

3 Critical Issues in Microfinance Commercialization

The extent of commercialization in the microfinance industry varies from country to country. It is evident that there has been greater microfinance commercialization in Southeast Asia than in South Asia. The main reasons are the difference in attitudes toward commercialization and the roles that governments play in enabling or discouraging commercial microfinance. Perceptions matter because they can influence policies. Therefore, the basis for positive and negative views of commercialization are explored in this chapter. Experience counts too, and the long history of microfinance in the region provides some empirical evidence concerning the correlation of commercialization with different attributes of outreach, institutional size, ability to attract private risk capital, mission drift, and competition. This evidence may shape future perceptions of commercialization and affect progress toward it. These and other major issues concerning the commercialization of microfinance are analyzed next.

THE PERCEPTION PROBLEM

The commercialization of microfinance is a relatively accepted prerequisite to the sustainable expansion of outreach commensurate with demand by the poor in the Philippines. The term “commercialization” is associated by many Filipino stakeholders with “the adoption by MFIs of market-based principles in their microfinance activities regardless of whether they are under prudential or non-prudential government regulations” (Almario 2002, p. 3). This concept of commercialization is generally in line with how microfinance professionals worldwide view the term. There is a growing realization that commercialization allows MFIs greater opportunity to fulfill their social objectives of providing the poor with increased access to an array of demand-driven microfinance products and services (including not only credit but also savings, insurance, utility and other payments, money transfers, etc.).

However, this positive view of microfinance commercialization is not shared as widely in other countries of the Asia and Pacific region. For example, even in Indonesia where commercialization has progressed, the majority of stakeholders dislike the term *commercialization* because they associate it with taking advantage of the poor for the sake of profit. This is despite their general acceptance of many of the principles associated with commercialization, such as financial self-sufficiency, extensive outreach, and high operational efficiency. While in practice, the Indonesian microfinance industry is dominated by commercial players and institutional sustainability is generally accepted as a prerequisite for the expansion of outreach (the substance of commercialization), terminology remains an issue. Most practitioners in Indonesia prefer to use the term *business orientation* to reflect the positive aspects of commercialization. Euphemisms, such as “surplus,” are traditionally used in place of “profit” and institutional sustainability is used as an acceptable catch-all phrase indicating many of the principles of commercial microfinance elaborated in this report.

Commercialization is a relatively new consideration in South Asian countries, such as Bangladesh and Sri Lanka. As with most Indonesian stakeholders, the term commercialization carries with it a negative connotation of exploiting the poor for profit. Sri Lanka has had a long history of benevolent approaches to poverty reduction and state subsidies, which contribute to resistance to the term. Likewise, domination of the microfinance industry in Bangladesh by NGOs having a strong social orientation contributes to some resistance to the term there. In both cases, continued strong subsidization of the industry underscores these beliefs that commercialization would be bad for the poor and would sabotage rather than assist in the development of the microfinance industry.

Persistence of negative attitudes toward commercialization is not unique to microfinance, indicating that they may also be due to problems of translation. Sanderatne (2002, p. 2) points out that, “negative connotations are far worse in most national languages as they connote big business, multinationals, capitalism and exploitation of the poor.” The issue of terminology may unnecessarily hinder wider acceptance of the principles underlying commercialization and the development of an enabling environment to achieve it. Although terminology may not explain all the reasons why some stakeholders do not accept commercialization as a means to expanding microfinance on a sustainable basis commensurate with demand, alternate phrases

such as “business orientation” that would depend on the local language and social norms may be more conducive to the commercialization of microfinance.

WHAT IS THE CORRELATION BETWEEN COMMERCIALIZATION AND OUTREACH?

The term *outreach* is generally used to describe the provision of services to a target market. Broadly, however, outreach has many different aspects. Four of the most commonly considered attributes of outreach are breadth (number of clients served), depth (extent to which the poor are served), scope (range of products offered), and sustainability of services (permanence of service provision). The relationship between several attributes of commercialization and these different aspects of outreach are summarized in Box 3.1 and the performance of commercial MFIs in each of these areas is analyzed below.

Breadth of Outreach

Breadth of outreach is usually measured by the number of clients served with microfinance products and services. In South and Southeast Asia, it is greatest in Bangladesh and Indonesia with about 12 million outstanding microloans in each country at the end of 2001. Commercial MFIs have achieved the largest breadth of microsavings outreach in Indonesia, where the BRI Units alone supply more than 27 million deposit accounts, serving about half the total number of households (Table 3.1).

Indonesia is also the world’s leader in terms of the percentage of microcredit supplied on a commercial basis, estimated to be more than 80% of the industry total. Savings mobilization there by predominantly formal MFIs has fueled broad microcredit outreach. Interestingly, the market leader in terms of number of microloans is the profitable state-owned pawning company, *Perum Pegadaian* (PP), with 43% of the total outreach. The BRI Units and BPRs combined provide 39% of the total number of outstanding microloans but 72% of the volume.

