IV Developing Rural Financial Markets in Asia: What Has Been Learned?

Asian countries have employed a variety of policies in their efforts to expand formal finance in rural areas. The purpose of this chapter is to summarize how financial markets in rural Asia have evolved, and the lessons derived from both the good and the bad experiences in the region. The concepts discussed in the previous chapter are used to organize the analysis in this chapter. The next section begins with a summary of the views found in the first and second ADB studies of rural Asia. It then describes two Asian phenomena: the "East Asian Miracle" and the recent financial and economic crisis. This is followed by a discussion of the status of rural financial markets in the region today. The second section describes what has been learned from three of the more successful financial institutions in the region: the Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand, the unit desa system of Bank Rakyat Indonesia (BRI), and the Grameen Bank (GB) in Bangladesh. They are discussed in more detail in the three case studies found in later chapters. The combination of successes and failures provides insights into the appropriate strategy to follow in the region as discussed in Chapter V.

MAJOR DEVELOPMENTS IN THE REGION: LEARNING FROM FAILURES

The studies of rural Asia conducted by the ADB in the 1960s and 1970s found heavy emphasis by most governments

on creating institutions and programs to channel subsidized credit to farmers. Lessons learned about the problems of directed credit made little impact on the policies pursued by most Asian governments during the 1980s and 1990s. However, the failures in the region, along with some of its successes in microfinance, contributed to the emergence of the new paradigm, even though today many of the countries in Asia still pursue the old paradigm.

The Directed Agricultural Credit Paradigm in Rural Asia

The Perspective of the 1960s and 1970s

ADB made a survey of Asian agriculture in 1967/68 (ADB, 1969), which noted that following World War II many Asian countries had developed specialized agricultural lending institutions. Many were designed to support agricultural cooperatives that had a long history in several countries. For example, BAAC was formed in Thailand in 1966, and the Agricultural Development Bank in Viet Nam started the same year. In the early 1960s, the Agricultural Development Bank of Pakistan was created, the Republic of Korea merged its Agricultural Bank and cooperatives into the National Agricultural Cooperative Federation, and the People's Bank of Ceylon was created. In the Philippines, the Agricultural Credit Administration, the Development Bank of the Philippines, and the rural banks were developed during the 1960s. Most if not all of the share capital of these specialized institutions was provided by government grants or loans (Ong, 1969).

Direct lending to farmers by governments was also common in the 1960s. For example, the Provincial Food Bureau and the Provincial Supply Bureau in the PRC made short-term loans to farmers. Direct loans were made to farmers in Sri Lanka by the departments of Agrarian Services, Fisheries, and Land. In Thailand, various departments in the ministries of

Agriculture and Interior made loans to farmers and fishers (Ong, 1969).

A second rural Asian study by ADB in 1976/77 (ADB, 1978) reviewed the major developments that had occurred during the ten-year period following the first survey. It noted that many innovations and encouraging developments had occurred in financing agriculture. These included:

- A major expansion in the number of banking outlets in rural areas. Commercial banks in India had opened 5,000 new branches (largely as a result of nationalization of the banks). The Bank of Ceylon had set up 400 rural branches. In the Philippines, the Philippine National Bank had set up 100 branches, and over 500 rural banks had been established.
- Sharp increases in loan disbursements. Commercial banks increased agricultural lending in India by a factor of 32 from 1968 to 1974. Rural banks in the Philippines increased lending ten-fold during 1965 to 1975. In Sri Lanka, the People's Bank increased lending by a factor of almost 2.5 from 1969/70 to 1973/74.
- An expansion in the number of institutions making loans without collateral. Many were lending 100 percent of the cost of cultivation, and some were making long-term loans.
- Special programs had been introduced to increase food production by providing subsidized credit and inputs to farmers. The Bimas project began in Indonesia in 1967, and Masagana 99 started in the Philippines following the disastrous 1972 harvests.
- Governments encouraged or mandated existing financial institutions to increase agricultural lending by imposing credit quotas. They required rural bank branches to be opened in exchange for the authorization to open urban branches, and by creating credit guarantees.

In spite of these achievements, several problems were noted in the second survey:

- Loan recovery, which had plagued many earlier cooperative credit schemes, continued to be a serious problem (and later led to the collapse of both Bimas and Masagana 99).
- Interest rates charged to farmers were usually low, did not reflect the scarcity of credit, and often encouraged large farmers to preempt the scarce supplies.
- Medium- and long-term credit was limited, and the volume of agricultural credit actually fell in many countries relative to funds allocated to manufacturing.

Both the 1967/68 and 1976/77 studies were ambivalent in their conclusions about agricultural credit. The first study noted the difficulty of ascertaining the degree to which the demand for fertilizer and new seed associated with the new crop technologies was constrained by lack of credit (ADB, 1969, p. 41). The second study concluded, on the one hand, that governments in the region obviously did not utilize the powerful array of controls over State and private financial institutions "to encourage an adequate and proportionate flow of investment credits to the agricultural sector" (ADB, 1978, p. 94). On the other hand, the study noted that the new technology increased the demand for operating and investment credit, but warned that the small farmer credit programs in fashion were "generally unworkable in terms of actually serving the target group" (ibid., p. 258). Moreover, it argued that neither interest nor input subsidies, nor systems to control input use were likely to stimulate the use of credit or channel it in the right direction. It noted that the rapid expansion of credit institutions had exceeded either local demand or the capacity of institutions to supply and supervise credit (ibid., p. 261). This implied that the institutional issues associated with agricultural credit had not been resolved in spite of the many efforts undertaken since World War II to build rural institutions and to institutionalize the supply of agricultural credit.

