 300, who raise – and manage! - their own funds? Outreach can be increased in two ways: by increasing the number of institutions, and by increasing the number of their clients. There is no best practice! Much depends on factors such as population density, settlement patterns and, last not least, the institutional preferences of the local people. On a fragmented financial market, which will continue to characterize most of the financial landscape in developing countries for some time to come, much speaks in favor of small institutions owned and managed by local people.

3. How to mobilize savings

God helps those who help themselves

Proverbial wisdom has it that even God can help only those who help themselves. In the past, donors and governments have been trying to do better than God: by also trying to help those who failed to help themselves. They even turned this into a philosophy by declaring that the poor are too poor to help themselves. It was claimed that they need cheap credit and should be treated with sympathy when defaulting. This may sound like a philosophy of the past as every enlightened microfinance advocate now pleads for market rates of interest and timely repayment. Yet definitions of market rates and of timely repayment vary widely; and the donor practice of supplying *easy* money continues unabated.

Credit-driven MFIs keep the poor from saving

The practice of providing subsidized targeted credit has hurt the poor immensely by depriving them of access to savings deposit facilities. It is only quite recently that many development banks, the major providers of subsidized credit, have begun to provide savings deposit facilities. Many donor-supported credit programs include a savings component; but these are usually compulsory savings of a limited magnitude, while excluding the vigorous collection of voluntary savings. E.g., the Small Farmers Development Program (SFDP) of the Agricultural Development Bank of Nepal, ADBN, has stipulated compulsory savings since its inception in 1975, but their magnitude always hovered around 1% of loans outstanding.

The foremost interest of the poor is access to savings deposit facilities

In credit programs with a compulsory savings component there is invariably a close match of the number of savers and borrowers, the former slightly in excess of the latter. However, in institutions which offer unbiased savings and credit services, the number of savers exceeds the number of borrowers by a wide margin as the following few examples show:

	Savers	*Borrowers*
SEWA, India	56,541	20,840
Navajiban Co-operative Society Ltd., Nepal	195	67
Regional Rural Development Bank, Sri Lanka	24,902	3,136
Bank Purba Danarta, Indonesia	5,850	263
Bank Rakyat Indonesia	16,174,000	2,488,000

Most striking examples of institutions which attract far more savers than borrowers are Bank Rakyat Indonesia, which is a bank for the near-poor and not-so-poor, with a ratio of borrowers to savers of 1:6.5, and Bank Purba Danarta, which was set up with church funds as a commercial bank for the poor, with a ratio of 1:22.2. The poor and the not-so-poor do have savings, and they do want to deposit them. But they also want to be able to withdraw them when they need them, which many NGO-supported MFIs try to prevent, treating compulsory savings like equity.

Donor dependency leads to unsound practices

Once governments or donors do the first step by providing operational and loanable funds, the way to self-reliance and institutional viability seems to be long and arduous. Easy money frequently fails to provide the right incentives and is not taken seriously. Unsound financial practices are likely to ensue, among them inordinately long loan periods, inappropriate installment periods, excessive loan sizes, lack of insistence on timely repayment and insufficient interest rates. If people would administer easy money the same way as their own hard-earned savings, much benefit might be derived from such injections. But donor interventions tend to prevent this, e.g. by insisting on monitoring donor and own funds separately. In one small MFI in Nepal we found 72 different ledgers: one for each loan program differentiated by donor and the loan purposes imposed by them. The managers and clients of small financial institutions thus know where their loans come from: donor funds or own savings. Even this can be rectified to some extent by sound practices: In P4K, BRI excludes villages and substricts from access to further credit if arrears exceed 10%. As a result, timely repayment of bank loans from groups which also mobilize their own resources is excellent.