Perhaps most remarkable about the Indonesian experience is that commercialization has allowed the sustainable expansion of

Box 3.1: Commercial Microfinance – Outreach Nexus		
Commercial Attribute	Results	Impact on Outreach
Commitment to financial self-sufficiency and profitability	Charge at least cost-recovery lending interest rate	More sustainable outreach (improved continuity of services)
Improved efficiency	Continually reduce operating and other costs; lower prices for clients	Increased depth of outreach
Focus on client needs and preferences	Design of more demand-driven, flexible financial products	Improved scope, breadth, and depth of outreach
More formal institution with transparent operations	Access to a wider menu of commercial sources of funds	Increased breadth of outreach
Commercialization breeds increasing competition	MFI's vie to retain and continue to attract new clients by going up-market, down-market, or tapping into new geographic locations or client types (sectors)	Increased breadth and/or depth of outreach

microsavings services on an unprecedented scale in addition to expanding access to microcredit. For example, at the end of 2001, savings mobilized by the BRI Units in the *Simpedes* savings product alone (Rp15.9 trillion, or US\$1.5 billion) equaled 1.61 times the amount of their total outstanding loan portfolio (Rp9.8 trillion, or US\$946.3 million). Deposit mobilization is also important for BPRs, which on a

Table 3.1: Comparisons of Breadth of Microcredit Outreach

Country	Total number of households (million)	Number of poor households (million)	Number of outstanding microloans (million)	Number of outstanding borrowers/ Number of poor households (%)	Estimated percentage of microcredit supplied on a commercial basis ^a (%)
Bangladesh	23.4	10.5	12.0	113.8	42.0
Indonesia	47.5	12.8	12.0	93.8	82.4
Philippines	13.8	5.1	1.0	19.6	40.0
Sri Lanka	3.8	1.0	1.65	165.0	35.0

^a Percentage of credit supplied by MFIs that have attained FSS of total microcredit supplied. For Indonesia, the main commercial suppliers of microcredit are PP, BRI Units, BPRs, and until its closure by the Indonesian central bank in April 2004 BDB. In Bangladesh, only the microcredit provided by ASA, BRAC, and BURO Tangail (all of which are fully FSS) is considered commercial enough to be included. For Sri Lanka, estimated microcredit provided only by CRBs and TCCSs estimated to be profitable is included. For the Philippines, the percentage reflects microcredit provided by commercially-viable rural banks, thrift banks, cooperatives, and microfinance NGOs.

combined basis funded 90% of their outstanding loan portfolio (Rp5.6 trillion, or US\$604.0 million) with deposits (Rp5.1 trillion, or US\$534.6 million). In addition, commercialization has contributed to changing practitioners' perceptions that microsavings are also a valuable service for the poor as well as being a stable source of funds to support growth in the microloan portfolio.

Provision of deposit services is also strong in Sri Lanka because of the predominance of cooperatives as the main suppliers of microcredit. At the end of 2000, the CRB and TCCS networks together mobilized deposits of SLRs15.8 billion (US\$175.8 million), more than enough to satisfy their needs for lending. The CRBs and TCCSs provided SLRs7.8 billion (US\$86.6 million), representing 42.3% of the total market supply of microloans outstanding and 50.3% of the total number of outstanding microloans at the end of 2000. With more than SLRs14.8 billion (US\$164.5 million) of deposits, the CRBs are the most active organizations in mobilizing deposits, receiving in excess of four times the amount that the system lends out. Their performance in deposit mobilization is remarkable, especially considering that the CRBs supply more than 5.3 million individual deposit accounts compared to Sri Lanka's 3.8 million households and total population of 19.7 million.

These achievements in deposit mobilization in Asia are particularly impressive in comparison with other regions, which have had much less success mobilizing microdeposits. Even the Latin American

microfinance industry, which is often considered the most commercially advanced, has had significantly less success in deposit mobilization and relies more heavily on borrowing to fund its microcredit portfolio.

When considering *relative* achievements in breadth of outreach, it is necessary to consider the size of the target market in each country and to compare the supply with estimated demand. Table 3.1 attempts to do this by presenting the total number of poor households as a basis for comparison along with the total number of microloans supplied and the percentage provided on a commercial basis.⁸

The high percentage of microloans to poor households in Bangladesh and Sri Lanka indicates excess supply of microcredit due to the availability of substantial subsidized microcredit, which continues to be disbursed in these two countries, and the fact that targeting of cheap credit is highly prone to “leakages” or capture by nonpoor borrowers. In Sri Lanka, the state-supported Samurdhi (= prosperity) Banking Society (SBS) and other subsidized government programs accounted for close to 40% of total microcredit supply or 620,677 clients at the end of 2000. Other reasons for the high market penetration may also be that not only poor households are borrowing. For example, it is generally accepted in Bangladesh that about 10% of microloans are borrowed by nonpoor clients. While it may appear that the market for microcredit in Bangladesh and Sri Lanka is approaching saturation, in fact there remain several areas in which a demand-supply gap exists. For example, the demand of a variety of microfinance clients is unmet in terms of the range and flexibility of products available (such as voluntary savings, consumer loans, agricultural loans, insurance, etc.).

