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Introduction

The microfinance industry is increasingly interested in seeing how commercial principles can be used to expand outreach to the poor. Access to demand-driven microfinance provided by sustainable microfinance institutions (MFIs) has proven to be a powerful tool for poverty reduction by improving the ability of poor people to increase incomes, build assets, and reduce their vulnerability during periods of economic hardship (CGAP 2003, p. 5).¹ Based on the successes of a few MFIs in simultaneously expanding outreach and improving financial self-sufficiency, the microfinance field has advanced considerably toward identifying best practices. Despite this progress, it is estimated that about 90% of people in developing countries—about one billion poor people—still lack access to institutional savings services or credit (Robinson 2001, p. 9). In the Asia and Pacific region alone, it is estimated that about 95% of some 180 million poor households still do not have access to institutional financial services (ADB 2000a, p. 1). The MFIs that have achieved the largest outreach to date have increasingly applied commercial principles in their operations and are generally financially self-sufficient. The commercialization of microfinance is, therefore, attracting increasing attention as potential means for narrowing the persistent demand-supply gap for demand-driven, sustainable microfinance products and services.

While microfinance commercialization has been evaluated in a few Latin American countries, relatively less attention has so far been paid to the Asian experience. This report analyzes the major issues surrounding the commercialization of the microfinance industries in four countries in South and Southeast Asia and in the Asia and Pacific region generally. The countries of particular focus—Bangladesh, Indonesia, Philippines, and Sri Lanka—vary considerably in

¹ Microfinance is defined here as the provision of a broad range of financial services including deposits, loans, payments services, money transfers, and insurance to poor and low-income households and their farm or nonfarm microenterprises. An MFI is defined as a single organization (for example, an NGO providing microfinance) or a unit whose primary business is microfinance within a diversified institution (for example, a microfinance unit within a commercial bank).

socioeconomic conditions (Table 1.1) and represent different stages of microfinance development and commercialization of the industry. This report reviews the progress made toward commercialization, examines the implications and challenges of microfinance commercialization, and recommends approaches to promote the commercialization of microfinance while preserving the traditional MFI social objective of expanding the poor's access to financial services. In examining these issues, this report incorporates the perspectives of various stakeholders including microfinance clients and potential clients, microfinance practitioners, government officials, donor community representatives, and academics. It also draws from Latin American experience, as appropriate.

METHODOLOGY AND ORGANIZATION

The four country studies upon which this report is based integrate theoretical considerations drawing from the “financial systems” paradigm² and practical field experience for analyzing the commercialization of microfinance. The examination of issues draws from extensive stakeholder consultations in each country of study through individual and group meetings as well as country workshops. In addition, the main findings and recommendations incorporate data and analysis from relevant local studies and international publications, as noted throughout.

All institutional and financial data presented in this report are based on self-reporting by the MFIs surveyed by the authors, unless otherwise noted. Readers should be mindful that the self-reported data provided are often based on estimates only. This is particularly an issue with nongovernment organization (NGO) MFIs (microfinance NGOs) that do not separate microfinance from social intermediation efforts and with financial institutions, such as commercial banks, rural banks, and cooperatives, that do not differentiate their microfinance operations

² The financial systems approach to microfinance considers microfinance as part of a country's general financial services market, focuses on the development of sustainable (subsidy-free) financial institutions, and recognizes that microfinance clients are willing to pay the full cost of these services if they are designed and delivered efficiently and consistent with clients' specific needs. This approach also recognizes the importance of policy environment and financial infrastructure for development of a robust financial system (Otero and Rhyne 1994; Von Pischke 1988).

Table 1.1: Comparison of Country Contexts^a

Selected Socioeconomic Indicators	Bangladesh	Indonesia	Philippines	Sri Lanka
Demographics				
Population (million)	133.4	213.6	77.0	19.7
Rural population (%)	74	58	41	77
Land area (square kilometer)	144,000	1,904,570	300,000	65,610
Population density	926	112	257	300
Population growth rate (%)	2	2	2	1
Human Development Index	0.478	0.684	0.754	0.741
Life expectancy at birth (year)	61	66	69	73
Mortality rate (less than 5 years old/1,000)	83	51	39	18
Literacy rates				
(% adult males, % adult females)	53, 31	92, 83	96, 95	95, 89
Population living under the poverty line (%)	45	27	37	25
Rural population (%)	74	58	41	77
Infrastructure				
Electricity consumption				
(kilowatt hour/capita)	89	345	454	255
Paved roads (% of total roads)	10	46	21	95
Economy				
Inflation (%)	2	13	7	14
GDP growth (%)	5	3	3	3
GDP components:				
Services (%)	52	37	54	55
Industry (%)	25	47	31	26
Agriculture (%)	23	16	15	19
GNI/capita, Atlas method (current US\$)	370	680	1,050	830

^a Figures reflect most recent reliable estimates available during 1997–2001.
GDP = gross national product; GNI = gross national income.