Savings are the backbone of institutional sustainability

Internally generated resources make MFIs independent of donors and government agencies and their administrative impositions. Government and donor funds can be withdrawn at any time. Under pressures to exercise budgetary restraint, all governments, sooner or later, will cut down their subsidies for poverty lending. Donors should not be called in to take their place. Instead, to alleviate poverty and contribute to institutional sustainability, donors should be called upon to help the poor to help themselves: by upgrading or establishing their own small local financial institutions, be they formal or nonformal, and mobilizing their own resources. They should stop giving them cheap money. In the same vein, they should stop supplying easy money to governments lest they fail building a financial infrastructure and mobilizing savings. What is needed in this initial phase is advice, or technical assistance, not financial assistance.

Types of internal resources

Internal resources are the essence of self-help and self-reliance. There are five major types of internal resources of MFIs: equity or share capital; compulsory savings, which are similar to equity; voluntary savings; insurance premiums; and undistributed profits. MFIs which mainly rely on **equity** tend to remain small and insignificant, at least when equity is contributed in equal shares as in cooperatives. Under conditions of inequality, private shareholding institutions with unequal shares, among them finance companies, may mobilize a much larger resource potential. Insistence on **compulsory savings** can send the wrong signals: if people need to be forced into saving, there must be something wrong with it! **Voluntary savings** are by far the most important growth factor. In fact, with the right incentives, particularly positive real returns, and appropriate collection services, e.g., at door-steps, the growth potential may be unlimited. It is mainly voluntary savings which tie the growth of the

microbusinesses financed by the MFI to the growth of the MFIs themselves. Savings products may include voluntary withdrawable irregular savings , passbook savings, time deposits, long-term contractual savings with special provisions for microloans, short-term regular savings, rotating savings, lottery savings and numerous other forms. Appropriate savings collection services, which may be tied together with loan installment collection, may be of crucial importance, and savers may be willing to pay a fee for the privilege. Most MFIs are not permitted to keep current accounts. Few MFIs have **insurance programs**, but those which do, as the SFCLs in Nepal, found insurance premiums to be a major form of resource mobilization. Undistributed **profits** may be a major source of funds, particularly in small communally or member-owned local institutions with low transaction costs. With the consent of their members, they may impose a relatively high interest rate for the purpose of mobilizing funds (as do most informal nonrotating savings and credit groups).

Start-up equity contributions instead of loans to MFIs?

In exceptional cases small equity contributions (rather than loans) by donors to emerging local financial institutions may be feasible to augment internal resources and contribute to self-sustained growth. Small equity contributions are likely to be treated like their own money – and should therefore NOT be monitored separately! They also help cutting down on transaction costs – compared to programs of small loans to large numbers of villages which have to be repaid in even smaller installments. However, great care is to be taken by first testing such an intervention before applying it on a broad scale.

How to overcome legal constraints to deposit mobilization

To protect depositors, regulators throughout the developing world tend to prevent non-bank MFIs from mobilizing savings unless they are cooperatives and restrict lending to their members. Many MFIs are concerned about the financial health of their clients and the waste of their meager resources if these go uncollected, as well as about their own financial health which is contingent upon sufficient resources. The most direct solution would be to acquire banking or cooperative status. If this is found not feasible, MFIs may sell debt papers, which means they borrow money from local people: usually for a fixed term. There may be two alternatives: papers with a fixed interest rate, which is normally higher than the bank rate; or venture capital with profit sharing, which requires properly supervised accounting. The latter may be particularly attractive in Islamic countries.

Access to sources of refinance

Healthy MFIs which have exhausted their own internal resources and whose clients have additional demand for profitable investments may need access to sources of refinance. Promoted by the Asian and Pacific Rural and Agricultural Credit Association in cooperation with GTZ, ***Linking Banks and Self-Help Groups*** has become a proven and tested way of solving the refinancing problem for small informal and semiformal MFIs, the two largest national projects being in India and Indonesia (the latter serving as an exposure training site for APRACA). Before turning to donor resources, if ever, every effort should be made to facilitate access to the banking sector with its savings deposit, credit and transfer services. If the microfinance institutions have banking status, they may have access to the central bank as a *lender of last resort*. If they do not, the central bank may refinance commercial banks as wholesalers to MFIs. In all developing countries microfinance represents a minute portion of total financial intermediation. Whether there is any justification in going beyond the lender of last resort if the commercial banks and the central bank are unwilling to refinance microfinance institutions with their modest refinancing needs – this is a question beyond the scope of this book. It is an issue that might need to be taken up jointly with multinational, bilateral and national financial institutions.