In contrast, the low relative microcredit outreach of MFIs in the Philippines points to the absence of large, directed and subsidized credit programs and only relatively recent expansion of MFIs on a commercial basis. Despite having hundreds of small-scale private rural banks, cooperatives, and microfinance NGOs, total microcredit outreach has been quite limited to date. The majority of microloans are supplied through donor-funded lending programs geared toward agricultural borrowers. Only a handful of microfinance NGOs have

⁸ Insufficient data for most countries concerning the number of microdeposit accounts prohibits performing an analysis of the breadth of microdeposit outreach similar to that in Table 3.1. However, deposit mobilization data by the BRI Units, BPRs, CRBs, TCCSs, and other MFIs is discussed, as available, in this section.

achieved scale or become financially viable. Although growth rates of commercial MFIs are around 20–30% per year, their low average scale of operations means that it may take several more years before they penetrate the microcredit market substantially. A large increase in microcredit outreach is not likely to come from the gradual growth of the vast majority of existing microfinance NGOs. It is more likely that other types of organizations (rural banks, cooperatives, etc.) will increasingly enter microfinance, as it becomes clear that the poor can be bankable and as the methods for reaching the poor become better understood.

Notwithstanding the positive impact of commercialization on breadth of outreach, the Indonesian experience stresses other effects of commercialization on the breadth of outreach. For example, in cases where microfinance is just one part of the business portfolio of the service provider, such as is the case for BRI, microsavings and profits may be used to finance or cross-subsidize nonmicrofinance operations at the expense of breadth and depth of outreach. A household survey carried out in October 2000 concluded that 67.7% of the sample households do not have credit from any formal or informal financial institutions and 61.9% of the sample households do not have savings accounts in any formal or informal financial institutions. The survey also showed that the proportions are high even for the cohort of households with viable enterprises: 58.2% do not have loans from financial institutions and 51.7% do not have savings in a financial institution (BRI 2001b, p. 36–37). Despite BRI's microdeposit portfolio of almost US\$2 billion in 2000, it lent less than half that amount to its microborrowers, even though there was an obvious unsatisfied demand for microloans in Indonesia. Instead, much of its savings portfolio and profits supported its commercial lending portfolio.

Depth of Outreach

Depth of outreach addresses the income level of the client served and is usually measured by such indicators as average initial loan size or deposit balance at any given point in time. Geographic coverage is also typically considered as an indicator of outreach depth, where there is high geographical concentration of the poorest clients. However, it should be kept in mind that microcredit may not be the instrument of choice to assist the poorest of the poor or “hardcore poor”—the bottom 50% of households below a country's poverty line.

The poorest often do not have sufficient debt capacity to be good candidates even for microcredit. Providing members of the hardcore poor having no means of income production with access to microcredit is likely to do them more harm than good. In these cases, governments and donors should focus instead on social intermediation including increasing access to health services, and support training in literacy, numeracy, and entrepreneurship. Deposit services are likely to have a deeper outreach than credit because all poor people are deposit worthy, although they may not be credit worthy, and tend to save for a variety of purposes.

Of chief concern in terms of commercialization and its impact on depth of outreach is whether there has been and will be a trade-off between commercialization and the provision of financial services to the poor and the poorest who have productive activities. Experience to date indicates that because of the continued existence of a demand-supply gap, the extent of the trade-off has been small to none. In fact, commercial MFIs have had a very good record of reaching the poor and some of the poorest in the countries of study. In Indonesia and the Philippines, where the commercialization of microfinance has progressed most, several examples indicate that commercialization can lead to an increase in the number of poor and very poor served.

PP, although state-owned, is a commercially-oriented pawning company in Indonesia. It provided 22.2 million loans to 15.7 million borrowers in 2001 and the vast majority of loans were quite small. As Table 3.2 shows, about 88% were less than Rp500,000 (roughly less than US\$60) (Fernando 2003c, p. 4). Also, the wide range of items accepted/pawned, which include gold, jewelry, household items, electronic goods, motor vehicles—and recently even unhulled paddy, valuable fabrics, and hand-woven cloth—indicates that PP indeed serves microcredit clients ranging from very poor to low income, in addition to the nonpoor.

Table 3.2: Distribution of Perum Pegadaian Loans by Size, 2001

Loan size (US\$ equivalent)	Number of loans (million)	%
1.1 – 4.5	8.6	39
4.5 – 16.7	5.4	24
16.7 – 55.5	5.6	25
> 55.5	2.6	12
Total	22.2	100

Source: Fernando 2003c, p. 4.

About 35% of PP clients are farmers, fishers, and small-scale enterprise operators. Despite the poverty level of its clients, PP's loan recovery rates are high. Collateral is sold when borrowers default, but it has only had to auction 0.5% of all pawned goods to date. Together, these indicators all point to a good depth of outreach.

Although the average microcredit loan amount varies widely, revealing broad market coverage, Table 3.3 indicates that depth of outreach of major commercial suppliers of microcredit in Indonesia is greater than the average for MFIs worldwide and approximately double the average of MFIs that have achieved FSS. While the requirements for collateral and/or cosigners on most loans provided by commercial MFIs—such as PP, the BRI Units, and the BPRs—may have excluded some of the poorest borrowers, they do not appear to have diminished outreach to the poor. Even the average outstanding loan size of the BRI Units, which is the highest among major commercial MFIs, is only half the gross domestic product (GDP) per capita, which is low compared to MFI loan sizes worldwide.

