2 Progress Toward Microfinance Commercialization

Although the outreach of Asian MFIs is impressive when compared with other regions of the world, most MFIs in Asia have not reached operational self-sufficiency (OSS) and very few have achieved financial self-sufficiency (FSS),[5] unlike many MFIs in Latin America. More importantly, most MFIs do not show a significant commitment to achieving FSS. The lack of commitment of the majority, however, is overshadowed by commendable efforts being made by a few MFIs in this direction.

The country studies found that countries with strong enabling environments also have MFIs that have made significant progress toward commercialization. The presence of many attributes of an enabling environment in Indonesia, for example, has contributed to the ability of commercial MFIs to provide more than 80% of the total number of microloans supplied in the country. Utilizing the conceptual framework for assessing commercialization of the microfinance industry described above, Table 2.1 shows that the operating environments of Indonesia and the Philippines have been more conducive to the commercialization of microfinance than those in Bangladesh and Sri Lanka.

Indonesia and the Philippines began deregulating their financial systems earlier, and have proceeded further along the commercialization continuum, than countries in South Asia, such as Bangladesh and Sri Lanka. Indonesia and the Philippines also lead the Asia and Pacific region in terms of establishing a legal and regulatory framework friendly to the establishment of formal, small-scale banks conducive to offering microfinance on a commercial basis. Liberalized bank entry and branching in Indonesia in the 1980s and in the Philippines in the 1990s allowed banks, rural banks in particular,

[5] Operational self-sufficiency (OSS) requires MFIs to cover all administrative costs and loan losses from operating income. This is calculated by dividing operating income by operating expenses. Financial self-sufficiency (FSS) requires microfinance programs to cover all administrative costs, loan losses, and financing costs from operating income, after adjusting for inflation and subsidies and treating all funding as if it had a commercial cost (MicroBanking Bulletin 2003, p. 52–53.).

Table 2.1: Attributes of Microfinance Commercialization

MFI Commercialization	Bangladesh	Sri Lanka	Philippines	Indonesia
Microfinance is provided by MFIs that				
· attempt to recover costs	*	*	***	***
· have achieved operational self-sufficiency	**	*	**	***
· have achieved financial self-sufficiency	*	*	**	***
· access commercial sources of funds at market-based rates of interest (commercial bank loans, voluntary savings mobilization, etc.)	*	*	**	***
· are formal, regulated MFIs	*	*	**	***
Conduciveness of the Operating Environment to Commercialization				
1. Policy Environment				
MFIs are allowed to charge cost-recovery interest rates	yes	yes	yes	yes
Minimization of ad hoc debt forgiveness by government	*	*	**	***
Removal of subsidized, directed microcredit	–	–	*	*
Minimization of soft loans and grants by donors	–	–	*	**
2. Legal Framework				
Extent to which framework for secured transactions allows pledging of nontraditional collateral (movable assets, etc.)	*	*	**	***
Suitable licensing options for new MFI entrants or semiformal MFIs interested in transforming into formal financial institutions	–	*	***	**
3. Regulation and Supervision				
Extent of specialized regulation and supervision for microfinance	–	–	***	*
Capacity of the entity authorized to regulate MFIs to fulfill its mandate effectively	–	–	**	*
4. Money Markets and Capital Markets				
Availability of wholesale loan funds at market-based interest rates	–	–	*	*
Extent that commercial banks lend to MFIs without guarantee mechanisms	–	–	*	**
5. Support Institutions				
Existence of a credit information bureau that captures information concerning microcredit	–	–	*	*
MFI performance standards are in place	–	–	**	–
Extent that MFI performance data are collected and MFI performance ratings are conducted	*	–	**	–
Active microfinance association(s) or network(s)	*	*	**	*
Strong local providers of microfinance training	–	–	*	–

Key: – zero/no; * few/low/small extent; ** moderate number/moderate extent;
*** majority/high/large extent.

to expand access to financial services in traditionally underserved areas of these countries. By the end of 2001, Indonesia had more than 2,100 rural banks and the Philippines, about 786. Bangladesh and Sri Lanka do not have the legal framework to support the establishment of privately-owned unit banks whose locations, small sizes, and lower minimum capital requirements make them well suited to providing commercial microfinance.