4. How to build viable and sustainable institutions

Microfinance markets remain segmented

As financial markets in developing countries are highly fragmented and segmented, there can be no single best way of building viable institutions. National and global market integration are ends to be achieved in the long run; but for the time being segmentation remains a fact of life in microfinance. Many markets remain relatively secluded and isolated; and institutions may have to devise special products and instruments to effectively serve them. Local markets may be so special that only local, rather than national, financial institutions are effective.

Is viability feasible for MFIs?

The majority of MFIs presented in the literature are not viable. How to achieve viability and yet serve large numbers of poor people is considered one of the greatest challenges for MFIs. Some question even whether this a feasible objective. Our study has shown that this fear is unfounded. It is correct that MFIs created and supported by donors rarely cover their costs and make a profit. This is also true of most of the MFIs in our sample. However, there are a few MFIs in our sample which have demonstrated that MFIs can mobilize their own resources, price their products adequately, manage their risks and high near-perfect repayment, cover their costs, and make a profit.

Guidelines for viability

The participants of the Bank Poor '96 Workshop emphatically agreed that viability is feasible. Inspired by their own collective experience and based on the workshop reports, they formulated the following guidelines:

(1) Vision:	*Be a service-oriented commercial institution*
(2) Strategic planning for viability:	*Commit yourself to viability:* Set clear goals and objectives Set medium-term plans and monitor Develop an industry standard of performance
(3) Proper pricing:	*Cover your costs from the margin* by setting appropriate interest rates (at all levels of institutions involved) Cover the cost of funds, administrative costs, and loan losses, and allow for a profit margin Take inflation into account Offer attractive real returns on savings
(4) Savings mobilization:	*Mobilize your own resources:* Provide safety and attractive returns Promote voluntary withdrawable savings Provide doorstep collection services Offer suitable products (passbook savings, contract savings, fixed deposits, savings certificates)
(5) Credit products:	*Offer attractive credit products:* Provide for accessibility, simplicity, and timely delivery Accept suitable collateral and substitutes Offer proper loan periods Minimize grace periods if any

	Allow for small regular instalments Offer proper loan sizes Provide collection services, possibly in conjunction with savings collection
(6) Efficient operations:	*Reduce costs of operations:* Standardize and computerize Establish MFI as a separate entity Decentralize and localize operations Increase the number of customers Expand into new areas Assure accountability Work towards simplicity and transparency Provide incentives to branches and staff
(7) Risk management:	*Maximize recovery:* Insist on timely repayment Offer repeat loans of increasing size Install a Management Information System, monitor loans and take action Select borrowers carefully Use appropriate collateral and substitutes Provide incentives for timely repayment Build credit discipline, use peer pressure
(8) Well-trained human resources:	*Recruit and train good staff:* Provide skill and motivation training Provide orientation, promotional & refresher training Organize exposure training for management
(9) Client-support services:	*Cooperate with other agencies to provide add-on services!* Cooperate with GOs, NGOs, SHGs Establish service centers as subsidiaries.

Viability in a nutshell

What it takes to attain MFI viability comprises positive real interest rates on loans; positive real interest rates on savings deposits; high timely repayment rates; a high degree of self-financing from internal resources; appropriate microfinance products and services; and vigorous striving for a profit-margin.

5. How to provide a conducive policy and legal environment

From financial repression...

