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FINANCE for the POOR

The Future of the Commercial Microfinance Industry In Asia

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Introduction

The future of commercial microfinance in Asia, as in other regions of the world, lies in the financial sector, which has become more inclusive during the last decade than at any time in history. Commercial microfinance is still emerging but is now becoming a global industry that is in the process of developing common standards, policies, regulations, measurements and adjustments, and tools and methods, which enable broad and deep outreach on a commercial basis.

In Asia today, financial services are being delivered commercially and profitably to tens of millions of economically active poor and middle-income clients who live in countries with low- and lower-middle-income economies.[1] But the unmet demand for these services remains huge. Commercial microfinance is the only option for meeting this demand sustainably over the long term.

The legal, policy, and regulatory structures for microfinance vary greatly among different countries of the region—as do the politics. At one end are countries where national leaders have understood both the preconditions of large-scale commercial microfinance and its benefits to the economy, the society, and the poor (e.g., Cambodia and Indonesia). Both the routes of such countries to sustainable microfinance and their achievements have been different, and all still face multiple challenges. Yet they have developed financially self-sufficient institutions that serve low- and

[1] This discussion concerns East, South, and Southeast Asia. Central Asia is excluded since microfinance databases tend to group together Central Asia and Eastern Europe, as in *The MicroBanking Bulletin's* Eastern Europe and Central Asia category of microfinance institutions (Eastern Europe and Central Asia). The author is grateful to Enjiang Cheng, Michael Chu, Nimal Fernando, Sanjay Sinha, M.S. Sriram, and Graham A. N. Wright for insightful discussions concerning the issues discussed; they are not, however, responsible for the views expressed here.

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The Future

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lower-middle income people profitably, providing them loans, savings facilities, and other financial services.

At the other end of the continuum are countries with various combinations of repressive financial markets, weak banking systems, failed banks, collapsed financial sectors, and poorly functioning legal and judicial processes (e.g., Lao People's Democratic Republic, Myanmar, and Viet Nam). In such countries, large-scale commercial microfinance awaits major changes in government policies.

Other countries (e.g., People's Republic of China [PRC], India, and Pakistan) are currently in various stages, emerging from long histories of interest rate ceilings on loans, large-scale subsidized credit programs to targeted populations, directed credit allocations, and the like—characteristics that have typically led to politicization, misuse of funds, high defaults, and high losses. In such countries, serious although generally slow attempts are being made to bring about basic changes.

In these and other Asian countries, the transition to an inclusive financial sector is under way, with different countries at various points along the continuum. This paper looks at a few of the cutting-edge markers of the commercial microfinance industry in Asia and identifies some signs of the future.

What can we learn from industry leaders? What are some signs of industry development, and what are some obstacles and challenges ahead? Where can we foresee the future in the present? How can finance for people so long excluded from the financial sector be both economically and socially profitable?

Microfinance in an inclusive financial sector

Characteristics of an inclusive financial sector include

- policies, legal structure, and regulations appropriate for all levels of commercial finance;
- informed, competent public supervision of regulated financial institutions;
- commercial financial institutions of different types with varying customer bases;
- loans financed by public savings, commercial debt, private investment, retained earnings, and other commercial funds;
- widespread client access to commercial loans, savings accounts, remittances and transfers, insurance, and other products (not necessarily through the same institutions);
- competition among efficient and innovative local, national, regional, and international institutions, resulting in wide outreach to economically active poor and middle-income women and men; and
- shared industry standards.

No developing country in Asia has yet reached this stage but some are close, while others are on the way, as illustrated below.

Overview of Asian institutions participating in *The MicroBanking Bulletin*

Compelling evidence for the development of the Asian microfinance industry can be seen in table 1, which provides performance measurements for 2002 for participating Asian microfinance institutions (MFIs) that were analyzed in the 2003 issue of *The MicroBanking Bulletin* (MBB). The MBB is widely viewed as the industry's best source of global commercial microfinance data. Its participating institutions are either fully financially sustainable on a commercial basis or strongly dedicated to becoming so. These MFIs are thus among the best in Asia.

Microfinance in Asia
Adjusted Averages, 22 MBB Asian Participants

Indicator (2002 data)	Large MFIs N=4 (18% of Asian MFIs in database)	Other Asian MFIs N=18 (82%)	Performance: large MFIs as multiple of other MFIs
Number of loans ('000)	1,282	28	46 X
Value of loans ($ million)	380	3	127 X
Number of voluntary savings accounts ('000)	7,615	17	448 X
Value of voluntary savings accounts ($ million)	664	0.3	2,213 X

Source: *The MicroBanking Bulletin 2003* and data from the Microfinance Information Exchange (MIX).

The table uses average performance data for the MBB's Asian participants to compare the 4 large MFIs with the 18 other MFIs. The MBB defines large MFIs as those with portfolios of $8 million or more. The MBB adjusts the data for each institution, as needed, for subsidies, loan loss provisioning, and inflation.

The first column of figures shows average performance data for the four large institutions, which represent 18% of the total Asian MFIs participating in the MBB.[2] The next column shows the performance means for MBB's peer group

[2] The four large MFIs in MBB's large Asian peer group represent four different kinds of institutions. They are Indonesia's Bank Rakyat Indonesia, a state-owned commercial bank more than a century old, and recently partially privatized; Association for Social Advancement (ASA), a nongovernment organization (NGO) in Bangladesh; Cambodia's ACLEDA Bank, a specialized bank that was transformed from an NGO and First Community Cooperative (FICCO) in the Philippines. FICCO, which began its microfinance activities in 1999, was a credit union founded in 1954.

of 18 Asian MFIs that have portfolios below $8 million (82% of the total MFIs).