Central bank reforms in Indonesia and the Philippines in the 1990s also contributed to a conducive environment for commercial microfinance. In the Philippines, a new central bank was established in 1993 with a mandate to maintain price stability and to regulate and supervise banks and quasi-banks. The central bank is explicitly prohibited from engaging in development banking or financing (ADB 2000b, p. 20). In Indonesia, a new central banking law was enacted in 1999, narrowing its mandate to maintaining the stability of the currency. The function of prudential supervision is to be transferred to a new institution and the central bank's previous role as an "agent of development" has been abolished. Both these shifts in central bank roles contributed to decreasing the number of subsidized credit programs being implemented by the central bank (and the amount of credit involved) and improved the climate for private provision of commercial microfinance.

BANGLADESH

The microfinance industry in Bangladesh has a long history of subsidy dependence. Dominated by the Grameen Bank and microfinance NGOs, microfinance in Bangladesh has historically operated mostly on a noncommercial basis, although two of the largest such NGOs, the Association for Social Advancement (ASA) and the Bangladesh Rural Advancement Committee (BRAC), are commercially viable and currently mobilize 33.7% of the total microsavings deposited and supply 41.0% of the total microcredit (Table 2.2). However, even these two microfinance NGOs access subsidized funds for onlending through the heavily donor-supported apex institution, *Palli Karma-Sahayak* Foundation (PKSF). A requirement of borrowing from PKSF is that the onlending annual interest rate not exceed 15% (flat). While ASA has often turned down direct donor funding, both continue to access "cheap" PKSF funds (provided at 4.5–7.0% for 3–4 year terms, which is less than half the prime rate). PKSF's onlending interest rate ceiling generally acts as a disincentive for MFIs to charge sustainable interest rates, making cost coverage difficult if not impossible for most microfinance NGOs and inhibiting commercial providers.

Table 2.2: Microfinance Supply in Bangladesh
As of end-2002, unless otherwise noted

	No. Members ('000)	No. Active Borrowers ('000)	Outstanding Loans (Tk million)	Average Outstanding Loan Amount (Tk)	Net Savings (Tk million)
Large microfinance NGOs:					
BRAC	3,532	2,918	9,143	3,144	4,984
ASA	2,136	1,976	8,094	4,096	2,405
Proshika	2,923	1,586	4,751	2,977	1,616
Subtotal of large microfinance NGOs	**8,591**	**6,480**	**21,988**	**3,393**	**9,005**
Medium-sized microfinance NGOs[a]	2,494	1,831	4,756	2,597	2,118
Small microfinance NGOs	1,752	1,141	3,214	2,817	1,745
Subtotal of all microfinance NGOs	**12,837**	**9,452**	**29,888**	**3,169**	**12,868**
Grameen Bank	2,483	2,483	12,663	5,100	8,952
BRDB	3,635	–	317	–	–
Ministry of Youth and Sports	549	–	479	–	–
PDBF	360	–	1,007	–	–
WEDP (12/31/2000)	177	–	130	–	–
Total	**20,041**	**11,935**	**44,484**	**3,732**	**21,820**

[a] Medium-sized microfinance NGOs include the remaining "top 20: microfinance NGOs in terms of membership and over Tk85 million (US$1.5 million) in outstanding loans as of Dec. 31, 2002.