Table 3.3: Outreach Depth of Commercial MFIs in Indonesia, 2001

	Avg. O/S loan size (US\$ equivalent)	% GDP per capita
BRI Units	337	49.9
BPRs	333	49.0
Perum Pegadaian	42	0.1
MBB Average for MFIs Worldwide	453	66.6
MBB Average for FSS MFIs Worldwide	752	110.6

BPR = *Bank Perkreditan Rakyat*; BRI = *Bank Rakyat Indonesia*; MBB = MicroBanking Bulletin; FSS = financial self-sufficiency; MFI = microfinance institution.

Notes: "MBB Average for MFIs Worldwide" includes data on 147 MFIs that submit data to the MBB for adjustment and comparison purposes. "MBB Average for FSS MFIs Worldwide" captures data on 62 MFIs that MBB classified as financially self-sufficient.

Source: Authors' calculations and Microbanking Bulletin 2002.

In terms of average microloan amount, the difference between Indonesia and Bangladesh may seem quite large, but comparing the two as a percentage of GDP per capita shows less difference. For example, while the average amount of a microloan provided by the BRI Units or BPRs in Indonesia is around US\$335 and the average in Bangladesh is about US\$65, expressed as a percentage of GDP per capita they are 49% and 25%, respectively. The difference is mainly attributable to broader market coverage by Indonesian commercial

MFIs than by Bangladesh microfinance NGOs and this skews the data, hiding the fact that a large percentage of lending by commercial MFIs in Indonesia is quite small and comparable to the depth of outreach achieved by less commercial MFIs in Bangladesh. For example, the BRI Units' wide market coverage hides the fact that 30% of its loans disbursed in the first half of 2001 were less than US\$194 or 28% of GDP per capita.

Gauging Philippine rural bank financial performance in microfinance operations is extremely limited by the fact that there is very little information on their activities other than from those that are members of the national microfinance network, the Microfinance Council of the Philippines, or the MABS Project. The 41 rural banks that participated in the Microfinance Council's survey reported as of June 2001 a combined 105,739 clients, P553.2 million (US\$11.1 million) in outstanding loans, and an average outstanding loan per client of P5,231 (US\$105). This average outstanding loan amount is only slightly higher than that reported by the 22 microfinance NGOs (P3,742 or US\$75) and 23 cooperatives (P4,853 or US\$98) that report to the Microfinance Council. These findings indicate that despite the more commercial orientation of the rural banks, they have achieved a depth of outreach similar to that of microfinance NGOs, which is an indication that they are serving equally poor clients.

In terms of geographic coverage, commercial microfinance has made less headway. In Indonesia, the BRI Units and even some BPRs have had success in pioneering and expanding village units and mobile services in many areas. However, in general, commercial MFIs have had limited achievements reaching down to the village level and to less populated areas. These areas remain the domain of tiny traditional financial institutions that are unable to benefit from economies of scale and suffer from lack of legal status and human capacity to undertake financial intermediation. In addition, although demand may be largely depressed for small farmers and agriculturally-based microenterprises (due to low or negative returns on most types of agricultural production), this potential market niche has remained virtually ignored in terms of microcredit and more importantly, microsavings. Competitive pressures within Indonesia's microfinance industry have not developed sufficiently to push commercial MFIs to reach clients in less densely populated, harder-to-reach rural areas.

Scope of Outreach

Commercialization and the competitive pressures it has brought about in some highly populated areas have increased MFI client orientation and the development of demand-driven products including individual loans, a wide range of deposit products, and new products, such as housing and consumption loans, as well as life insurance. For example, focus on developing demand-driven microfinance products and services in Indonesia has led to wider scope of outreach in terms of the numbers and types of financial contracts supplied (Schreiner 2002, p. 11). In addition, competitive pressures in Bangladesh have prompted some movement away from the traditional Grameen model historically dominant there and toward savings mobilization, both as a useful service for the poor and source of funds for expansion. However, only the most commercially-oriented MFIs in the four countries studies have experimented with offering microinsurance, money transfer, or payment services on a sustainable basis.

Indonesia's highly commercial approach to microfinance has led to the development of demand-driven loan and deposit products, as well as money transfer and payment services. Between the three major commercial MFIs, clients can choose between pawning numerous types of goods at pawn service providers. The BRI Units and BPRs offer microloan products that have flexible terms and repayment schedules, generally tailored to the cashflows of the client's activities. Numerous types of deposit services are also available at the BRI Units and BPRs with different mixes of liquidity and returns. The BRI Units also offer other financial services, such as money transfers, and serve as payment points for telephone, electricity, and property tax bills. The wide range of microfinance products and services available resulted from a commercial approach, which focused on the quality of outreach and client satisfaction. The goal of commercial MFIs is to offer all of these products and services on a fee basis, setting the interest rates and any other applicable charges high enough to cover the costs of the transaction.