Source: World Bank 2002; UNDP 2002.

from their larger-scale financial intermediation in accounting or operational terms.

The remainder of this chapter provides the analytical framework for considering issues surrounding the commercialization of microfinance. Chapter 2 gives an overview of progress toward microfinance commercialization in each country studied, highlighting differences and reasons for them. Chapter 3 analyzes several key issues surrounding the commercialization of microfinance. Chapter 4 discusses several approaches to microfinance commercialization with emphasis on roles for governments, donors, practitioners, and support institutions. The report concludes with a discussion on the future of microfinance commercialization and remaining unresolved issues.

FRAMEWORK FOR UNDERSTANDING COMMERCIALIZATION OF MICROFINANCE

Commercialization means different things to different people but international microfinance professionals are increasingly considering commercialization to be “the application of market-based principles to microfinance” or “the expansion of profit-driven microfinance operations” (e.g., Poyo and Young 1999; Christen 2000). There is a growing realization in the international arena that commercialization allows MFIs greater opportunity to fulfill their social objectives of expanding the poor’s access to an array of demand-driven microfinance products and services (including not only credit but also savings, insurance, payments, money transfers, etc.). As highlighted in the Rural Asia Study by the Asian Development Bank (ADB) (ADB 2001), it is evident that a commercial approach is essential for microfinance development if the services are to be expanded to reach the majority of excluded clients and to provide a wide array of services on a sustainable basis. Most MFIs that have incorporated commercial principles into their operations have done so with the expectation that it will allow them to grow exponentially on the basis of borrowed or intermediated funds (Christen and Drake 2002, p.3). In the absence of commercial approaches, the prospects are not good for reaching a significant number of potential clients with quality and diverse services on a permanent basis.

This report adopts a comprehensive view of microfinance commercialization. It considers commercialization at micro and macro levels, proposing that it involves both institutional factors (MFI commercialization) and attributes of the environment within which MFIs operate (commercialization of the microfinance industry).

MFI Commercialization

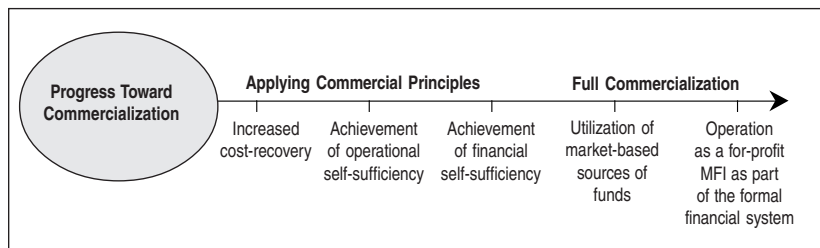
MFI commercialization is not a straight-forward issue of finally turning a profit or attaining institutional financial self-sufficiency. Rather, it should be considered as progress along a continuum, as depicted in Figure 1.1 and described as follows.

- Adoption of a professional, business-like approach to MFI administration and operation, such as developing diversified,

demand-driven microfinance products and services and applying cost-recovery interest rates.

- Progression toward operational and financial self-sufficiency by increasing cost recovery and efficiency, as well as expanding outreach.
- Use of commercial sources of funds; for example, nonsubsidized loans from apex organizations (wholesale lending institutions) or commercial banks, mobilization of voluntary savings, or other market-based funding sources.
- Operation as a for-profit, formal³ financial institution that is subject to prudential regulation and supervision and able to attract equity investment.

Figure 1.1: Illustrative Attributes of MFI Commercialization



Progress toward MFI commercialization is usually hastened by a strategic decision of an MFI’s owners/managers to adopt a for-profit orientation accompanied by a business plan to operationalize the strategy to reach full financial self-sufficiency and to increasingly leverage its funds to achieve greater levels of outreach. Recognition

³ Providers of institutional financial services can be formal or semiformal financial institutions. “*Formal institutions* are defined as those that are subject not only to general laws and regulations, but also to banking regulation and supervision. Semi-formal institutions, are those that are formal in the sense of being registered entities subject to all relevant general laws, including commercial laws, but informal insofar as they are, with few exceptions, not under banking regulation and supervision. *Informal providers* (generally not referred to as institutions), are those to which neither special banking law nor general commercial law applies, and whose operations are such that disputes arising from contact with them, often cannot be settled by recourse to the legal system” (Ledgerwood 1999, p.12–13).

that the key to achieving substantial levels of outreach is building a sound financial institution essentially means that an MFI needs to charge cost-covering interest rates and continually strive for increasing operational efficiency.