Comparing the averages shown in these columns, the last column indicates the following.

- The average number of loans for the 4 large institutions is 46 times the average for the 18 institutions in the "Other" group.
- The mean value of loans for the 4 large institutions is 127 times the mean for the "Other" group.
- For the number of voluntary savings accounts, the large MFIs have, on average, 448 times the average for the "Other" group.
- The mean value of savings for the 4 large institutions is 2,213 times the mean for the "Other" group.

This table shows that, as in any emerging industry, a few industry leaders have pulled out in front of the other MFIs and are dominating the commercial microfinance market. Industry leaders are typically characterized by clear ownership, qualified and committed governance, and skilled and accountable management—and by vision, skills, and efficiency. Such leading institutions cover their operating and commercial financial costs and risks, and return a profit after adjustments. This table offers glimpses of the future in the present.

Commercial microfinance in four countries

Commercial microfinance in Bangladesh, PRC, India, Indonesia—countries that together account for 82% of Asia's population—is examined briefly here. The purpose of this section is not to suggest what these or other Asian countries, or financial institutions, should or should not do in incorporating microfinance into their financial sectors. That is up to each country and institution. Rather the approach is to indicate what country and what institution would need to do should they choose to develop large-scale commercial microfinance systems that would be incorporated into the country's financial sector.

Indonesia, home to commercial microfinance for more than a century, now has the largest commercial microfinance institution in world history, i.e., Bank Rakyat Indonesia (BRI). But it was not always such. In 1983, BRI had a large, failed subsidized rural credit program that had been operating since 1970. It was characterized by high defaults and large and continuing losses. The below-market credit went mainly to rural elites, encouraging corruption along the way. About 3,600 units (the lowest level banking unit) existed; none was profitable.

In 1984, the entire system was converted into commercial microbanking, with combined massive outreach and profitability every year since 1986 (even when the country's financial system collapsed in 1997–1998). In 2003, BRI shares were offered to the public on the world's major stock markets. At the initial public offering, BRI shares were oversubscribed by nearly 16 times. About 40% of the bank's shares are now privately owned. In 2004, BRI's microbanking system had 3.2 million outstanding loans clients with $2.1 billion in loans, a long-term loss ratio of 1.6%.[3] It had $3.5 billion in 31.3 million savings accounts. In 2004, BRI's microbanking system made $233 million in profit (before tax); its return on assets was 6.8%.

But Indonesia still faces challenges in microfinance: (i) the country needs more and better competition for BRI; (ii) large, unmet demand for financial services still exists, especially for loans; and (iii) many poorly performing, donor-subsidized microcredit programs exist in Indonesia that need more careful rating and review and less artificial respiration.

Overall, Indonesia is home to the world's largest profitable commercial microbanking system. BRI is the first microfinance intermediary to offer shares broadly in the world's main financial markets. Together these two points—which are directly related—provide an important insight into the future of the global commercial microfinance industry.

Bangladesh, PRC, and India. These countries are quite different from one another in many ways, including microfinance. But they all have substantial strengths in developing commercial microfinance. They all face major challenges, many of them common (quite similar to some challenges Indonesia faced in 1983).

Strengths. The PRC and India have common strengths, including a strong average annual gross domestic product growth from 1990 to 2003 (9.5% for the PRC and 5.8% for India); many well-educated people and high levels of technical capacity; a vast banking infrastructure; large household deposits in regulated financial institutions; and a huge unmet demand for microfinance services. The PRC also has very high adult literacy (91% in 2002), and recently had a partial financial liberalization. High economic growth is creating a rapidly increasing unmet demand for rural financial services. India has seen considerable financial liberalization in recent years. It has a number of internationally recognized microfinance experts, a diversity of MFIs, and a developing stream of ideas for, and experiments in, microfinance. Bangladesh has a rather different set of strengths, including exceptional breadth and depth of microcredit outreach and good record-keeping for financial nongovernment organizations (NGOs) through the Credit and Development Forum. Bangladesh, the home of some major international microcredit industry leaders, is well-known internationally for developing microcredit methods. It has a large unmet demand for voluntary savings products, individual loans, domestic money transfers, and microinsurance services.

Challenges. These countries have many challenges in common. They do not yet have large-scale profitable commercial microfinance intermediaries. To develop inclusive financial systems that provide commercial financial services to the majority of the population, the following need to be undertaken—in varying degrees—depending on the country.

- Remove credit subsidies and interest rate ceilings that undermine commercial microfinance.
- Upgrade the regulatory and supervisory capacity for commercial microfinance.

[3] BRI defines long-term loss ratio as the cumulative amount due and unpaid relative to the total amount that has come due.

- Overcome endemic moral hazard issues. Thus, many currently operating MFIs are badly in need of (i) clear ownership; and (ii) qualified, responsible, and accountable governance and management (and the transparency that makes accountability possible).
- Carry out extensive education directed at the widespread political opposition to commercial microfinance, coupled with effective curbs on local government interventions in MFIs.
- Improve market research for new, more flexible client-focused products substantially.
- Build institutional capacity in governance, management, organization, training, technology, knowledge of the microfinance market, and product development.