Competitive pressures in Bangladesh have helped the expansion of microcredit product types offered there. Of the four countries studied, it has the most microfinance competition in densely populated areas. The most commercially-oriented microfinance providers have been gradually offering a wider range of products and services tailored to client demand. Competition is leading to diversification at the level

of the industry, but not necessarily at the institutional level. Not all MFIs are diversifying their products, but many are attempting to meet unmet demand by serving new market niches.

Although most microcredit lenders in Bangladesh still follow the traditional Grameen model, the types of credit products available are diversifying (Box 3.2). Today, there are more than 15 credit products including daily credit, leasing loans, and housing loans, among others. Individual lending is also growing with several commercially-oriented MFIs offering microenterprise loans tailored to the needs of “graduated borrowers” and those caught in the “missing middle,” with a business too small to qualify for bank credit but too large to be considered as a

Box 3.2: BURO Tangail Responds to Competitive Pressures

Established in 1990, BURO Tangail (BT) operates in one of the most competitive environments in the Bangladesh microfinance market, where many suppliers provide services. In response, BT has increased its commercial orientation over time. Its increased commercial orientation is reflected not only in the high level of FSS but also in its growth rate and operating efficiency. Between 1997 and 2002, it increased the operating area from 1,032 villages in 5 districts to 2,025 villages in 9 districts. At the end of 2002, it had 91,866 active borrowers and 124,446 voluntary savers in its books. The adjusted FSS of BT was 125% at the end of 2002 while the operating expense ratio was 20.7%. BT maintains an average loan balance that is just 20% of gross national product per capita, despite the fiercely competitive market situation.

BT has responded to the competition in a variety of ways. It has strived to improve efficiency. It has improved liquidity management and maintains very few assets in cash: it put almost 90% its total assets in the loan portfolio by the end of 2002. It has also tightly controlled administrative costs: at the end of 2002, these costs were only 5.7% of the average total assets, much lower than its Asian peer group average of 8.9% in the Microbanking Bulletin. Thirdly, BT has offered flexible products: it increased the number of its savings products to three and made each type voluntary (independent of any microloan outstanding) and completely liquid. This enabled BT to have a competitive edge in the market. BT also increased the number of its loan products to nine and remains committed to providing high quality, flexible, demand-driven financial services to the poor.

Source: Prepared by the authors based on information provided by BT.

target client by most of the more poverty-focused MFIs. For example, the Association for Social Advancement (ASA) moved from group lending to individual lending in response to its customers' preferences; the largest NGO provider of microfinance in Bangladesh, BRAC created BRAC Bank primarily to serve small and medium-sized enterprises.

To fuel their future growth, commercially-oriented MFIs in Bangladesh have begun to mobilize voluntary deposits. The microfinance market in Bangladesh is still largely oriented toward microcredit. Practically all clients have taken loans; savings are often on a forced rather than a voluntary basis, following the Grameen model. Nevertheless, savings play a central role in the economic lives of all households and microenterprises. Whether families use traditional assets (such as livestock or gold) or bank accounts, the purpose is the same: to build a financial security cushion. These savings are perhaps the most important factor in creating the domestic investment needed for sustainable economic growth.

Recognizing savings as a useful service for their clients, as well as a potentially large and stable source of funds, ASA and the Bangladesh Unemployed Rehabilitation Organization (BURO) Tangail introduced flexible voluntary savings, term deposits, and time deposits among their "associate members" (nonmembers) with good response, but these deposit services were later discontinued following a notice by the Bangladesh Bank in the national daily newspapers in September 2000, prohibiting such services to nonmembers. The notice reprimanded all organizations (not only NGOs) taking deposits without a license from the Central Bank of Bangladesh. BURO Tangail has continued offering flexible savings services, but only within its membership. Currently, the savings products available in the microfinance NGO sector (for members only) include mandatory savings, special savings, forced savings/group savings, contractual savings, time deposits, and daily savings.

Following both social and commercial agendas, MFIs in Bangladesh and the Philippines are increasingly experimenting with offering microinsurance products. With regard to their social missions, several microfinance NGOs are recognizing households' needs for protection against risk. Microinsurance is seen as a means for clients to reduce their vulnerability in order to take advantage of economic opportunities. In addition, access to insurance allows clients to reduce the impact of losses that could exacerbate their poverty situation.

Relating to their commercial agenda, MFIs venturing into microinsurance desire to enhance their sustainability and profitability by reducing the impact of client risks on MFI loan and savings portfolios by generating additional revenue and by becoming more competitive in their services (Brown 2000, p. 3).

In Bangladesh, microfinance NGOs are gradually becoming interested in offering insurance products, particularly life insurance, to their existing credit and savings clients. Interest has been generated following the successful microinsurance experiences of a private sector provider, Delta Insurance. A sample of 528 microfinance NGOs surveyed by the Credit and Development Forum (in December 1999) showed that 76 (15%) had some kind of insurance product. To date, provision of insurance by NGOs may still be regarded as being experimental. The premiums are calculated using rules of thumb rather than actuarial data or financial analysis.