Major Policies and Programs of the 1970s and 1980s

Notwithstanding the ambivalence implicit in these ADB studies, the decades of the 1970s and 1980s witnessed considerable efforts by policymakers to expand agricultural lending in most Asian countries. The approach used often during much of this period can be characterized as following a directed credit paradigm with the following characteristics:

- Interest rates for farm loans were subsidized and loans for small farmers were set at especially low rates.
- The source of funds for most programs was the government and donors. Local savings mobilization was largely ignored.
- The objective of government policy was to increase the supply of loans made to farmers with little attention given to institutional sustainability.
- Production packages were created for farmers in which credit was treated as an input like seeds and fertilizer.
- Credit was targeted for "productive purposes." Loans for consumption and rural nonfarm enterprises were ignored and, in some cases, prohibited.
- Many credit programs were aimed at small farmers and employed supervised credit through cooperatives as a means to ensure it was used properly.[1]
- Cooperatives were the primary credit channels in many countries, while commercial banks and agricultural development banks were more important in others.
- Transaction costs for lenders and borrowers were largely ignored.
- Some programs eventually broadened their target groups from small farmers to the rural poor.

[1] This approach emerged in response to the default and other problems encountered in early credit projects. Credit provided through cooperatives with strong extension support appeared to be promising in Brazil, Mexico, and India (FAO, 1964).

The Special Case of Directed Credit in East Asia

Studies during the 1970s and 1980s began to question the directed credit model as an appropriate strategy to speed growth and development. However, East Asia is often advanced as a special case in which directed credit and government intervention in financial markets made a more positive impact on economic growth than elsewhere. It is important to understand how the region's financial markets may have contributed both to its successes and to the financial and economic crisis in Asia that began in 1997. An analysis of the high-performing Asian economies led to the conclusion that good capital market fundamentals explained the contribution that capital markets made to efficient resource allocation in these countries. The rapid deepening of financial markets contributed to economic growth, but the record on directed credit was mixed. All East Asian economies provided generous credit to exporters with varying degrees of subsidy. The best success occurred in those countries with strong civil societies and professional public financial institutions such as in Japan, the Republic of Korea, Singapore, and Taipei,China (World Bank, 1993).

Five unique features have been proposed to explain the success of governmental interventions in East Asia's industrial growth (Stiglitz and Uy, 1996). First, national savings were promoted by creating postal savings and provident funds, restricting consumer credit, protecting banks against failures, employing mild financial restraints, and keeping public deficits low. Second, prudential regulations were employed to enhance the solvency of financial institutions. Third, financial institutions, including development finance institutions, were created and effectively utilized to augment resource flows to priority sectors. The successful institutions insisted on commercial standards and avoided political pressures to finance bad projects and poor incentives to screen and monitor projects. Fourth, the financial restraints slightly lowered interest rates and encouraged firms to invest. These also increased the franchise value of banks, which provided strong incentives for prudent banking. Finally, the results were more favorable than in many other developing

countries because a large part of the directed credit went to private rather than public enterprises, credit allocation was usually based on objective performance criteria, credit was more common than outright subsides, total directed credit was relatively small compared with commercial credit, monitoring was more effective, and credit policy changes were made quickly when existing policies did not function properly.

The study left unanswered, however, the question of whether or not East Asia's successful experience could be replicated. The current crisis reveals that past financial policies may have contributed to rapid growth in Southeast Asia, but they also contributed to the currency and financial crisis that evolved into an economic and social crisis with potential repercussions reaching far beyond Asia.

Understanding the Financial and Economic Crisis in Asia

The rapidly growing literature on the Asian financial and economic crisis reports on competing assessments of its causes, reforms to be undertaken, and the need and methods for restarting the growth process. It is necessary to learn from these financial problems and proposed solutions in order to speculate about the implications for developing Asian rural financial markets.

The crisis was unexpected, as witnessed by the optimistic views about the region reported in a survey of Asia by the Asian Development Bank published in 1997 (ADB, 1997a) that was followed just a few months later by Thailand's currency devaluation. Analysts tend to agree that the seeds of the crisis were sown in the early 1990s with massive capital inflows that fueled a large increase in domestic bank lending, which drove investment in the region (e.g. Corsetti, Pesenti, and Roubini, 1998; Park and Song, 1998). Much of the investment was directed towards projects in the nontradable sector, especially speculative investments in stocks and other financial assets. In Thailand, specifically, this created a bubble in the real estate market

financed partly by nonbank financial institutions. The region's spectacular export performance began to slow in 1996, and a growing number of firms suffered losses and were unable to meet their debt obligations. Several went bankrupt. The real estate bubble broke in Thailand in early 1997 and defaults in the financial and corporate sectors began to rise, sparking concerns among foreign and domestic creditors. The cost of offshore borrowing rose and countries began to finance a growing share of their current account deficits with short-term foreign currency loans. Thailand depleted its reserves trying to defend its fixed exchange rate and was forced to devalue. This contributed to financial panic among investors and led to contagious speculative attacks on other currencies. The massive inflow of capital into the region quickly turned into a massive outflow leading to a collapse in regional currencies.