In most Asian countries, access to financial services has been a matter of growing concern to large numbers of people. Many governments have responded positively to this concern, moving boldly from financial repression to financial system reform. They have attempted to match the demand of the people for adequate financial services with the government's responsibility for financial stability and economic growth.

... to prudential deregulation

In this endeavor, they have begun to deregulate the interest rate regime, to adjust the legal environment including the banking law, to transform financial institutions into effective intermediaries between savers and investors, to provide opportunities to local people to establish and own their own financial institutions, and to encourage sound banking practices. Many bridges have been built in the process: over the gap between financial institutions and clients, the gap between formal and nonformal finance, the gap between government and people, the gap between savings and credit. By building these bridges and gradually increasing the outreach of their banking system, some developing countries have substantially alleviated poverty. It is now being recognized that only a harmonious balance between the interests of governments, financial institutions and the people including the poor will guarantee stability and lead to equitable growth. This harmonious balance is to be embedded into a policy and legal environment conducive to a full range of financial services for all segments of the population including the poor.

Prudential regulation and supervision

Under conditions of a repressive policy environment, unregulated MFIs may have a competitive advantage as they are free to set their own interest rates. However, once the policy environment is deregulated, much is to be gained from prudential regulation and supervision. Three reform measures are of crucial importance for the development of viable institutions with sustainable microfinancial services:

(1) *The deregulation of interest rates on deposits and loans:*
permitting each institution to adjust its interest rate structure to its effective costs, including the costs of serving marginal clients in remote areas, of collecting microsavings and microinstalments, and of doorstep services.

(2) *A revision of the banking law:*
facilitating the establishment of a wide branch network of banks and permitting local people to establish their own small financial institutions with moderate capital requirements. In addition, the legal system should provide for alienable private land use rights or land ownership titles as a basis of collateral and for the efficient processing of claims arising from bad debts.

(3) *The provision of effective bank supervision:*
providing guidance and supervision to institutions with microfinancial services in the interest of both the MFIs and their clients. In the case of a multitude of small local microfinance institutions, such supervision may be provided by a separate second-tier regulatory authority.

The case of Indonesia

Of the countries covered by this study, Indonesia may serve as a model country in the making of a favorable policy environment for microfinance. As Bp. Soedradjad, Governor of the central bank of Indonesia explained during the Bank Poor '96 workshop, the policy environment has enabled microfinance institutions (MFIs) in Indonesia (a) to gain legal status as rural banks (Bank Perkreditan Rakyat) with low equity capital requirements (US$25,000 in 1988); (b) to vigorously mobilize their own resources, offering attractive interest rates with positive real returns; (c) to charge interest rates on loans that cover their costs and finance their expansion; and (d) to have access to commercial and central bank refinance. Several of the Indonesian NGOs which participated in the workshop took advantage of this policy environment and established their own banks. The overall experience is presented in detail by Binhadi, the former Vice-Governor of Bank Indonesia, in *Financial Sector Deregulation, Banking Development and Monetary Policy: the Indonesian Experience (Institut Bankir Indonesia, Jakarta 1995).* It also includes the full text of the rural banking law of 1988, which has led to the establishment or transformation, respectively, of more than 2,000 MFIs into formal sector rural banks (among them Bank Shinta Daya, which is presented in detail in our chapter on Indonesia). How has the 1997/98 financial crisis affected microfinance and the microeconomy in Indonesia? In the midst of the turmoil, it is too early

for a conclusive answer. But an internet discussion on the Development Finance Network during the time of writing (January 1998) has so far testified to no adverse overall effect, and included some cautious hints to positive effects on small farmers and microentrepreneurs.

Towards self-regulation and self-supervision

Supervising large numbers of MFIs exceeds the capacity of most central banks or superintendencies in developing countries. Discussions are presently under way in Indonesia of establishing a second-tier regulatory authority as a self-regulatory and self-supervisory apex organization for MFIs under the rural banking (BPR) law. There are similar processes elsewhere. A first step in the Philippines was the establishment of a Rural Bankers‘ Association, which provided a forum of interest articulation for the establishment of more formal structures such as a second-tier regulatory authority. With technical assistance from USAID, the TSPI Development Corporation has recently taken steps towards this objective, developing standards for MFIs as a first step towards self-regulation.