In the Philippines, offering insurance services is done in a more sustainable manner by some MFIs. *Tulay Sa Pag-Unlad* (TSPI), a microfinance NGO that operates on a commercial basis, has developed an innovative approach to offering microinsurance (Box 3.3) by teaming with a large private sector insurance company that accepts the underwriting risk.

Growing numbers of MFIs are offering money transfers for commercial reasons. Money transfers or remittances remain a large, untapped microfinance market niche, with a few commercially-oriented MFIs showing interest. The Central Bank of the Philippines reported that remittances were US\$6.2 billion in 2001, with about 60% coming from the United States and Canada (BSP 2001, p. 28). Formal institutions, such as rural banks, are increasingly tapping into this market niche and, given the scale of remittances, they may become an important part of the microfinance service menu for many. Lamberte (2000, p. 16) notes that some rural banks have been developing linkages with international remittance transfer companies, such as Western Union or commercial banks. Because rural banks are prohibited from foreign exchange transactions, they enter into an arrangement with commercial banks, which are allowed to perform foreign exchange transactions, so that the Philippine peso equivalent of the foreign exchange earnings of overseas Filipino workers can be remitted to their rural bank accounts.

Given the scale of remittance transfers in the Philippines, the development of remittance services may have high potential to expand

Box 3.3: TSPI's Microinsurance Initiative

As a means to help clients deal with risk, *Tulay Sa Pag-Unlad*, Inc. (TSPI) invited 11 insurance companies to bid on becoming its insurance service partner. The bidders worked around a "shopping list" of client needs and fixed fees based on payment capacity of poor microentrepreneurs. Eight insurance companies provided proposals and TSPI chose three of those to present to a sample of 79 clients for feedback. Based on client response, TSPI selected Cocolife as their insurance partner for women microentrepreneurs participating in TSPI's *Kabuhayan* (Livelihood) program, which follows the Grameen model.

In October 2001, TSPI through Cocolife extended microinsurance coverage to an initial 29,968 clients. By March 2002, TSPI had enrolled 37,743 for coverage. The benefits include: 1) life insurance of P25,000 (US\$500) (amount doubled in case of accidental death); 2) disability insurance up to P25,000(US\$500); 3) medical expense reimbursement up to P2,500 (US\$50) per year; and 4) settlement of the unpaid loan balance in case of client death. As of March 2002, TSPI had 29 insurance claims and 15 claims for medical expense reimbursement.

TSPI has noted increased client satisfaction and motivation to participate in its broadening services. In a recent TSPI impact assessment of its *Kabuhayan* program, clients ranked "other financial services," notably the microinsurance coverage, as the most-liked program feature. Thus, while TSPI's main intention in offering microinsurance was to help clients and their families cope with risk, it likewise helped TSPI to retain and expand its client base. Microinsurance benefits TSPI by decreasing its average cost of servicing loans, supports the organization's efforts to sustain services, and helps clients mitigate risk.

Source: TSPI 2002, p.1–2.

the customer base of MFIs and add to their profitability. Indeed some experimentation by CARD (Center for Agriculture and Rural Development) Bank in providing remittance services in cooperation with a domestic money transfer service provider has already taken place. In addition to the fee income generated by remittance services, other benefits for MFIs also may lay in the ability to cross-sell other services. For the consumer, the advantages of MFIs as transfer agents may include lower costs than those of established transfer agencies,

transparency about exchange rates disclosed at the point of sale, and increased reliability, security, and speed.

Sustainability of Outreach

Sustainability of institutions essentially implies permanence. Sustainability, in itself, is important because access to microfinance services, especially microsavings, remains important throughout a client's life and sustainable institutions tend to improve welfare the most (Navajas et al. 2000, p. 335). Microcredit repayment is also tied to client perception of viability of the lender and the prospect of developing a long-term financial relationship. Sustainability is even more critical when considering the precarious financial conditions of most microfinance clients. However, sustainability is not the end in itself for development practitioners; it is rather the means to the end of increased breadth and depth of outreach.

Commercial MFIs are much better suited to stand the test of time and have the greatest sustainability of outreach because they are less dependent on the changing whims of donors. To reach the millions of people who need microloans and other microfinance services, MFIs must make the transition to commercially viable and efficient institutions that can mobilize savings, access commercial finance, and achieve full cost recovery through appropriate interest rates. Their integration into the formal financial sector allows commercial MFIs the flexibility and funding base required for them to weather economic or financial upheavals in order to maintain sustainability of outreach.

Commercially-driven MFIs, such as PP and the BRI Units, have proven for nearly two decades that providing large-scale financial services can be both economically and socially profitable. It has been amply demonstrated that even in exceptionally severe country and regional economic crises, MFIs that operate on a commercial basis can continue to serve millions of poor clients while remaining solvent and profitable. At no better time was this witnessed than during the recent Asian financial and economic crisis. With the sharp downturn in financial intermediation by traditional commercial banks during the time of the crisis (1997–1999), PP saw its pawning operations almost double and since then its business has continued to grow. The BRI Units earned US\$177 million in profits in 1996, before the crisis began, and US\$121 million in 2000, reflecting recovery after profitability ebbed slightly during the crisis years.