The herd effect of foreign investors, contributing both to the boom and the bust, has been identified as one of the major causes of the crisis. However, analysts also argue that in retrospect, policy shortcomings in the region were partly to blame. A long list of structural distortions in the Asian financial and banking sectors was summarized as follows: "lax supervision and weak regulation; low capital adequacy ratios; lack of incentive-compatible deposit insurance schemes; insufficient expertise in regulatory institutions; distorted incentives for project selection and monitoring; outright corrupt lending practices; non-market criteria of credit allocation according to a model of relationship banking that emphasizes semi-monopolistic relations between banks and firms somehow downplaying price signals. All these factors contributed to the build-up of severe weaknesses in the undercapitalized financial system, whose most visible manifestation was eventually a growing share of non-performing loans" (Corsetti, Pesenti, and Roubini, 1998, p. 3).[2]

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[2] The implications of this summary are somewhat at odds with the authors of Emerging Asia (ADB, 1997a, p. 120) who concluded that investment is subject to the market test in East Asia. Sachs (1997) also offered an early analysis of the potential threat of excessive lending driven by moral hazard incentives in Latin America, Central Europe, and Southeast Asia.

The IMF-supported response to the crisis employed a tightening of monetary policy and higher interest rates in an effort to restore investor confidence. Critics have argued that these policies contributed to a vicious circle: otherwise solvent companies could not pay the higher interest rates leading to higher levels of nonperforming loans and credit risk, exacerbating the recession, and causing a further contraction in the supply of credit (Corsetti, Pesenti, and Roubini, 1998; Stiglitz, 1998).

Many financial reforms have been recommended to correct these structural problems. They have been summarized as a) reducing the incentives for excessive borrowing, b) improving governance of the financial sector, and c) enhancing prudential regulation, especially for short-term capital flows (World Bank, 1998a). By mid-1998, the most seriously affected countries, Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand, were planning or were already implementing financial reforms, including strengthening the supervisory and legal framework for banking operations; tightening capital adequacy requirements; strengthening accounting/auditing requirements; tightening bank disclosure, loan classification and provisioning requirements; tightening guidelines on loan exposure; and introducing a funded deposit insurance scheme (Kochkar, Loungani, and Stone, 1998). These changes have a great deal to do with information: improved information for financial institutions about the performance of clients, and improved information for regulators about the portfolios of financial institutions. Tighter regulations and better and more transparent information are expected to lead to more prudent behavior by financial institutions.

What are the implications of the crisis for the development of rural financial markets? First, as noted in the case studies, there is concern about the potential problems with rural loan recovery in Thailand and Indonesia because of a sharp rise in unemployment and fall in incomes. There is also concern about the supply of deposits and funds for rural lenders to make new loans, but the possible longer-term impact is more important.

The crisis has raised important issues about the fragility of financial systems associated with the globalization of capital markets and the appropriate ways to use financial markets for enhancing growth. One argument stresses that domestic financial reform should precede the opening of the capital account (Garnaut, 1998; Eichengreen and Mussa, 1998). This view implies accelerating the pace of banking reforms in countries like the PRC and India as they open their economies to more foreign investment. Demand will increase for more transparency in corporate and banking operations and greater attention to the governance of institutions in all countries. Although the rural financial system is largely outside the immediate concern of policymakers, efforts to strengthen financial systems will likely have spillover effects into rural banking.

There may be a desire in some countries to treat agricultural banking more like commercial banking. This would lead to a tightening of credit standards, more attention to credit risk, greater capital requirements, more rigorous credit appraisal, more realistic loan provisioning, better trained employees, and more professional management. These changes along with the cost of greater reporting requirements will drive up banking costs in the short run but will strengthen viability in the long run. The immediate reaction could be higher collateral requirements but, as the financial system becomes more professional, there should be greater potential to shift to cash-flow lending. There may be difficulties in designing an acceptable special regulatory framework for institutions licensed as specialized banks for the poor. Overall, these changes are consistent with the shifts in thinking that have occurred about the appropriate way to develop rural financial markets, as discussed in the next section.

Rural Finance in Asia in 1999

The analysis presented in the case studies reveals an obvious conclusion: adoption of the new paradigm is very uneven in Asia. Several countries in the region have adopted

more of a market approach to rural finance than was the case in the 1960s and 1970s. Sadly, many countries have not done so, and they are paying the price in the form of poorly performing institutions that require large subsidies. Moreover, outreach is not increasing very rapidly; a large proportion of the rural population is still denied access to formal financial services. The new paradigm has been adopted more readily by some microfinance organizations (MFOs) than by traditional agricultural lenders.

The policies and institutions of Southeast Asian countries have generally evolved into more of a market-oriented approach than have other countries, and the results have been strikingly better. For example, Thailand has followed an approach to rural finance that emphasizes commercial banks and the government-owned BAAC. The private commercial banks were initially given quotas for agricultural lending that could be met by direct lending or by depositing funds in BAAC. The banks generally serve larger farmers and agribusinesses. BAAC has expanded, makes loans to both groups and individual farmers, serves most of the small and medium sized farms, and now reaches some 80 percent of the country's farmers. BAAC has slowly increased the share of savings in its total resources. Its interest rates are still somewhat subsidized and this negatively affects its sustainability. In aggregate, the agricultural credit to agricultural GDP ratio grew from about 0.06 in 1970 to nearly 0.70 by 1996. Most farmers now have access to the formal financial system, there is relatively little need for special credit programs for the poor, and the entire system is largely self-financed.