Do MFIs benefit from banking status?

Or should they remain hidden within a nonformal financial sector? The answer is an unequivocal yes, they should stay informal, if the policy environment is repressive, enforcing interest rate regulation, submitting institutions to inappropriate supervisory agencies, or simply barring institutions from sound practices. In most countries, equity capital requirements are such that banking status is beyond the reach of local MFIs. Half of the MFIs included in this study testify to the inappropriateness of the policy and legal environment. They are registered as societies under the Societies Act (mostly in South Asia) or as non-stock non-profit corporations as in the Philippines, or as private or public trusts. A number of countries, among them Indonesia, Philippines, India and Nepal, have substantially brought down the capital requirements for small banks to ease the entry. Yet many small institutions lack the capital or the banking skills to qualify for formal status. Most of the other half are cooperatives, credit unions and cooperative banks. Given their credit union leaning toward wage and salary earners who want to save for the rainy day, many were found to be dominated by salaried employees and relatively better-off farmers willing to sacrifice access to credit to concerns for safety of deposits.

Non-bank MFIs of the poor

The obvious solution is for the poor to get together and take the initiative to set up their own organizations. It is then up to them to decide whether or not to include the nonpoor, to limit membership to women or men only, to have equal shares or unequal shares, and to have equal or unequal votes. Depending on the situation, they may or may not have them registered as cooperatives; and, if equity requirements are low as in Indonesia, to eventually strive for rural banking status. The latter may not be necessary in countries where savings and credit cooperatives already fall under the banking law (as in Vietnam and Germany). In other countries, such as the Philippines, India and also Indonesia, the government effectively discourages the establishment of more than one registered savings and credit cooperative in a given locality and uses them mainly as a credit channel. The latter fact has given cooperatives in many countries such a bad name that people will not join an entity called a cooperative. The solution found in Vietnam after the collapse of over 7,000 socialist cooperatives was to establish a new system under new names, comprising People’s Credit Funds, Regional Funds and a Central Fund. Again, policy and legal reform may have to come first before the effective transformation or upgrading of MFIs. In the meantime, small local groups, particularly those which are fully owned and managed by their members, may be better off remaining informal – an option chosen by large numbers of informal MFIs of indigenous origin in many developing countries, among them the ubiquitous rotating and nonrotating savings and credit associations.

6. Sound microfinance practices

Governance and sound practices

Important as ownership and governance of MFIs are, our study has shown that what is ultimately of crucial importance are sound microfinance practices. A national government bank, a cooperative with equal shares and votes, a community credit institution, a rural bank, a privately owned rural shareholding bank, an NGO microfinance program – they all may be viable or unviable depending on the soundness of their banking practices. The likelihood of sound banking varies by type of ownership and governance, and so does the likelihood of outreach to the poor, though not always in the same direction. But basically, any institution can be viable, and any viable institution can provide financial services to the poor. Similarly, sound practices can be applied in any policy environment, though with different ease: a deregulated policy framework facilitating sound practices, a repressive environment forcing a nonformal status on MFIs to be viable. In government-approved niches or in the nonformal sector, virtually *any* practice can be implemented regardless of the regulatory environment.

Best practices?

A note on the World Bank term *best practices* is in order. Sound microfinance practices are crucial to the sustainability of microfinancial services. In a newly emerging field like microfinance, there may be no *best practices*. The search for *best* practices would imply that there is an optimal way of doing things. Hence, all that needs to be done in this case is to find that best practice and replicate it. The continued fact of financial market fragmentation means there are no *best practices* that can be identified once and for all and then be replicated. There can only be *sound* practices that are appropriate under particular social, economic, cultural and political conditions, but always remain subject to proof. To weed out unsound practices, there must be competition among different types of institutions and strategies. The search for best practices can be dangerous. It is likely to lead to uncritical, if not dogmatic, replication.