Building inclusive financial systems. If large-scale commercial microfinance is desired, some immediate, yet helpful, steps include the following:

The PRC. (i) Continue financial liberalization, including lifting interest rate controls and allowing risk premiums on loans. (ii) Continue government effort to manage and reduce the huge "historic burden" of nonperforming loans (NPLs). (iii) Rationalize more than 30,000 rural credit cooperatives (RCCs) that are owned by local members but controlled by the central government. The owners of RCCs do not make the major decisions, and the decision makers are not owners. This results in serious moral hazard issues, including governance and management problems, incompatible goals, and conflicts of interest. Some RCCs could be closed down; others could become real cooperatives; and some could be privatized. Others could become banks or regulated nonbank financial intermediaries (NBFIs). (iv) Reduce, when possible, the Government's highly subsidized lending to RCCs, and educate key members of the political opposition to commercial interest rates. (v) Give high-level priority to end local government interventions in the RCCs and elsewhere—a long-standing source of massive bad debts. (vi) Restructure the RCC organization: current rigid service areas constrain innovation, expansion, and competition. (vii) Note that large variations in regional environments suggest the need for diversity in rural markets (new kinds of MFIs, including private banks, NGOs legalized as regulated NBFIs, etc.). (viii) Facilitate bank entrance to the microfinance market, starting in large townships and county seats. (ix) Encourage effective competition.[4]

India. What is lacking? First is the sustained political will that is needed to make commercial microfinance a national priority. Second is a set of examples of financially self-sufficient microfinance intermediaries with large-scale outreach.

The following are needed to achieve commercial microfinance: (i) Establish a powerful home in the union and state governments (commercial microfinance is currently not the responsibility of any department in the central bank or in the government. (ii) Promote further financial liberalization, including removal of remaining interest rate restrictions. (iii) Use effective methods to counteract the widespread political opposition to interest rates that allow MFIs to cover costs and risks. (iv) Encourage commercial banks to go downmarket (e.g., ICICI Bank, the country's largest private bank, is currently innovating); and allow the development of microfinance banks with an all-India license. (v) Review and revise the legal and regulatory structures for nonbanking finance companies. (vi) Continue to reform the regional rural banks (RRBs). While recent reforms helped the viability of RRBs, these improvements were generally at the expense of their microcredit mandate. But with appropriate political will and effective governance and management, some RRBs could be relatively easily turned into commercial microfinance industry leaders. (vii) An independent high-level review of the role of the National Bank for Agriculture and Rural Development, and of its program for linking self-help groups and banks—including real costs, loan repayment, financial performance, organization, outreach, etc.[5] (viii) Continue addressing reforms in the cooperative sector relating to its role as microfinance providers.

Overall, India has a large, unmet microfinance demand and, among its various MFIs, has nearly all the ingredients needed for commercial microfinance, including management and technical capacity, infrastructure, human capital, market knowledge, and commercial viability. But these and other requirements for large-scale commercial microfinance are not yet generally found together in individual institutions. That is the next step.

Bangladesh. The poorest of the four countries, Bangladesh is known internationally for its remarkably widespread microcredit (although not generally for commercial microfinance). But Bangladesh has long-term serious weaknesses in its banking system, in its regulatory framework, and in its ability to enforce prudential regulations. Systemic political realities that have kept the banking system weak for decades exist.[6] In addition, Palli Karma Sahayek Foundation (PKSF), a powerful apex body, provides subsidized loans to NGOs and holds a near-monopoly on wholesale MFI loans for microcredit—leading to widespread subsidy dependence and low levels of commercial funding. PKSF is also reportedly moving toward requiring recipient MFIs to agree to interest rate caps on the loans they provide to borrowers. But some MFIs refuse to accept subsidized loans under this condition. These conditions severely constrain the ability of Bangladesh to become a center of commercial microfinance. The country's commercial banks are characterized by weak governance and high NPLs, coupled with extensive political interference. Most microcredit is in non-regulated NGOs and in the Grameen Bank (an especially licensed financial institution that is not subject to laws governing financial institutions). Grameen is well-known globally for its microcredit outreach but needs to improve loan repayment, accounting practices, and transparency. At BRAC and the Association for Social Advancement (ASA)—both world-class industry leaders—

[4] See Cheng 2003, 2004; Cheng and Zhong Xu 2003; and Watson 2002 for recent discussion of microfinance in the PRC.

[5] Careful studies conducted recently in various regions (but limited in scale) have, among them, suggested that although self-help groups (SHGs) are widely promoted, a considerable number are vulnerable to politicization, show substandard performance, and are characterized by substantial subsidies and continuing losses (see for example, M-CRIL Microfinance Review 2003; Mahajan and Ramola 2003; Sinha and others 2003). A thorough, independent review is needed, given the massive promotion of this approach to microfinance.

[6] See Meyer and Nagarajan 2000.

microcredit is financially self-sufficient after adjustments. Since their microfinance services are unregulated, they cannot legally mobilize large-scale voluntary savings.[7]

In this context, what are the possibilities for large-scale commercial microfinance in Bangladesh? (i) Place banking and PKSF reforms at the center of any large-scale and permanent commercialization of microfinance. But it is unclear if and when this may be possible. (ii) Assist as an interim solution the Grameen Bank, which now mobilizes voluntary savings, to become a well-regulated commercial intermediary that is transparent and externally rated, using international accounting standards. (iii) Assist BRAC, ASA, and a few other leading NGOs to become (or to create new) institutions that are appropriately regulated and supervised commercial microfinance intermediaries providing clients a wider choice of financial products.

The commercial microfinance industry in Asia in 2025

Commercial microfinance is still an emerging industry in Asia, well-developed in some countries, and at varying stages in others. If we look to the future of the global microfinance industry in the next 2 decades, some crucial developments seem likely.