An important part of the Indonesian agricultural credit system involved the integrated Bimas project implemented through BRI from the late 1960s until it collapsed in the early 1980s. The major reforms undertaken by the BRI unit desa system in 1983/84 transformed it into one of the most dynamic rural financial institutions in the region. It serves millions of clients with nontargeted loans and mobilizes savings so successfully that surplus rural savings flow to urban areas to finance corporate lending. Both farm and nonfarm enterprises are served. Other rural financial institutions in Indonesia have

been less successful, however, and appear not to have learned from the BRI example. The performance of many smaller provincial and local financial institutions is not as good as that of BRI. Many highly subsidized poverty-oriented projects have recently been created. They represent an unwise departure from the Government's drive to create sustainable rural finance, and may undermine some nonsubsidized financial institutions that follow a market-oriented approach.

The South Asian countries generally have been less successful than Southeast Asian countries in developing viable rural financial systems in spite of the huge amount of resources spent on the task. Bangladesh, Pakistan, and Nepal have emphasized targeted lending by specialized agricultural development banks (SADBs) to individual farmers and cooperatives. Funds have largely come from the government and donors. Loan recovery rates are low, and in all three countries, financial institutions are highly subsidized. The top-down approach used in rural cooperative development also has serious problems in these countries.

India nationalized its banks and implemented a massive expansion of public and private bank branches and cooperatives in rural areas, and created specialized regional rural banks to reach the rural poor, small farmers, landless workers, and small entrepreneurs. The government still owns 80 percent of the banking industry, and the cooperatives are significantly controlled by the states. The National Bank for Agriculture and Rural Development (NABARD) is the apex institution responsible for agricultural credit policy and refinancing rural lending. The Integrated Rural Development Program (IRDP) was created in 1978 for poverty alleviation. It provides subsidized loans and cash subsidies to the poor. Loan recovery is a serious problem for banks and cooperatives, and the loan *melas* of the 1980s (see Chapter VIII) and the loan waiver of 1991 represent political abuses of the banking sector that damaged credit discipline. Interest rates on loans were largely deregulated in 1996, but many financial institutions have not used this flexibility to improve their sustainability. The rural financial system has expanded outreach; however, it provides

poor quality service and is highly subsidized. The country is trying to move towards more of a market-oriented system, but progress is slow because the strong tradition of mandated credit is proving difficult to change.

The formal financial system in Bangladesh is under severe stress. The nationalized commercial banks, agricultural development banks, and even many of the new private commercial banks face huge loan recovery problems, as do the agricultural cooperatives. The central bank sets quotas for agricultural lending and rediscounts rural loans. Surprisingly, a robust microfinance movement has emerged, which includes the specialized Grameen Bank and hundreds of NGOs that lend to the poor. These microlenders have achieved significant breadth and depth of outreach, although most are highly dependent on subsidies. Fortunately, most have avoided the bad-debt syndrome that plagues the banks. The combination of bank, cooperative, and microfinance lending amounted to about 9 percent of agricultural GDP in 1993/94, which was higher than a decade earlier. The future of rural finance is unclear. The MFOs have been freer than banks to adopt a market-oriented approach, but both the agricultural lenders and microlenders fail to cover fully their costs and risks of lending.

The transition economies, represented by the PRC and the Kyrgyz Republic in this study, face the major challenge of building a market-oriented financial system. The PRC has gone through three phases of financial reforms since 1979. The rural sector is now served by a state bank, a policy bank, rural credit cooperatives (RCCs) and rural credit foundations (RCFs). The financial system has been successful in mobilizing a large amount of savings from rural households. The RCCs are most important in mobilizing these savings and they channel a significant share of these resources into loans to township and village enterprises (TVEs). The unregulated RCFs emerged in the 1990s in response to the demand for financial services by households and collectives. They are more important in lending to households than to TVEs and collectives. Lending quotas and interest rate ceilings have been relaxed for commercial banks but, because of high costs and loan defaults, there are serious

doubts about the sustainability of most rural financial institutions. Loan recovery is a serious problem for most institutions and jeopardizes sustainability. Information is incomplete about rural access to the formal financial system and the viability of the system.

The financial system in the Kyrgyz Republic is highly unstable and the banks, including the two that service rural areas, have serious problems with nonperforming loans. Interest rates have usually been negative in real terms and subsidized farm loans are provided through local government budgets. There is little information about the newly created Kyrgyz Agricultural Finance Corporation or the savings and settlement companies that are designed to mobilize savings and provide payment services. Likewise, several donor-assisted microfinance schemes have recently been started in rural areas, but there is little information about their performance. The entire system is weak and most institutions have little capacity to make good loans and recover them. The weaknesses of the financial system constrain the emergence of a vibrant agricultural sector.