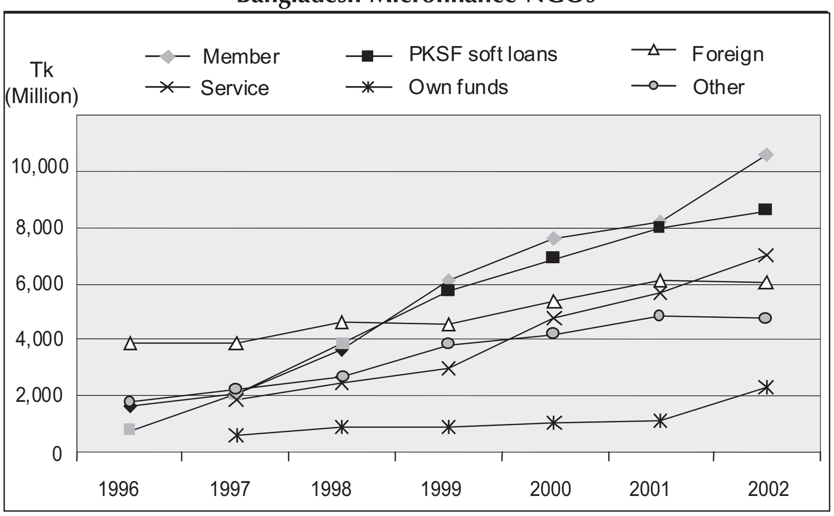
ASA = Association for Social Advancement; BRAC = Bangladesh Rural Advancement Committee; BRDB = Bangladesh Rural Development Board; NGO = nongovernment organization; PDBF = *Palli Daridro Bimochon* Foundation; WEDP = Women Entrepreneurship Development Programme.

Source: CDF 2003.

At the end of 2002, grants and concessional funds accounted for about 37% of the loanable funds for the microfinance industry. Contrary to popular opinion, donor funding to the microfinance sector has been rising in absolute terms. On the positive side, MFIs are accessing more loan funds than before, albeit at subsidized interest rates, rather than relying primarily on grants to capitalize their loan portfolios. In addition, past grants and soft loans have helped a few NGOs to develop their own capital base and to benefit from economies of scale as they rapidly expanded.

In addition to grants and soft loans, other major sources of funds include member (voluntary and mandatory) savings (27%), followed by service charges (18%) and credit extended by local banks (8%) on a nonsubsidized basis. The amount of member savings is growing rapidly (Figure 2.1). Microfinance NGOs' income from service charges and fees is also increasing, although at a slower rate. These trends represent a shift away from grants to use of savings and other sources of funds, pointing to gradual commercialization of microfinance funding sources.

Figure 2.1: Trends in Sources of Revolving Loan Funds for Bangladesh Microfinance NGOs



Source: Credit and Development Forum 2003, and previous years.

However, most of the nearly 700 microfinance NGOs remain small, capacity-constrained institutions. In addition to their poor management and operating performance, many small NGOs and programs simultaneously operate (pre-credit) social mobilization efforts and (post-microcredit) business development services or "credit plus" activities that cloud their financial performance and hinder their ability to become financially viable. Given the level of subsidy dependence in microfinance in Bangladesh, there is only a minute presence of private commercial banks in this field and their operations are also subsidized.

INDONESIA

The Indonesian microfinance industry is exceptionally old and one of the most commercial in the world in terms of its provision of microfinance with large-scale and sustainable outreach. The industry is heterogeneous, but the dominant players are formal and fund their operations through deposit mobilization and bond issuances. One of the best known MFIs, being the largest in the world, is the *Bank Rakyat Indonesia*'s (BRI) Micro Business Division (referred to as the BRI Units). Also important until recently was *Bank Dagang Bali* (BDB) as one of the first commercial banks established (in 1970) primarily to serve low-income and poor clients. While the only microfinance windows of the banking sector with national coverage are the BRI Units, BDB had regional significance with 31 branches and offices located mainly on the island of Bali.[6]

Other major commercial MFIs include 714 outlets of a state-owned pawning company (*Perum Pegadaian*, or PP), which in 2001 provided 22.2 million microloans to about 15.7 million clients, and the 2,143 locally-owned people's credit banks (*Bank Perkreditan Rakyat*, or BPR), which on a combined basis in 2001 accounted for about 15% of the total microfinance market by number of microloans and microdeposits. Although performance is extremely varied across institutions, the provision of microfinance by the system of BPRs is considered highly commercial by virtue of their formality and reliance on deposits as their main source of funds. Table 2.3 presents recent supply data from Indonesian MFIs.