Sound practices!

According to the experience of the MFIs in this study, sound microfinance practices may comprise the following:

- **Internal resource mobilization:**

Internal resource mobilization makes microfinance institutions independent of government and donor funding. It provides a solid basis for the sustainability of microfinancial services. Major resources include share capital, savings deposits and profits, and perhaps debt papers. For microfinancial institutions operating in the microeconomy, high interest rates on loans may also be an effective instrument of internal resource mobilization

- **Microsavings:**

Savings products and innovations to be promoted may comprise convenient deposit facilities for the accumulation and safeguarding of savings for microenterprise self-financing, consumption and emergencies; positive real returns to prevent erosion by inflation; savings products that differ in yield, maturity and incentive structure, such as voluntary savings withdrawable at any time or fixed deposits vs. regular compulsory savings that are non-withdrawable, lottery savings, raffles, etc.; and collection services organized by institutions or customers, such as doorstep daily savings collection, which differentially distribute transaction costs to institutions and clients. In subsistence agriculture and marginal informal sector activities, where virtually any type of credit, or indebtedness, might be inappropriate, savings promotion that strengthens the self-financing capacity of small farmers and microentrepreneurs may be the only responsible financial strategy.

- **Microcredit:**

Microcredit products are more appropriately differentiated in terms of maturities, installments, services and collateral requirements (ranging from joint liability and personal guarantees to tangible collateral and pawning) than in terms of loan use, which is costly to appraise and, for fungibility reasons, difficult to control. Viable and sustainable microcredit schemes require: prudent adjustment to household savings, investment and repayment capacities; small loan sizes, with ceilings growing over a cycle of repeat loans up to a level determined by the absorptive capacity of the microenterprise and household economy; dynamically growing savings-to-credit ratios; market rates of interest autonomously determined by financial institutions and differentiated according to costs and services provided; loan maturities and repayment modalities according to customer needs and differentiated, in case of wholesaling, according for each level of intermediation; short maturities, no grace periods and short installment periods in case of initial loans; insistence on, and incentives for, timely repayment; and the development and provision of cost-effective monitoring systems.

- **Microinsurance:**

Microinsurance is the most underdeveloped part of microfinance. Yet various schemes exist that are viable, benefiting both the institutions and their clients. Such schemes have generally served two major purposes: (1) They have contributed to loan security; and (2) they have served as instruments of resource mobilization. On a modest scale, various forms of life and health insurance have been successfully practiced in different countries. There are also successful examples of accident insurance and cattle insurance. There are virtually no cases of viable crop insurance schemes.

- **Product reciprocity:**

Product reciprocity ties credit to savings and insurance. It avoids moral hazard and improves financial discipline. For otherwise unbankable customers, it establishes a track record. To banks, it offers a cost-effective solution to the information problem.

- **Collection reciprocity:**

Through collection reciprocity, an institution may combine the collection of savings with the collection of installments, which can be crucial to arrears prevention in the informal sector where incomes are daily or irregular, but not monthly, and are likely to escape collection without appropriate timing and collection techniques. Recovery rates can be further improved by tied lending, which interlinks credit with commodity transactions, which are widespread in the nonformal sector but may also be successfully applied by formal financial institutions, perhaps through a subsidiary.

- **Microfinance procedures and services:**

They should be customer-oriented, i.e. simple, fast and on time; be market-oriented and in competition with those by other formal or nonformal institutions; and cover their cost. Appropriate procedures and services should be applied to attain sound financial management, convenient and safe savings collection and deposit facilities, appropriate loan appraisal and processing procedures, adequate risk management (including collateral substitutes, nonformal collateral, loan protection schemes and prudent loan disbursement), timely repayment collection, proper monitoring and loan supervision, and effective information gathering, all of which may include cooperation between different formal and nonformal intermediaries in fields where each is most effective.