To summarize, this survey of rural Asia has revealed a surprisingly large number of countries that have made relatively little progress in adopting the new paradigm in their rural financial policies. Although there are important exceptions, the primary problems today are similar to those two decades ago:

- Interest rates are often too low to cover the costs and risks of lending. Some MFOs have adjusted their rates high enough to cover most costs, but regulations and political pressures have kept rates low for many agricultural lenders.
- Countries have resisted adopting more of a market approach to rural finance. Targeted programs, subsidized refinance funds, and restrictions on clientele served still exist, although they are somewhat less repressive than in past years. The sustainability of financial institutions continues to be a secondary objective.

- Many rural financial institutions are weak and exist only because of subsidies. Nonperforming loans are a serious problem and sap their vitality.
- Savings mobilization is still relatively neglected in spite of the earlier successes of rural cooperatives in Japan, Republic of Korea, and Taipei,China.
- Policymakers continue to be largely preoccupied with the problems of agriculture and overlook the broader demand for financial services by the rural nonfarm economy.
- Most rural finance institutions are ill-equipped to make long-term loans and to utilize new information and communication technologies characteristic of modern banking.

LEARNING FROM SUCCESS: THREE FLAGSHIP INSTITUTIONS

The authors of the ADB studies in 1967/68 and 1976/77 faced a serious problem. They could document the many failings of agricultural credit projects and identify a few promising trends (e.g., number of banking outlets, increases in disbursements), but they had few successes to enable them to evaluate what is possible with a different approach. Fortunately, today there are several successful Asian institutions that illustrate the possibilities, as discussed in the following sections.

What are the Characteristics and Performance Indicators of Successful Rural Financial Institutions?

Three Asian institutions have been studied extensively because their performance has been far superior to that of most rural financial institutions in the developing world. These flagship institutions are BAAC in Thailand, the BRI unit desa system in Indonesia (BRI-UD), and the Grameen Bank (GB) in Bangladesh.

Comparative information about them is presented in Table IV.1 and more details are provided in the country case studies.

Table IV.1: Selected Characteristics and Performance Measures of BAAC, BRI-UD, and the Grameen Bank

Item	BAAC	BRI-UD	GB
Year established/reorganized	1966	1983/84	1983
Clientele	Farmers, cooperatives, farmers' associations	Rural low-and middle-income households	Rural poor
Financial services	Loans and savings deposits	Loans and savings deposits	Loans and compulsory savings
Lending technology	Group and individual	Individual	Group
Approximate number of loans outstanding	3.1 million	2.3 million	2.1 million
Volume of loans outstanding	$3.8 billion (non-cooperative loans)[a]	$1.2 billion	$289 million
Average outstanding loan	$1,285	$567	$142
Average outstanding loan as percent of GDP per capita	42[b]	54	64
Average annual volume of savings	$2.8 billion	$2.6 billion	$133 million
Average annual savings as percent of average annual outstanding loans	66.5	199.0	45.6
Number of savers	4.4 million[c]	14.5 million	2.1 million
Approximate nominal effective annual interest rate	8.3 to 15.5	32.7	20
Interest rate spread	1995: 4.1	1994: 21.7	1995: 8.0
Total operating costs as percent of annual average outstanding loans	1995: 3.5	1994: 13.5	1995: 10.6
Return on assets	1995: 0.55	1994: 4.8	1995: 0.14
Percentage of outstanding loans in arrears	8.3	6.5	3.6
Subsidy dependence index	1995: 35.4[b]	1995: negative[d]	1996: positive[e]

Source: Adapted from Yaron, Benjamin, and Piprek (1997) except where noted.

[a] BAAC reported total loans outstanding in 1996 of baht 177 billion (about $6.9 billion).

[b] Reported by Muraki, Webster, and Yaron (1998b). According to their estimates, in 1995 BAAC would have had to increase its average yield on loan portfolio from 11.0 to 14.89 percent (i.e., 35.4 percent) to be free of subsidies.

[c] Reported by Fitchett (1997).

[d] Charitoneko, Patten, and Yaron (1998) reported that the BRI unit desas were so profitable in 1996 that they could have reduced their yield on loan portfolio from 31.6 to 16.3 percent and still have remained subsidy independent.

[e] Reported by Morduch (1998b). According to his calculations, the GB would have to increase its nominal interest rate on general loans from 20 to 33 percent to become free of subsidies.

The data in Table IV.1 present a comparative analysis of institutional performance using the two criteria increasingly accepted as the appropriate framework for analysis: outreach and self-sustainability (Christen et al., 1995; Yaron, Benjamin and Piprek, 1997). This framework does not attempt to assess impact on clients (as was advocated in the old paradigm), but rather focuses on the performance of the financial institution. The implicit assumption is that clients will continue to use the organization if it provides them with useful services that make a positive impact on their lives.[3]

Outreach refers to the increased degree of market coverage for low-income groups previously without access to formal financial services. It includes both a horizontal dimension (breadth of outreach or number of clients served) and a vertical dimension (depth or level of poverty of clients). In addition, the types and variety of financial services offered are also considered. Sustainability refers to the ability of a financial institution to supply financial services on a continuous cost-covering basis without external subsidies. A sustainable institution must cover its costs including operating expenses, loan and inflationary losses, and the cost of funds without external subsidies. It must make a profit to compensate owners, to accumulate reserves against future losses, and to fund new investments. Subsidy dependence is the inverse of sustainability, and the calculation of a subsidy dependence index (SDI) has been effectively used to evaluate the degree of subsidization received by a financial organization (Yaron, 1992).