One of the most important first steps Indonesian policymakers took to provide a conducive operating environment for commercial MFIs was to liberalize interest rates in 1983, which set the stage for MFIs to charge cost-recovery rates and maintain spreads that allowed for profitability. In addition, high-level political support for the transformation of BRI Units during 1983/84 from agricultural credit disbursement centers to a commercially-oriented system for micro- and small-scale lending and deposit services resulted in an increase in microfinance services for 27 million savers and 2.8 million borrowers by the end of 2001 (BRI 2001a, p. 44). In addition, a tiered legal and regulatory framework stemming from 1988 banking reforms allowed

[6] BDB was closed by the Indonesian central bank in April 2004 because of noncompliance with prudential regulations.

Table 2.3: Indonesian Microfinance Supply Data, 2000–2002

MFI Name/ Type	Units No.	O/S Loans No.	%	O/S Loans (Rp billion)	%	Total Deposits No.	%	Total Deposit (Rp billion)	%
Formal MFIs									
BDB	31	9,311	0.1	57	0.3	242,146	0.7	190	0.6
BRI Units	4,063	2,790,000	23.2	9,841	43.5	27,040,000	77.5	21,991	74.2
BPRs	2,143	1,900,000	15.8	6,420	28.4	5,200,000	14.9	5,597	18.9
Perum Pegadajan	714	5,230,743	43.4	1,355	6.0	–	0.0	–	0.0
Semiformal MFIs									
LDKPs	1,603	500,000	4.2	337	1.5	871,000	2.5	342	1.2
BKDs	4,518	658,871	5.5	198	0.9	571,744	1.6	38	0.1
Cooperatives									
KSPS	1,097	655,000	5.4	531	2.3	655,000	1.9	85	0.3
USPs	35,218	–	0.0	3,629	16.0	–	0.0	1,157	3.9
Credit Unions	1,071	296,000	2.5	272	1.2	296,000	0.8	249	0.8
Total	**50,458**	**12,039,925**	**100.0**	**22,640**	**100.0**	**34,875,890**	**100.0**	**29,648**	**100.0**

BDB = *Bank Dagang Bali*; BKD = *Badan Kredit Desa*; BPR = *Bank Perkreditan Rakyat*; BRI = *Bank Rakyat Indonesia*; KSP = *Koperasi Simpan Pinjam*; LDKP = *Lembaga Dana Kredit Pedesan*; MFI = microfinance institution; O/S = outstanding; USP = *Unit Simpan Pinjam*.

Notes: **BDB**: all figures reflect self-reported data as at end-2001 (BDB was closed by the Indonesian central bank in April 2004 because of noncompliance with prudential regulations); **BRI Units**: data are as of end-2001 (BRI 2001a, p. 44)—units are BRI Units (3,823) and village service posts (PPDs) (240); **BPRs**: data are as at 30 September 2002 from Bank Indonesia 2003; ***Perum Pegadaian***: data are as of end-2001—units are number of branches (BI 2001a, p. 147), the total number of outstanding loans is based on 15.7 million customers served in 2001 (with an average loan maturity of 4 months), and the total outstanding loan amount is from ADB (2003); **LDKPs**: estimates are for 30 June 2000 for 7 of 8 types of LDKPs (Holloh 2001, p. 34); **BKDs**: data are as of 31 July 2002, provided by the BRI Head Office—the number of units equals the active number of BKDs; **Cooperatives**: data are as of 30 April 1999, based on estimates presented in BI (2003) and ADB (2003); **Credit Unions**: data are as of end-2001 (ADB 2003).

the expansion of unit (rural) banks conducive to commercial microfinance operations throughout Indonesia.

PHILIPPINES

In contrast to Bangladesh and Sri Lanka, the Government and donors in the Philippines have been very constructive about moving microfinance commercialization forward. The Government established the National Credit Council (NCC) in 1994 to rationalize government directed credit programs and developed a national credit delivery system capable of addressing the issues of poverty. The NCC's focus has been exclusively on small credit and microcredit, and one of its early tasks was to draft and disseminate Policy Guidelines for Credit for the Poor for government agencies implementing lending programs. In 1997, the NCC published the National Strategy for Microfinance, which has set the national framework for microfinance, emphasizing the role of the private sector including MFIs, and the need for an enabling policy environment. With the National Strategy for Microfinance in place, several laws and executive directives have been issued over the last few years to make it effective. A major United States Agency for International Development (USAID)-funded project, the Credit Policy Improvement Project, has been supporting implementation of these positive initiatives.