- For industry leaders, finance will not generally be a constraint. Loans will be financed from capital markets, public savings, investments, and other commercial sources.
- The major players will be large, regulated financial institutions, especially banks (some transformed from NGOs), but will also include large credit unions and credit union federations.
- Participating banks may be publicly or privately owned, or both. In countries with very weak banking systems, the dominant microfinance institutions may be NGOs or cooperatives.
- Commercial microfinance providers will operate in increasingly competitive environments, leading to improved efficiency and to better services and lower costs for clients.
- Outreach to low-income clients will be greatly expanded.
- New technology will have important roles, and strategic alliances among types of institutions with different comparative advantages will continue to develop.
- Joint ventures will develop across national borders; some large commercial financial institutions will provide microfinance in multiple countries. Some multinational banks will enter the market.
- Mergers and acquisitions will also occur, and many MFIs will either turn to other kinds of activities or close down.
- Ownership of commercial microfinance intermediaries will become increasingly multinational (as what happened at BRI).
- Commercial microfinance is changing rapidly, as are the markets and the skills required to provide microfinance services profitably on a large scale. To retain their leadership, today's industry leaders will need to change in fundamental ways.
- The roles of donors and foundations are likely to turn mainly to various forms of industry development and to funding institutional capacity building, especially in new markets.
- In many countries, commercial microfinance will be absorbed into the financial sector—as what is already happening in some parts of Asia.

[7] BRAC also owns a bank, but it is not the home of BRAC's microfinance activities.

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WHAT FINANCE CAN AND CANNOT DO

Finance cannot create opportunities. It only makes it easier to exploit them. What it can do is identify the areas of opportunity and decline, and achieve a better match by giving to sectors with a future while taking from those with only a past. Finance can find and mold the clay of opportunity, but it cannot create the clay itself.

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ANZ Bank's Microfinance Experience in the Fiji Islands

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Introduction

What motivates ANZ, Australia's third largest bank, to bank the unbanked in the Fiji Islands? One might assume that the reason was a sense of obligation as part of its corporate social responsibility strategy. Although that was certainly part of the strategy, it was driven primarily by market opportunity. Under the stewardship of the Managing Director–ANZ Pacific, the ANZ has identified an estimated 6.5 million people in the Pacific with no bank account. A little over a year ago, ANZ began a project to take banking services to the rural people in the Fiji Islands (Fiji). Having completed that task, ANZ is today preparing to find new and innovative ways to deliver basic, affordable, and reliable banking services to some of the most remote and needy communities in the Pacific.

Who is ANZ Banking Group Ltd?

ANZ, whose history dates back to 1835, is one of the world's largest banks, with businesses serving more than 5 million customers. It has assets of Australian dollar (A$)247 billion, and produces around A$3 billion in net profit each year. ANZ has more than 28,000 employees, and is represented not only in its primary markets in Australia and New Zealand but also in other parts of Asia and the Pacific, United Kingdom, and the United States of America. ANZ is

- one of the 10 largest and most successful companies in Australia;
- the leading and largest company in New Zealand;
- the leading bank in the South Pacific; and
- Australia's leading bank in Asia.

ANZ has taken a leadership position in promoting financial literacy through various forms. ANZ has

- a seat in the Australian Federal Government's Financial Literacy Task Force;
- recently completed a discussion paper on community development finance;
- developed a matched savings program in collaboration with the Brotherhood of St. Lawrence that targets Australia's most disadvantaged; and
- introduced financial literacy programs for staff, customers, and the wider community.

Fiji Rural Banking

In late 2003, a small team of ANZ bankers from Australia, the Fiji Islands, and Vanuatu carried out a fact-finding mission in the rural areas of Fiji. This mission, launched by ANZ Country Head in Fiji, aimed to determine the need or desire for banking services in the rural community, and conduct preliminary analysis on possible solutions. Having been in the country since 1880 and being the largest bank in Fiji, ANZ took a longer-term view of the country, its prospects, and its relative position in Fiji as a developing nation. However, from ANZ's perspective, it will most likely remain a developing nation if 50% of the population remains financially excluded and not part of the formal economy. Recognizing this situation, ANZ was driven by a desire to include a larger part of the population and definitively start along a path to greater and more inclusive development.

The rural community of Fiji has over 400,000 people, representing roughly 50% of the total population. The team concluded that the need was high and the desire for a banking service, even greater. A key recommendation was the appointment of a head of rural banking in Fiji who would take these findings, formulate a solution, and then implement it.

ANZ implemented this recommendation. The appointed head of rural banking came to Fiji in April 2004 without an inkling of the final solution. She had little knowledge of Fiji and none of rural Fiji. Having worked in the sector for the past 11 years as ANZ Regional Manager of South West Victoria in Australia, she knew little about retail banking. However, she spent her childhood in very large, remote cattle properties in far North Queensland where the nearest hospital was over a 6-hour drive away as was the nearest bank, grocery store, and school. Given this background, she understands and has empathy for those living without basic services, something that urban people might take for granted. This helped her establish an early affinity with the rural people of Fiji.

For the first three months, she focused on knowing her future customers. She knew that whatever the solution was had to be what the rural Fijians wanted. She set out to achieve the buzz phrase "customer centric value proposition." ANZ recruited a project officer, also a very passionate banker, with an excellent knowledge of Fiji's culture, customs, vernacular, and geography. This combination worked very well. The two-member team spent time on the village mat, talking with both Fijian and Indo-Fijian communities to ensure that they understood their future clients' needs. The team started with a series of 10 questions ranging from—Do you want a bank? If yes, what would you use a bank for? What would you save for? How often? Sometimes the team got more than it bargained for, including being washed away in a fatal, flash flood in one of Fiji's remotest parts. The solution was not hard to create—it just sort of came out of these early conversations.

The Fiji Rural Banking Solution

Obviously, these potential clients did not want or need a traditional bricks-and-mortar bank branch nor did they want a fancy technological gadget for their banking. In fact, both these solutions intimidated them. However, they wanted a safe and affordable, yet accessible, place to keep their money. The idea of a mobile bank has been done elsewhere before—in Kenya and Viet Nam, among others—and the team spent time researching on these programs.