Sustainability is a desirable objective for financial institutions for at least two reasons: first, the temporary access to loans for a targeted clientele may produce some benefits, but creating a long-term sustainable financial relationship is more valuable because it provides clients with the opportunity for future benefits. Moreover, a sustainable institution benefits more

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[3] The case studies discuss other indicators of the performance of the financial system, such as trends in the volume and interest rates charged for informal loans. Studies of other impact measures are also cited.

clients than one that begins with a flourish but collapses in a few years. Second, a sustainable institution is generally free of the whims and budgetary constraints of the government and donors. This helps borrowers develop positive expectations for long-term access to services if they observe the terms of their loan contracts. It also helps the institutions grow beyond the limits permitted by the subsidies provided, and helps shield them from political intrusions. Many MFOs are striving to achieve operational sustainability by covering their operational costs exclusively through interest income. In addition, several others are attempting to cover loan and inflationary losses without external subsidies.

Concerns have been raised regarding possible trade-offs between outreach and sustainability (e.g. Hulme and Mosley, 1996). Institutions that strive for self-sustainability may try to reduce costs through making larger repeat loans to existing clients rather than making additional small loans to new poor clients. Conversely, realizing economies of scale through achieving a wider outreach may contribute to sustainability since costs per unit lent decline as loan volume rises. Therefore, achieving greater breadth of outreach may improve sustainability, while reaching greater depth of outreach may detract from sustainability if the costs and risks of lending cannot be covered by interest income.

The three financial institutions have slightly different objectives (Table IV.1). BAAC was created in 1966 with a specific mandate to serve agriculture and only recently began to serve nonfarm enterprises. BRI-UD was reorganized in 1983/84 following the collapse of Bimas and it took on the objective of serving rural low- and middle-income households. Its loan portfolio has been dominated by loans for trading and other nonfarm activities. Grameen started as an NGO program in 1976 and became a specialized bank for the poor in 1983. Almost 90 percent of its current clients are women, and many of them borrow for farm-related and nonfarm activities. Therefore, BAAC is largely an agricultural lender, GB is a specialized MFO, while BRI-UD fits between the two orientations. BAAC and BRI-UD are more active than GB in savings mobilization.

GB largely makes group loans, BRI-UD makes only individual loans, and BAAC uses both types of technology.

All three institutions have millions of clients with loans, but BAAC has been relatively the most successful as it reaches over 80 percent of the country's farm families. It has a larger loan portfolio because of its larger average loan size. The frequent method for evaluating depth of outreach (i.e. poverty level of clients) is to compare average loan size with the country's GDP per capita. In that comparison, BAAC also performs well in reaching the poor.

Two performance criteria sharply differentiate the three institutions. The first is savings mobilization. The total amounts of savings for BAAC and BRI-UD are roughly equal, but the number of savers is much larger in BRI-UD. Moreover, the total savings in BRI-UD far exceed its loan balances, while BAAC and GB rely on other sources of funds for a significant share of their total lending. Unlike the other two, Grameen does not actively promote voluntary savings.

Sustainability is the second major difference among the three. BAAC employs a policy of low interest rates, and as a result its interest rate spread is the smallest. Although it is highly efficient, as shown by its 3.5 percent operating costs, its profits and return on assets are low. It has some problems with loan arrears, especially for loans made to cooperatives and farmers' associations. Considering the various types of subsidies received, it would have to raise the average yield on loans from 11 to almost 15 percent to become free of subsidies. The GB has an even more serious problem because, to be free of subsidy, it would have to raise its nominal interest rate on general loans from 20 to 33 percent.

BRI-UD is unique. It charges the highest interest rates and earns the highest rate spread of the three, so it can easily cover its higher operating costs. In fact, it was so profitable in 1995 that it could have reduced its yield on loan portfolio from 31.6 to 16.3 percent and still remained free of subsidy. Given these estimates, BAAC would need to charge roughly a 15 percent nominal rate for its loans, BRI-UD almost 16 percent, and GB about 33 percent. However, these values vary from year

to year depending on the amount of subsidies received, and it would be necessary to evaluate carefully loan loss provisions, profits needed for future investment and growth, and several other factors before determining optimum interest rates. Simply by considering the differences in loan sizes, it should be expected that BAAC would reach self-sufficiency with lower interest rates, while the GB would need to charge the highest rates of the three.

What Factors Determine the Success of Rural Financial Institutions?

The experience of these three institutions along with analyses of financial institutions in other countries reveals crucial factors that influence the ability of financial institutions to achieve outreach and self-sustainability. The three-pronged framework for developing financial markets, described in Chapter III, is used as the way to organize the ideas presented here.