Three main types of retail MFIs currently serve the market: a sizable proportion of the 2,865 cooperatives registered with the Cooperative Development Authority (as of 1997; ADB 2001, p. 3), about 500 of approximately 900 microfinance NGOs, and at least 100 of 786 rural banks. The oldest of these suppliers are the cooperatives, which began in the early 20th century. The focus on commercializing cooperatives including their provision of specialized microfinance services is relatively recent and actively promoted by various government and donor efforts, through technical assistance, training, and funding support.

Initiated in 1952, the rural banks continue to be the dominant provider of commercial micro- and small-scale financial services to a wide range of peri-urban and rural entrepreneurs. Low minimum capital requirements for rural banks have meant that the formal financial system has had much greater microfinance outreach than in most countries. Rural banks, for example, supply 4.7 million deposit accounts, covering about a third of total households in the Philippines, and contribute about 20% of the total number of deposit accounts in the country. This is especially remarkable considering that 91% of deposit accounts at rural banks had balances less than P15,000 (US$300) as of March 2002. Given the suitability of rural banks for engaging in the sustainable provision of microfinance, the USAID-funded Microenterprise Access to Banking Services (MABS) program has been working over the last few years to bring about a sizable expansion of loan and deposit services to microenterprises and other groups at lower socioeconomic levels by assisting participating rural banks to increase significantly the services they provide to the microenterprise sector.

Since the 1980s, the number of NGOs providing microfinance has steadily increased, targeting poor populations traditionally without access to financial services other than from informal providers. Each of these retail MFIs has expanded its provision of microfinance because of numerous recent and ongoing government- and donor-supported programs to expand microfinance outreach to the poor on a commercial basis. However, relatively few of them are familiar with microfinance technologies and microfinance markets as profitable opportunities. This is mainly because of the relatively recent emphasis of the Government and donors on commercial approaches to microfinance stemming from the 1994 creation of the NCC. The total microcredit clientele supplied is currently estimated to be around one million poor and low-income people, or about 20% of the total number of poor households. Numerous microfinance NGOs are trying to fill the demand gap, but the vast majority remain small, capacity-constrained institutions that have more of a social than commercial focus (Llanto 1997, p. 2).

Despite the increase in the number of microfinance NGOs, the highest growth in commercial microfinance provision is clearly coming from formal financial institutions employing a commercial approach to microfinance. For example, several microfinance NGOs have established microfinance-oriented rural banks or thrift banks in order to scale-up their activities, and more plan to do so. In addition, existing cooperatives and rural banks are increasing their microfinance operations, in large part because of donor-supported technical assistance and training focused on increasing their provision of sustainable microfinance. Also, the market is attracting new entrants, such as the MicroEnterprise Bank (MEB), which was established with the primary mission of providing microfinance on a commercial basis.

SRI LANKA

In contrast to Indonesia, the microfinance market in Sri Lanka is dominated by cooperatives and government microcredit programs. As in Bangladesh, Sri Lanka's microfinance industry also has long been subsidy dependent. The cooperative sector in particular has a long history of heavy-handed government involvement. More than one third of the microcredit supply is provided through government programs that are considered supply led and not commercially viable.

Organizations based on the cooperative model, such as the 311 cooperative rural banks (CRBs) and their 1,196 branches (at the end of 2001), more than 8,000 registered primary societies of the thrift and credit cooperative societies (TCCSs), and a few microfinance NGOs, have made the most progress toward commercialization, although the performance of individual institutions within each of these categories has been highly mixed. Cooperatives have been successful in mobilizing deposits, but the CRBs suffer from politicization of the multipurpose cooperatives for which they serve as the banking arms, and the TCCSs continue to serve as conduits for a few government-subsidized credit programs. In addition, cooperatives remain under the regulation and supervision of the Department of Cooperatives rather than the Central Bank of Sri Lanka, a situation that also contributes to diminishing incentives for moving toward a more business-like approach to providing microcredit.