The final solution of six banks on wheels—4-wheel drive trucks fitted out with normal banking facilities such as counters and office chairs—allows ANZ to provide a safe environment for its customers and staff. More importantly, the bank-on-wheels enables it to provide a regular, reliable, and affordable banking service to the community doorstep.

Products

Two products were designed to complement the uniqueness of Fiji rural banking—the savings account and the everyday account. The savings account has a nil opening balance, is operated with a passbook, pays interest on every dollar saved, and is charged a fee only when the customer withdraws.

The everyday account is suitable for salary earners, micro business owners, and those who want to carry out regular deposits and withdrawals. It is charged with a small monthly fee, is operated with a passbook, and can be accessed by using a debit card. In addition to these two products, ANZ also offers the full line of products available in a normal branch such as foreign exchange, insurance, and home loans.

All ANZ rural bankers are fluent in the local vernaculars. Information and newsletters are also printed in all three local languages—Hindustani, Fijian, and English—to ensure that the bank is as inclusive as possible. Bank staff members, always mindful that they are an invited guest in rural Fiji, act accordingly. They promote humility among their teams and will go to any length to ensure they are approachable and cognizant of local customs and traditions.

Identification Requirements

As part of the solution, an integral step in working with the Reserve Bank of Fiji is to find a way around the identification requirement to open a bank account. Prior to this, people wanting to open a bank account had to have extensive documentation. This did not work for many people who just did not have the need or use for passports, driver's license, and other documents. The project officer and the bank's internal audit team proposed a more appropriate identification document—a letter from the village chief, district officer, or church leader verifying the applicant's identity. In addition, the team asked for another form of identification such as baptism or marriage certificate, pension fund card, or school report card—requirements acceptable to the rural people. ANZ is mindful of anti-money laundering requirements but is adamant that these should not preclude people from opening a bank account.

Financial Literacy

In all discussions with the unbanked in Fiji, constant requests for information and education about financial matters were received. Parents wanted their children to be well-informed for them to have the best chance of financial success. Village elders wanted their constituents to be better prepared financially. The challenge was not only to listen to their pleas but also to carry out the task of banking the unbanked, which was an enormous task in itself, if it were to be done well. To this end, ANZ sought the assistance of the United Nations Development Programme (UNDP) and the Pacific Sustainable Livelihoods Programme. The partnership that ensued has been very successful to all stakeholders. The result is a financial literacy program that is administered and funded by UNDP and facilitated by a network of nongovernment organizations and the Fiji Government's Microfinance Unit. The program covers subjects such as how to budget, how to save, and how to manage money, including customary obligations.

What has ANZ Rural Banking Fiji achieved?

From October 2004 to end of March 2005, 25,800 previously unbanked, rural Fijians opened accounts and amassed more than $500,000—a substantial effort for a group of people who were written off as non-savers and poor. Most pleasing is that 4,000 of these accounts belong to young people under 18 years old whom the bank staff visit at their schools each fortnight to collect small but regular deposits. The savers are split evenly between men and women debunking another myth that men cannot and would not save.

Economic empowerment is evident. Women living in a very remote village in Namosi Province and making paper for a local cosmetics company now receive their payments directly in their bank accounts. Previously these women would make the long, expensive trek to the capital city to receive their money, yet would have nothing much to show for their hard work when they go back to their village a week later. Transport, food, accommodation, and the attractions of the big city swallowed up their hard-earned money. Now they are saving and contributing much-needed funds for a village sanitation project.

Resort workers can also receive their pay at their place of work through their bank account—a huge time-saver for the employees and employers who, in many cases, are large corporate clients of ANZ. They also appreciate the bank's services. Teachers, doctors, nurses, and other government workers—who previously had to wait weeks for their pay, travel long distances, take extensive time off their jobs, and then pay $5 to receive it—now get their pay at the nearest ANZ Rural Banking truck during its visit.

The entrepreneurial spirit has also been awakened. In May, the bank launched its first microfinance product, MicroLoan, to help savers who need credit to turn their business ideas into reality. Loans up to $1,000 are approved for customers who have saved regularly over the past 6 months. New roofs, solar power, school fees, boats, and better living conditions are no longer just dreams. The bank seems to be making a difference.

So can we bank the unbanked sustainably?

The answer is yes, we can. No doubt the bank needs to manage costs in this area of retail operations as tightly as, if not more tightly than, other business areas. The bank is relying on high take-up because this is a low-margin, high-volume business. Even more important is creating solutions that the unbanked customers think are of good value, reliable, and safe. The bank has high hopes that the program will not only be sustainable but also profitable and able to contribute to the bottom line of the greater ANZ group. The bank is aiming for a 50% market share of the unbanked in Fiji and the same cost-to-income ratio.

The other factor that the bank is conscious of is the importance of sustainability. The program has positively affected the lives of some of the Pacific's poorest citizens. Ensuring its sustainability to make it permanent is thus essential.

Where to now?

The regional response to the Fiji Rural Banking initiative has been substantial, especially from other Pacific island nations eager to have their own banking solution for the unbanked.

Early this year, ANZ announced that the strategy would be rolled out to other Pacific countries where ANZ has a presence. Fact-finding missions in eight countries are under way. UNDP has also indicated its willingness to sign on for other financial literacy projects in the region. A project called "Bank blo evriwan," which is pidgin for "Banking for Everyone," is already in the Solomon Islands. This program will be launched in late September 2005. ANZ is also very encouraged by early discussions and fact finding in Papua New Guinea.