As with the commercially-run operations of PP and the BRI Units, many of the BPRs had professional and fundamentally sound microbanking systems that were flexible enough to respond to changing demand during the crisis and robust enough to weather it. By virtue of their formal status and professionally-run microfinance operations, these MFIs had built up sufficient trust for their depositors to believe that their savings would be secure—formal MFIs were even able to attract savings transferred to them from failing traditional commercial banks. A major factor leading to success of commercial MFIs during the crisis was the substantial liquidity they maintained so that capital was not constrained (Robinson 2003). When borrowers perceived the availability of future loans, they “wanted to retain their option to re-borrow and made loan repayment a high priority” (ibid.). Further, “the crisis convincingly provides that savings deposits at BPRs are...even in difficult times the most stable source of funding...The most dynamic and best-managed BPRs were always those with a strong savings base.” (Robinson 2003, quoting from Steinwand (2001, p. 228, 303)

HAS COMMERCIALIZATION LED TO MISSION DRIFT?

Contrary to the common assumption that commercialization will shift an MFI’s target market away from the very poor to the less poor and nonpoor, commercial MFIs in Indonesia and the Philippines have not suffered from such “mission drift.” In fact, the experiences of several MFIs have shown that the commercialization level and depth of outreach have increased in tandem. The more important question is whether commercial MFIs are serving more poor clients than before. This question is relevant for both microcredit and microsavings.

The Number of Poor Microborrowers Has Increased

In Indonesia, the two main commercial providers of microcredit are PP and the BRI Units. These two providers dominate the market in terms of the absolute number of microloans they lend and the growth of their respective microcredit portfolios over time relative to other, less commercial microlenders. For example, PP increased the number of customers it served from 9.8 million in 1998 to 15.7 million in 2001 (ADB 2003, p. 4). During the same period, the BRI Units increased their microcredit client base from 2.5 million to 2.9 million borrowers.

The growth in the number of microcredit clients reached by these two providers accounts for virtually all the estimated growth of the industry in Indonesia as a whole in recent years.

In addition, average loan amounts at both institutions have remained relatively constant during this period, signifying that their target markets have remained essentially the same over time. For example, when compared to changes over time in GDP per capita, there is stability in the average *Kupedes* loans lent by the BRI Units, indicating absence of mission drift. Average outstanding loan amounts have been much more affected by inflation than change in target clientele. Although in nominal terms, the average outstanding *Kupedes* loan size increased by nearly 350% during 1990–2001, the total change over the period is only 26% in real terms, or about 3% real increase per year (Table 3.4). Table 3.4 shows that over time, the BRI Units' average *Kupedes* loan size has stayed relatively constant as a percentage of GDP per capita, at between 40–60% over the period. This is despite the business growth and increased debt capacity many of their microborrowers have enjoyed over time.

Table 3.4: BRI Unit *Kupedes* Loan Sizes Compared to GDP per Capita

Year	CPI	GDP per capita (Rp)	Avg. O/S Loan (Rp)	Avg. O/S Loan/ GDP per capita	Avg. O/S Loan at 1995 Prices (Rp)
1990	65.25	1,174,872	729,913	0.62	1,118,641
1991	71.39	1,378,075	792,204	0.57	1,109,685
1992	76.77	1,530,679	899,986	0.59	1,172,315
1993	84.21	1,757,962	1,032,395	0.59	1,225,977
1994	91.38	2,004,510	1,196,800	0.60	1,309,696
1995	100.00	2,333,833	1,409,702	0.60	1,409,702
1996	107.97	2,706,001	1,638,251	0.61	1,517,320
1997	115.24	3,140,516	1,791,257	0.57	1,554,371
1998	181.66	4,675,438	1,911,079	0.41	1,052,009
1999	218.89	5,350,848	2,407,725	0.45	1,099,970
2000	227.03	6,131,788	2,935,787	0.48	1,293,127
2001	253.14	6,939,909	3,538,500	0.51	1,397,843

BRI = *Bank Rakyat Indonesia*; CPI = consumer price index; GDP = gross domestic product; O/S = outstanding.

Source: BRI Micro Business Division.

Moreover, mission drift in the BPRs of Indonesia has generally not been a factor because local private ownership has emphasized microfinance service provision to a wide range of clients at the village level (for institutional risk management and continued good

community standing). There have been a few instances in which cooperatives were formed to act as quasi-banks/moneylenders to take advantage of relatively lax cooperative regulation and supervision to lend small amounts at very high interest rates, but these instances have been exceptions and not the norm.

The experience of credit unions participating in the USAID-funded Credit Union Empowerment and Strengthening Project (CUES) in the Philippines provides further evidence that an MFI's level of commercialization and depth of outreach can increase together. Aimed at commercializing credit unions, the CUES project helped 18 credit unions improve their financial discipline and enjoy savings-driven growth in their microcredit portfolio. From December 1998 to December 2002, loan loss provisions for loans delinquent more than 12 months increased from 10.3% to 100.0%, while delinquency decreased from 63.0% to 9.6%. In the same period, member-client outreach increased by 500% from 36,443 to 218,354. Three quarters of these member-clients were poor rural women and 107,744 of them had outstanding loans at the end of 2002, with an average outstanding balance of US\$271, indicating a commitment to low-income disadvantaged borrowers.