Policy Environment

The past urban bias of many economic policies in Asian countries has been reduced so prospects have improved for agricultural firms to be profitable. Profitable clients make better customers for financial institutions. However, other policy issues that influence the prospects for developing sound rural financial markets must be addressed in many Asian countries.

i. Interest Rates

Interest rates for farm loans are controlled in some countries and, in others, financial institutions are reluctant to raise rates even when they have been deregulated. To reduce subsidy dependence, financial institutions must charge rates high enough to earn interest spreads that will cover operating costs and losses. Interest rates must be positive in real terms to compensate savers for supplying resources for lending, and

enough profits must be realized to provide owners with a reasonable return on their capital and resources to generate reserves and reinvest for future growth. The financial institutions must be free to price their services according to the costs and risks of the clients served. Countries that control interest rates at low levels for the benefit of certain sectors or groups of clients destroy the possibility of institutions covering their costs. The low-interest-rate policies of BAAC and GB, and many MFOs, are well intentioned to assist their borrowers, but the cost for the institutions is that they cannot become completely self-sufficient. They have to rely on governments and donors to provide subsidies continuously. This introduces uncertainties and the possibility of politically motivated terms and conditions attached to such support. BRI-UD is able to avoid these problems because it determines the structure of its interest rates.

The second problem noted in the case studies is that institutions that operate on market principles face competition from subsidized institutions. So far this problem has not seriously affected these institutions but it is becoming more serious today in Indonesia. The Indonesian Government, the World Bank, and the UNDP are pumping subsidized credit into villages as part of projects designed to alleviate economic and social problems caused by the current crisis. BRI-UD may not be seriously affected; however this well-intentioned effort may contribute to the failure of some rural banks and other local financial institutions. It may also undermine the credit culture: the soft conditions and weak enforcement procedures associated with these special projects may lead borrowers to think of loans as grants. It is tempting for governments to channel emergency assistance through existing networks of financial institutions, but it can have a corrupting influence and damage institutional viability.

The freedom to set interest rates is often linked to the freedom to select clients. Subsidized credit projects usually carry restrictions about the target group to be served. This is a problem for the policy loans made by BAAC. The more narrowly specified the target group (e.g. small rice farmers), the greater

is the chance that the lender will end up with a risky, undiversified portfolio. Moreover, the greater the subsidy, the greater the potential for political intrusion over credit allocation, as demonstrated in the case of the Indian loan melas.

ii. Client Selection

With the exception of the special government projects administered by BAAC and the restrictions placed on the nonfarm enterprises it can serve,[4] these three flagship institutions select their own clients. Financial institutions must be able to design and market financial services that match the demands of their potential clients. They must avoid targeted programs that constrain them to serve a specific group or type of client. Such regulations or mandates inhibit them from diversifying their portfolios as a protection against systemic risks.

Clients should self-select themselves to use the products offered by specific institutions rather than being targeted by a specific program. This flexibility creates a banking relationship in which the clients realize that financial services are offered to them, not because of mandates, but because the institutions perceive them as valued clients. The institutions may choose to market certain products to specific types of clientele expected to be most interested in them. For example, the GB has increasingly shifted its membership to women because they were found to be better suited than men for attending the weekly meetings necessary for membership. Likewise, some MFOs require clients to operate a business for several months before seeking a loan as a way to avoid the high failure rate of new business start-ups.

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[4] In early 1999, legislation was passed in Thailand that gave BAAC broader authority to make rural nonfarm loans.

Financial Infrastructure

i. Legal and Regulatory Framework

The three flagship financial institutions operate under formal legal charters and are subject to regulations. This gives them an important advantage because it permits them to legally take deposits. The regulations may be different from those applicable to commercial banks to account for the special nature of their loan contracts and the absence of physical collateral to back the loans. Although the capacity and skills of the regulatory and supervisory authorities have been questioned in all three countries, especially during the financial crisis in Thailand and Indonesia, the safety and soundness of these institutions has thus far been assured. Of course, this is due in part to the backing they get from their governments and donors. The financial and economic crisis in Asia revealed that strengthening the regulatory framework is a requirement in all three countries in order to support the development of strong financial institutions.

One of the important lessons of the Bangladesh microfinance experiences is that it is possible to avoid temporarily some of the problems that affect the commercial banking system, such as complicated and expensive legal procedures to collect loans. Contract enforcement for micro and small loans requires securing payment without resorting to the legal system. As long as clients are motivated to repay by peer pressure and a desire to access a further loan, financial transactions can occur in the absence of a good, inexpensive legal framework. However, problems may develop when the Bangladesh MFOs make larger individual loans and more traditional forms of contract enforcement are required. The more the MFOs begin to act like traditional banks, the more they will share the same problems.

ii. Information Systems

No systematic analysis has been done about the information systems used in these three countries. Grameen has a centralized system in which all accounts are recorded. It

was reported that this system saved it from the problems encountered by many other MFOs whose records were swept away in a recent flood. Land titling projects are underway in Thailand. They should make it easier and cheaper to access information about the legal status of land offered as collateral, and this will reduce transaction costs for lenders.

As the financial markets become more sophisticated and competitive, efficient systems will be required to supply information about the indebtedness and repayment history of borrowers. A lender must have ready access to information to determine if a loan applicant has outstanding loans elsewhere. This information must be accurate and current. Regulated institutions often have to provide the names of delinquent borrowers such that one institution knows a borrower's status with another institution. However, this information is usually not available from nonregulated institutions. Some countries in the region have a special problem in simply identifying people because there are no national identity cards.