Advocates of this approach rightly argue that charging cost-covering interest rates is feasible because most clients would have to pay, and many indeed do pay, even higher interest rates to informal moneylenders.⁴ MFIs that charge cost-covering interest rates are an attractive option for this clientele even though the interest rates that an MFI might charge may seem high relative to the corresponding cost of borrowing from a commercial bank. The relevant basis for interest rate comparisons in the eyes of the client is the informal sector where she or he usually can access funds, not the commercial banking sector, which rarely serves this market (Internationale Projekt Consult GmbH 2002).

As an MFI's interest and fee revenue covers first its operating costs and then the cost of its loanable funds, it may be considered to be increasingly operating on a commercial basis. MFI profitability enables expansion of operations out of retained earnings or access to market-based sources of funds. The more efficiently an MFI operates, the more profitable it will be, which allows it to achieve greater outreach. In this way, outreach, profitability, and efficiency can be considered interrelated and useful indicators to gauge the performance of commercial MFIs. However, it is important to remember that commercialization is no magic formula for success: even a commercial MFI can perform poorly. Having a commercial structure in terms of private ownership and access to market-based sources of funds does not necessarily mean that the management and operational capabilities are sufficient to ensure high performance.

Operating as a for-profit, formal financial institution may be the most complete hallmark of MFI commercialization because this implies subjectivity to prudential regulation and supervision and that the MFI has become fully integrated into the formal financial system. However, MFIs strive for varying degrees of commercialization; not all aim to become formal financial institutions. The degree of profit orientation

⁴ However, it is important to note that there are no reliable data on outreach of informal moneylenders by poverty level of their clients. In the absence of such data, the assumption that most poor households do borrow from informal sources at high interest rates may be questionable.

is primarily driven by the nature of the MFI's funding and the decision to formalize is usually closely linked to a host of external factors, which are discussed next.

Commercialization of the Microfinance Industry

Determination of the extent to which the microfinance industry is “commercial” is not solely dependent on the nature of the supply of microfinance by a variety of MFIs but rather takes into account elements of the operating environment that enable or constrain the provision of or access to commercial microfinance. These elements are the policy environment, legal framework, regulation and supervision, accessibility of different types of commercial funding sources, and the existence of a range of support institutions. The extent to which a country's microfinance industry may be considered commercial is contingent on the following.

1. Policy Environment

- Absence of government policies that impede the ability of MFIs to make progress toward commercialization (examples of policies that may hamper MFI commercialization are interest rate caps and selective, ad hoc, debt-forgiveness programs).
- Absence of subsidized (government or donor-supported) microcredit programs that may inhibit the development and growth of commercial MFIs and hinder competition.

2. Legal Framework

- Presence of the legal framework for secured transactions (the creation [legal definition], perfection [registration], and repossession [enforcement] of claims) as well as for microenterprise formation and growth (Fleisig 1996, p. 45; Lyman 2000, p. 39–41).
- Licensing options available to new MFI entrants or semiformal MFIs interested in transforming into formal financial institutions.

3. Regulation and Supervision

- Existence of prudential regulations and supervision practices that govern MFIs' mobilizing voluntary public deposits specifically or financial institutions in the broader financial markets generally,

and institutional capacity of the regulating body to effectively carry out its mandate.

4. Money Markets and Capital Markets

- Availability and access of MFIs to commercial sources of funds, such as nonsubsidized loans from apex organizations (wholesale lending institutions) or banks, mobilization of voluntary savings, private investment funds, or other market-based funding sources.

5. Support Institutions

- Existence of credit information collection and reporting services, such as credit information bureaus and credit rating agencies, that capture information useful to MFIs regarding borrower creditworthiness, loans outstanding, types of collateral pledged, etc., or to potential MFI investors. Examples include ratings of MFIs based on their portfolio quality and asset values; microfinance trade associations and networks; local microfinance technical assistance providers and training institutions; and domestic providers of business development services.