As the leading bank in the Pacific since 1880, ANZ is proud of the innovative work it has done to date in banking the unbanked. ANZ sees this venture as an opportunity to create a sustainable business across the Pacific as well as the opportunity to make a difference in the local communities. ANZ sincerely hopes that by creating some positive examples of how banking the unbanked can be done, other mainstream financial institutions in the region will also take up the challenge of providing basic, affordable, and reliable banking services, coupled with financial literacy, to all.

BLUEORCHARD FINANCE:
Linking Microfinance to International Capital Markets

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Introduction

The vast majority of the populations of emerging economies still work in the informal sector of urban and rural areas. Millions of micro entrepreneurs can often rely only on themselves to survive. Their income depends mostly on the success of a small business where they invest the bulk of their resources. Unfortunately, their ventures rarely extend far beyond the subsistence level, mostly because of lack of capital. These entrepreneurs and their families also lack access to suitable savings and insurance products.

Over the past 30 years, specialized financial intermediaries or "microfinance institutions" (MFI) have successfully targeted this market and developed products—loans, savings, insurance, and payments—and methodologies to serve it. Institutions of various legal structures such as banks and cooperatives also prove that microfinance is a risk-manageable and profitable business: microentrepreneurs borrow at market rates and boast a repayment track record that beats most commercial banks (97% on average).

Thousands of MFIs are active in the world today and an increasing number of them strictly operate under commercial rules. Commercialization is not a goal in itself but a means of ensuring that financial intermediation and products or services delivery are efficient. Profitability of field operators is also a prerequisite to sustain their social impact and to reach out to an ever-increasing number of clients.

Microfinance is developing into a transparent and regulated industry. Regulators, well-known business auditors, and rating agencies are significantly paying closer attention to leading microfinance institutions, given their growing importance in national capital markets. Their involvement provides a solid legal, financial, and political framework to sustain the growth of this industry.

Local and international sources of funding

Considering the huge annual credit demand estimated at a minimum of $50 billion, bilateral assistance from developed countries or concessional funds from multilateral development agencies will not be able to provide the level of funding needed on a sustainable basis. Access to commercial capital markets is the only solution to meet the financial needs of this fast-growing segment of the world population.

Domestic capital markets will increasingly represent the main funding sources for the local MFIs. The latter will increasingly capture savings; they will have access to credit lines from local commercial banks and some of them will even issue their own commercial paper. This is a natural and most welcome development trend of the microfinance industry that should be encouraged by all means.

The role of international investments in microfinance nevertheless remains crucial.

(i) International funding can adequately complement the local capital markets (e.g., through unguaranteed or subordinated loans, longer-term debt, innovative structured products, etc.) and offer diverse opportunities for

MFIs, which are always welcome during sudden local credit crunches.

(ii) International funding brings major international investors to the microfinance sector with much potential follow-up business for local MFIs.

(iii) Commercial investors will typically insist on proper professional practices from partner MFIs (e.g., accounting, audit, rating, transparency).

(iv) International investments may act as catalysts and could positively affect local commercial financing.

(v) International funding sources can help support the development of local or regional specialized investment vehicles targeting smaller structures operating in microfinance.

BlueOrchard Finance: a leading international debt fund manager for microfinance

BlueOrchard Finance was created in 2001 by a small group of private investors in Switzerland with the vision to become a global-leading asset management company focusing on a diversified range of investment products for the microfinance industry. It brings funds, professional management, and ongoing support to the microfinance sector worldwide on a commercial, sustainable basis—never forgetting the socioeconomic development goals shared by microfinance practitioners. BlueOrchard Finance aims at being internationally considered as a reference and preferred long-term commercial partner by a large number of microfinance practitioners and investors.

BlueOrchard Finance has been reasonably successful in achieving its mission so far. It counts today no less than 25 private shareholders and a solid professional team with extensive experience in banking, mainstream financial rating, and field microfinance. BlueOrchard Finance manages or advises investments worth $135 million through three investment vehicles in partnership with different financial institutions.

- **Dexia Micro-Credit Fund**: Luxembourg-registered SICAV (Société d'Investissement à Capital Variable) investing in short-term debt (maximum 3 years) of the best MFIs all over the world. Fund sponsor: Dexia Bank. Total portfolio: $60 million. Total microfinance portfolio: $47 million. Creation date: September 1998.
- **ResponsAbility Global Microfinance Fund**: Luxembourg FCP (Fonds Commun de Placement) investing in equity and debt (maximum 5 years) of MFI all over the world. Fund sponsor: Crédit Suisse. Total portfolio: $12 million. Total debt microfinance: $5 million. Fund main advisor: ResponsAbility AG. Other fund distributor: Raiffeisen Bank, Switzerland.
- **BlueOrchard Microfinance Securities I, LLC** : US Special Purpose Vehicle, having issued 7-year bonds in the US market through private placement to fund a portfolio of loans made to 14 leading MFIs in seven countries. Total microfinance debt portfolio: $83 million. Other partners: JPMorgan Securities, Overseas Development Investment Corporation, Developing World Markets.

BlueOrchard has invested in Asian countries, including Cambodia, India, Kazakhstan, Kyrgyz Republic, Mongolia, and Philippines. The proportion of the microfinance loan portfolios invested in Asia were 13.5% of the Dexia Micro-Credit Fund, 17.5% of ResponsAbility Global Microfinance Fund, and 6.5% of BlueOrchard Microfinance Securities. Legal formats of the MFIs funded include commercial banks, not-for-profit organizations, nonbank finance companies, and cooperatives.