The most commercial of these providers, in terms of their achievements in financial self-sufficiency and access to commercial sources of funds, are together estimated to mobilize virtually all of the small savings deposited but provide only one third of the total microcredit borrowed. The noncommercial providers of microfinance include numerous unsustainable government microfinance programs, many poorly performing CRBs[7] and TCCSs, and around 200 weak, small and medium-sized microfinance NGOs. Table 2.4 presents supply data from MFIs in Sri Lanka.

Because of the presence of highly subsidized microcredit, only a few private commercial banks are engaged in the sector. These include Hatton National Bank (HNB), Seylan Bank, and Sampath Bank. However, their combined number of microloans outstanding was only 1.2% of the industry total at the end of 2000 and none of their microfinance programs were profitable, despite their adoption of some nontraditional delivery methods based on microfinance best practices. The interest rate charged by these lenders is insufficient to cover the total cost of their microfinance operations, especially considering that

[7] CRBs, being an arm of multipurpose cooperative societies, do not have separate financial statements. Therefore, it is difficult to be precise on their profitability. However, CRBs have considerable potential to be viable providers of microfinance services.

Table 2.4: Sri Lanka Microcredit Supply
As of 30 June 2001, unless otherwise noted

Institution/ Program	Microcredit (Number of Active Loans)	Microcredit Amount Outstanding (SLRs million)	Average Microcredit Amount (SLRs)	Microcredit Amount Outstanding (US$ million)	Average Microcredit Amount (US$)
Bank of Ceylon[a]	100,241	1,831	18,266	20.3	203
People's Bank[a]	194,000	1,940	10,000	21.6	111
SBSs[b]	326,236	2,070	6,345	23.0	71
HNB[b]	9,237	379	41,031	4.2	456
Seylan Bank[b]	4,500	99	22,000	1.1	244
Sanasa Dev. Bank[b]	6,270	128	20,415	1.4	227
RDBs[c] (12/31/2000)	80,860	3,234	40,000	35.9	444
CRBs[d] (12/31/2000)	577,622	4,950	8,570	55.0	95
TCCSs[e]	252,682	2,845	11,258	31.6	125
SEEDS[f]	240,383	679	2,827	7.5	31
Janashakthi[g] (7/31/2001)	17,654	86	4,854	1.0	54
Total	**1,809,685**	**18,242**	**10,080**	**202.7**	**112**

CBSL = Central Bank of Sri Lanka; CRB = cooperative rural bank; HNB = Hatton National Bank; RDB = rural development bank; SBS = Samurdhi Banking Society; SEEDS = Sarvodaya Economic Enterprise Development Services; TCCS = thrift and credit cooperative societies.

[a] Bank of Ceylon and People's Bank figures reflect self-reported estimates of outstanding loans of SLRs5,000–100,000 (US$55 –1,100).

[b] SBS, HNB, Seylan Bank, and Sanasa Development Bank data reflect self-reported estimates of outstanding microcredit (loans up to SLRs 40,000).

[c] RDB data are based on the self-reported estimate of 80% of their disbursed loans being microcredit. This approximate percentage of microcredit and average loan size of SLRs40,000 (US$444) are based on conversations with RDB and CBSL staff.

[d] CRB data are based on CRB and CBSL staff estimates that 80% of CRB's outstanding loans could be considered as microcredit.

[e] TCCS data reflect self-reported estimates by the TCCS federation for microcredit outstanding.

[f] SEEDS data are self-reported estimates for microcredit outstanding.

[g] Janashakthi data are based on self-reported disbursements data for 2000 and average microcredit loan size of SLRs4,854 (US$54) as of 31 July 31 2001.

most provide costly nonfinancial services in addition to microcredit. Even if the nonfinancial services are excluded for pricing purposes, these banks do not seem to want to charge cost-recovery interest rates on their microcredit for fear of criticism that they charge higher rates on loans to the poor than to their traditional nonpoor clients.