- **Terms and conditions:**

They should be set by financial institutions rather than government agencies or donors. Financial contracts must be sound from both an institution's and its customers' viewpoints. To arrive at balanced loan contracts, an exchange of experience and mutual learning may be required between the various types of nonformal and formal institutions including:

(1) *informal financial institutions* with their wide range of contractual terms concerning interest rates, loan sizes, maturities, grace periods, loan purposes, reciprocities, collateral requirements, services, transaction cost sharing arrangements and unbounded innovations;

(2) *semiformal financial institutions* including projects and programs, which tend to be influenced by governmental or non-governmental donors and may combine comprehensive services with a lack of commercial orientation;
(3) *formal institutions* on tightly regulated markets, with a narrow and usually inflexible range of contractual terms; and (4) formal institutions on deregulated markets with their much wider range of terms, transaction cost sharing arrangements and innovations.

- **Microsavers and microborrowers as customers:**

Ultimately savers and borrowers must be regarded as a market for financial institutions: with the institutions as intermediaries, and savers and borrowers as customers or clients rather than beneficiaries. Contractual terms and conditions on that market are the result of negotiation and competition rather than administrative convenience and donor imposition.

7. Is there a special technology for combining outreach to the poor and institutional viability?

Our study has shown that:

- MFIs can be viable and at the same time reach out to the poor, particularly when including both the poor and the nonpoor among their clientele;
- savings mobilization is crucial for institutional sustainability, which may be undermined by generous donor support;
- sound banking practices are crucial, and that any type of MFI, be it cooperatively, privately, community- or government-owned, or be it formal or nonformal, can be viable provided it applies sound practices;
- both individual and group technologies are feasible;
- MFIs are most effective in providing sustainable financial services to the poor and nonpoor within a conducive policy and legal environment, though they may also do so in a repressive policy environment provided they stay nonformal and adhere to sound practices.

Some overall conclusion are that

- banking with the poor can be profitable, though the majority of MFIs have not adequately learned the art of microfinance;
- NGOs can establish viable and sustainable MFIs, while subsidy-dependent credit NGOs can be transformed into formal financial institutions that rely on their own internal resources and cover their costs from the margin;
- the poor are able to establish their own financial institutions and make their own decisions on access criteria, contractual terms and conditions, and loan purposes.

All this adds up to a microfinance technology package geared to profitable banking with the poor. Yet one technology may be singled out as a

- *special technology combining outreach to the poor and institutional viability*,

namely the group technology, which in this case is akin to the *strategy of linking banks and self-help groups*. The experience of institutions combining individual and group technologies indicates that the latter can cover their costs[3] and greatly increase outreach to the poor as a new market segment. However, they initially add little to a bank's overall profitability. Perhaps the historical experience of cooperative and savings banks in Germany has a story to tell in this context: they started as informal microfinance institutions around the middle of the 19th century and account now for two-thirds of all

[3] Gilberto Llanto, Bernd Balkenhol & Noor Zulkifli , in Breaking Barriers to Formal Credit: Asian Experiences on Collateral Substitutes (ILO, Geneva, & APRACA, Bangkok, 1996, p. 24) report "collection rates" of rural banks (BPR) in Indonesia of 100%, 100% and 97.5 % for 1992, 1993 and 1994, respectively, of Bank Shinta Daya (a private bank); 100%, 97.7% and 100%, respectively, of Bank Bina Swadaya Yogyakarta (a bank owned by an NGO); and 100% for 1993 and 90% for 1994 of Bank Jatiara (another NGO-owned bank).

financial intermediation in Germany. It thus takes foresight on the part of an institution's owners and management and the belief in a self-fulfilling prophecy: that the long-term growth of a microfinance institution and the microbusinesses it finances will be mutually reinforcing