Institutional Development

The three flagship institutions have benefited from a reasonably good policy environment and financial infrastructure, but an important part of their success is due to the careful process of institutional development that each has undertaken. This includes the design of the institution, management and governance, incentive systems, human capital development, and a variety of other factors.

i. The Design of Products and Services

Financial institutions must design specific products and services with two objectives in mind. The first is expected demand from perspective clients given the products supplied by other formal and informal sources. The second is the ability of the institution to cover the costs of offering the product or service, either as a single transaction or over the life of a long-term relationship with a client. It may be impossible, for

example, for a financial institution to offer competitively very small, emergency loans normally supplied by friends, relatives, neighbors, or moneylenders. BAAC and GB, as well as many MFOs, have demonstrated that it is possible to successfully design products and technologies to make short-term working capital loans without using the formal collateral normally required by formal lenders. A few are experimenting with longer-term housing loans.

An important characteristic of these three institutions is that they have used market research, test marketing, and pilot projects to test and adapt their products to meet the demands of clients. For example, the case studies describe the efforts that BRI-UD and BAAC have made to develop attractive savings products that contributed to their growth in savings. These organizations are also very liberal about loan use. Unlike targeted credit projects, they lend for a variety of purposes and recognize that clients are usually the best judge of how to use loans. However, they demand repayment regardless of whatever success or failure the borrower experienced in investing loan proceeds.

ii. Loan Recovery and Long-Term Relations

The design of products and services is related to loan recovery, which often determines the difference between success and failure of financial institutions. Borrowers with good repayment records cannot be expected to pay interest rates high enough to cover large loan losses. These three institutions report arrears of less than 10 percent and their actual loss rate is much lower. Good repayment occurs for several reasons. First, the institutions increase the borrowers' ability to repay by making mostly small loans and by setting repayment schedules that are consistent with the borrowers' cash flow and repayment capacity. The GB uses a weekly repayment schedule while BRI-UD requires monthly payments. A schedule of frequent payments keeps the size of each payment small and provides the institution with the opportunity to keep in regular contact with clients. As competition

rises, products and technologies need to change. The loss of customers may be a sign of poor service. For example, the GB and other MFOs in Bangladesh have recently experienced high drop-out rates, and one explanation may be the excessively rigid loan products, repayment schedules, and savings requirements (Wright, 1999).

Second, the institutions stimulate borrower willingness to pay in two ways. Joint-liability group lenders expect that peer pressure among the group members will contribute to repayment. An even more important factor is that the institutions promote the image of seeking a long-term business relationship with the client. Therefore, the expectation of a future loan with superior terms and conditions acts as an important inducement for repayment. In addition, BRI-UD uses the positive incentive of interest rebates as a stimulus for on-time payments, while BAAC imposes penalties for late payments.

Another factor affecting repayment is timely information about clients. All three institutions have good internal information systems. Loan officers know immediately when loans become overdue so they can follow up with their clients, analyze problems, and arrange for repayment. Loan payments and savings deposits are made weekly by GB clients in a transparent way in open meetings such that everyone immediately knows if someone is late in paying. This process places great social pressure on delinquent borrowers.

iii. Management and Governance

Managing large institutions with thousands of staff and hundreds of outlets is a huge task in countries where communication infrastructure is lacking. These three institutions have the reputation of being professionally managed and have achieved a high degree of efficiency in their operations. The management of these institutions has considerable autonomy in day-to-day operations. The founders of BRI-UD and GB are well known for their vision and commitment, and they have managed to instill it in their subordinates. The Government of Thailand is given high marks for choosing good managers for

BAAC. The attributes of good management and efficiency rather than political expediency were demanded by the governance system. The presence of foreign advisors who argued for strong institutional performance may have been an important protection for BRI-UD against political pressures.

iv. Staff Incentive Systems

Performance-based staff incentive systems are found in most successful institutions. The BRI-UD system was designed on the specific concept of profit and loss centers, which provides a framework for performance-based remuneration. Both BRI-UD and BAAC stimulate high levels of staff efficiency through formal staff incentives tied to bonus payments. Bonuses are paid either on institutional performance or the efficiency of the individual employees in making loans and mobilizing savings. They have also paid base salaries that are higher than some equivalent jobs in the public or private sector. Each loan officer serves a large number of clients and manages a large portfolio as a result of these incentives. GB has operated under more difficult constraints because of the negative example of the personnel policies of the bureaucratic State-owned banks. Group spirit and social commitment play a relatively larger role in affecting staff performance. In the difficult flood period, the GB first aided its employees to enable them to service their clients, and it offered special compensation and vacation time for those working under difficult circumstances.

v. Human Capital Development

The recruitment and hiring policies of these three institutions are different. BAAC and GB have higher educational requirements for potential loan officers, while BRI-UD hires staff with lower education levels, but who know the local environment in which they are assigned. All three have used intensive training programs for new employees to instill institutional mission and pride and to teach specific procedures and skills. BAAC has an ADB technical assistance project to

improve its operations and staff training. The demands on its staff will rise with the recent authorization to expand lending to new clients in nonfarm enterprises and to increase loan sizes for some of its existing farm clients. The new staff of BRI/UD and BAAC are assigned as trainees or apprentices so they can be evaluated before being hired as regular staff. Loan officers in BRI-UD earn higher levels of loan approval authority as they gain more experience. Decentralization of decisionmaking is possible because of the large investments made in human capital development.