BlueOrchard plans to further expand its activities in Asia and overcome what has probably been the biggest hurdle it has faced so far in this part of the world—the lack of appropriate foreign exchange hedging instruments. BlueOrchard is actively exploring options to improve its commercial funding offer by providing foreign exchange hedging solutions to its partner MFIs. This will only help cover deeper and broader the Asian region, provided no aggravating elements regarding foreign direct investments in microfinance emerge in the regulatory environment. Such impediments include interest rate caps imposed on international lending, high tax rates on interest earned, prohibition of direct lending to local MFIs, and prohibitive reservation policies imposed on foreign borrowings of MFIs. Even if they are made in local currency, commercial loans will only be possible if markets are not distorted by public subsidies and cheap lending from international organizations, resulting in crowding out of the commercial sector, which is unfortunately a characteristic of the market in Asia.

BlueOrchard Finance has been successful in maintaining itself at the leading edge of financial product innovations in the field of international funding for the microfinance sector.

- From the outset, it actively developed the first fully commercial microfinance debt fund (Dexia Micro-Credit Fund) that offers very attractive features to professional investors (e.g., monthly liquidity, strong geographic diversification, large asset base, steady net financial returns, low volatility, etc.).

- BlueOrchard Finance developed the first international microfinance collateralized debt obligation, a true breakthrough in many ways: (i) it uses advanced structured finance know-how, (ii) offers within the same product various risk-return options for a wide range of investors with different degrees of risk aversion, (iii) opens up the possibility for very fruitful private-public partnerships, (iv) delivers long-term funding in substantial amounts at fixed rates to microfinance operators.

- BlueOrchard Finance is finalizing the launch of the first international fund of local microfinance funds with a major European private bank. The objective is to be able to support the development of local investment structures aiming at local or regional investments, especially for smaller MFIs, through international private commercial funding. This vehicle will hopefully have a major activity in Asia in the future.

More projects aimed at broadening the range of funding and investment options for BlueOrchard's partner MFIs and

investors are also being considered in partnership with global financial institutions.

BlueOrchard Finance has successfully started to attract mainstream commercial investors to the microfinance industry. Major pension funds in the Netherlands, Switzerland, and United States have already invested significant amounts (from $5 million to $20 million each) in the products managed by BlueOrchard. This is a significant achievement, holding the promise of much larger flows of funds for the future. Similarly, some very important families and high net worth individuals have also shown their trust by investing in the same products. Distribution in the retail market is also being tested with one product in Switzerland. This is probably only the beginning and BlueOrchard thereby hopes to demonstrate that the private commercial sector can play a significant role in the international funding of MFIs.

The role of international public aid and private philanthropy

Multilateral and bilateral development agencies, as well as private philanthropists, play a key role in the emerging microfinance sector and still have key contributions to make to its future development. BlueOrchard Finance, nevertheless, believes that their actions should be targeted at solving issues where they have the highest value added. It is certainly the case in the field of MFI institutional building (by training staff and developing sound management information systems) or in creating an enabling market environment, for example, by developing audit and reporting standards, encouraging the use of financial rating agencies, establishing credit bureaus or practitioners' associations, and developing necessary regulations and supervision of MFIs.

On funding MFIs, BlueOrchard believes that public money should be really well targeted. Nothing is more damaging than to use public money to fund, on a subsidized-basis, microfinance operations that are already profitable and are able to access various commercial sources. However, it sadly happens too often today. Public agencies or private philanthropists engaged in such activities are crowding out the incipient private sector that can ultimately provide the volume of recurrent funding needed if the industry were to fully meet the demand for financial services in this market.

This does not mean that public or private subsidized money should not be used to fund microfinance. Rather such funds should be targeted at either creating or strengthening the new field delivery capacity (through private equity investments or subordinated lending to smaller MFIs) or at encouraging private commercial investors to enter the microfinance field. International development agencies could, for example, invest in the most subordinated tranches of structured investment products, leaving the most senior tranches to private commercial investors, thereby attracting them to test microfinance investments.

Another very useful area to invest public money is in the development of financial products missing on the market or not readily accessible by international microfinance investors. The most critical of these are foreign exchange hedging mechanisms and political risk coverage. Such opportunities for investment of subsidized public or private money would benefit from a huge leverage by successfully attracting private capital for the long term and would open new markets to long-term private funding of microfinance from hard-currency countries.

Conclusion

BlueOrchard Finance is deeply committed to its social and financial mission and will make a concerted effort to further advance the cause of microfinance in the realm of international commercial investments. It intends to continue partnership with its long-term MFI partners, and global financial institutions, and will hopefully work in cooperation with international development agencies and private philanthropists.

BOOK REVIEW

By Nimal A. Fernando
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Small Customers, Big Market: Commercial Banks in Microfinance. **Edited by Malcolm Harper and Sukhwinder Singh Arora. ITDG Publishing, UK. pp. xii+302**

The microfinance industry has evolved over the past 3 decades from an almost exclusively donor-dependent activity carried out by nongovernment organizations (NGOs) and state-owned specialized financial institutions or state-sponsored programs with a social mission to help the poor, to an industry with commercial prospects. With this evolution, the industry has grown to include an increasingly diverse range of service providers. These service providers include cooperatives, private sector nonbank financial institutions, and small-scale private unit banks. In a number of countries, microfinance NGOs have also been transformed into commercial banks that continue to focus on microfinance. Also, in many countries, conventional commercial banks are getting involved in microfinance in many different ways. This latter trend is important for a variety of reasons. First, specialized microfinance institutions alone can unlikely fill the vast gap between the demand for, and supply of, financial services for the poor on a sustainable basis. Second, commercial banks generally have the potential to scale up financial services for the poor and low-income households much more rapidly than specialized microfinance institutions: many of them have extensive branch networks, strong capital base and easy access to capital, management capacity and systems, a wide range of financial

products and services, and a legal charter to provide a range of services. Third, with the many comparative advantages that they enjoy, commercial banks have the potential to serve the low end of the market at more competitive prices. However, the development community has adequately recognized and harnessed this potential of commercial banks. Commercial banks themselves in general have also not paid much attention to this market potential. However, this is changing. This book focuses on commercial banks participating in this important process of change.

The editors of this book raise a number of pertinent and interesting questions in their introductory chapter: Why should the development community interested in reaching the unserved and underserved poor spend so much money to build entirely new institutions when hundreds of thousands of banking outlets are already in place? What is microfinance, other than the extension of profitable banking to a new market that has not been properly served before? Who could be better qualified to provide banking services to this new market than institutions that are already offering such services to large numbers of customers in the same towns and even the same village? These questions set the broad context for the cases presented in the book and provoke the readers to think outside the box.

The book offers 18 case studies from 15 countries. With the exception of the case of the Equity Building Society of Kenya and Producers Rural Banking Corporation in the Philippines, all other cases cover full-service commercial banks. The case studies show how each institution evolved its approach to microfinance and cover a wide range of modalities: commercial banks that adopted downscaling to enter this market, those that were established from scratch to offer microfinance services, and commercial banks that established subsidiaries to offer microfinance services. Nine of the cases are on Asian countries: Bangladesh, India, Indonesia, Mongolia, Pakistan, and Philippines. The other cases cover institutions in Benin, Egypt, Ecuador, Georgia, Guatemala, Haiti, Kenya, Kosovo, and Zimbabwe. This wide regional coverage allows readers to learn about cross-regional experiences.

Chapter 1 deals with the case of the Microbanking Division of Bank Rakyat Indonesia. Although this chapter covers one of the most successful commercial banking operations in microfinance and an institution that has probably the longest history of involvement in this field, given the already available comprehensive literature on this institution, the chapter does not provide new insights to the readers who are familiar with the existing literature. This is particularly so because the chapter fails to provide details on partial privatization that resulted in significant investments by foreigners in this bank primarily because of the profitability of its microfinance operations.

Of the cases covering Asian countries, the case of ICICI Bank in India (chapter 8) and the case of Khan Bank (chapter 18) deserve special mention. The chapter on the ICICI Bank discusses how the priority sector lending requirement played its part in ICICI's involvement in microfinance. When the ICICI Bank merged with the ICICI Ltd. (a nonbank financial institution), which did not have a priority sector lending obligation, the "merged entity suddenly needed to make a much stronger effort to meet its priority sector targets (imposed by the Reserve Bank of India on commercial banks) and the idea was to find these rural and priority sector assets without having to open a huge number of rural branches" (p. 105). However, ICICI Bank does not seem to look at microfinance merely as a way to meet the priority sector lending requirement. The chapter provides an excellent account of its multi-pronged business approach to microfinance and offers valuable insights to large-scale commercial banks that are interested in microfinance for profit.

The chapter on Khan Bank in Mongolia discusses an important case that offers very powerful lessons on restructuring state-owned agricultural development banks and how their potential can be harnessed effectively to provide quality financial services to low-income households, among others, on a sustainable basis. This case also disproves much of the generally held presumptions relating to agricultural development bank reforms. However, this chapter more or less repeats chapter 3 of the May 2004 publication of the Consultative Group to Assist the Poor (CGAP) on Scaling up Poverty Reduction: Case Studies in Microfinance. The authors unfortunately did not make an effort to provide more recent data than what was presented in the CGAP publication.

Chapter 4 presents the case of state-owned Sonali Bank's wholesale microfinance operations and illustrates how such banks can best participate in microfinance development. The chapter however provides inaccurate information on Bangladesh's second largest NGO/MFI, BRAC (p. 59), and states that microfinance activities of BRAC "have been constituted into a private bank, known as BRAC Bank." BRAC continues its microfinance activities as before and BRAC Bank does not focus on microfinance.

The book taken as a whole is a valuable source of materials on different approaches that commercial banks adopted to provide microfinance services, and the challenges they faced and continue to face in their effort to expand microfinance operations. As the editors noted in their concluding chapter, the experience of the institutions operating in different country-context illustrates that commercial banks can make money through microfinance operations even in difficult operating environments and that poverty of their clientele is not necessarily a barrier to this. Most of the cases also show that commercial banks can be particularly successful in providing valuable deposit services to poor households and in mobilizing large volumes of funds for intermediation. An increasing number of commercial banks seem to be repeating the BRI's success story in deposit mobilization. However, as the cases make clear, commercial banks that are serious about doing well have to adopt the right business model to achieve desired results.

The editors "believe that commercial banks alone have the potential to deliver microfinancial services in the volume and variety that are needed" and "hope that this book

will lead more banks to extend their outreach to greater numbers of poorer people who presently lack access to formal financial services" (p. 292). While their belief appears to be realistic, their hope may appear a bit unrealistic. However, this book certainly is one of the many steps needed to encourage further work on the subject and more commercial bank involvement in microfinance. The book also conveys an important message to other players in the microfinance market: competition is increasing over time and the players should be ready to face it, if they are to survive in the market.

Although the editors and the authors could have done a better job in presenting the cases in a more systematic manner, they should be commended for producing this collection of cases that as a whole provides useful insights on the subject. The book is an important addition to the burgeoning literature on microfinance and is strongly recommended not only for commercial bankers keen to expand their operations into microfinance but also for other practitioners, policy makers, staff of funding agencies, and academics.

[This book is available online at www.developmentbookshop.com]

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