For the Philippines, the case of CARD Bank is also instructive. Given that it has the longest experience with NGO transformation in the Philippines, CARD's experience gives at least some indication of how transformation might affect other recently formed, regulated, commercial MFIs with regard to mission drift. CARD's average outstanding loan balance of P5,450 in 2002 was only about P1,000 higher than it was in 1998 (which means it actually declined in real terms). This is in line with others in the industry and suggests that CARD's focus on the landless poor has been maintained.

The absence of mission drift is evident in the microfinance industry in other countries also. A Consultative Group to Assist the Poorest poverty audit in 2001 of Nirdhan Utthan Bank in Nepal confirmed that its transformation from an NGO into a commercial bank did not result in mission drift and that the poorest groups continue to be strongly served (CGAP 2002). The Association of Cambodian Local Economic Development Agencies (ACLEDA) transformation into a bank did lead the average loan size to increase from US\$272 to US\$349 from September 30, 2000 (pre-transformation) to 31 December 2002 (post-transformation). Given that the loan balance represents only 45% of per capita income and that the transformation resulted in a large

increase in microbusiness loans from 46,081 to 66,540 clients in the same period, one can conclude that ACLEDA was serving a significantly larger number of poor clients during the post-transformation period. In other words, the transformation has not resulted in mission drift, but deepening of ACLEDA's outreach (Fernando 2003a, p. 21).

More Microsavings Have Been Mobilized

Many microfinance NGOs have transformed into commercial MFIs in part to be able to access additional sources of funds for onlending. This goal has often translated into development of passbook savings accounts and other types of deposit products. Some of these products have been geared toward poor clients while others, such as time deposits, have been designed to mobilize larger amounts of funds from wealthier clients. Increasing mobilization of microsavings from generally poor and low-income households is an indication that a commercial MFI's mission remains focused on serving the poor (Box 3.4). There are several examples from the Asia and Pacific region and beyond that demonstrate that NGO transformation does not necessarily imply mission drift.

Box 3.4: CARD Bank's Commitment to Expanding Microsavings Outreach

While introducing voluntary savings for the public dramatically alters many aspects of the organization, it helps the MFI to maintain its social mission and increase its outreach. This is because voluntary savings are both a highly demanded service by the poor and a stable source of funds for financing microloans. To mobilize additional microsavings, CARD Bank entered into partnership with Women's World Banking to design and pilot-test savings products.

Source: Alip 2003.

In the Philippines, for example, the amount of voluntary savings mobilized by CARD Bank one year after its 1997 transformation from an NGO was just P4.9 million but this amount grew to P61.2 million by May 2002 (Alip 2003). The vast majority of savers were the

traditional clients of CARD NGO—the landless poor. By offering insured microdeposit services to the poor, CARD Bank is increasing its microdeposit outreach and fulfilling its social commitment to the poor.

In Peru, the microfinance NGO Acción Comunitaria del Perú transformed in 1998 into Mibanco (“My Bank”) and is now one of the leading commercial banks there. Soon after its transformation, Mibanco began offering savings accounts. By the end of 2002, it had US\$10.4 million in passbook savings. Poor and low-income households use Mibanco’s passbook savings facilities extensively. There were about 84,000 such accounts in December 2001, indicating that the bank has expanded its depth of outreach for savings significantly in recent years (Fernando 2003b, p. 12–13).

Evidence that commercial MFIs’ missions do not drift in terms of deposits as they become more commercial can also be found in the experiences of rural banks and cooperatives. As increasing numbers of rural banks and cooperatives enter the market, they bring with them the ability to mobilize deposits including microsavings from poor and low-income households in a cost-effective way. Rural banks in the Philippines, for example, mobilize a significant amount of microsavings: P5.3 billion (US\$106.0 million) in 4.3 million accounts as of March 2002. CUES-supported cooperatives nearly tripled their microsavings in just three years, from US\$3.3 million at the end of 1988 to US\$9.3 million at the end of 2001, while their average savings balance declined from US\$92 to US\$86 in the same period. In this way, commercial MFIs cater for an underserved market for small savings accounts while also satisfying their own need for a source of funds for onlending.

In Indonesia, the BRI Units have become the world leader in terms of MFI deposit mobilization by following a commercial approach to attracting small savings. The number of account holders of the *Simpedes* “rural savings” product alone grew from 10.1 million in 1996 to 17.6 million by the end of 2001. Most of the savers with *Simpedes* accounts are poor. Three quarters of these savings accounts held average daily balances of Rp500,000 (US\$59) or less and 40% of the total number of savings accounts held less than Rp50,000 (US\$6) on average. By focusing on satisfying client demand, the BRI Units, as with many other commercial MFIs, have been able to accomplish their mission of serving poor and low-income clients through increased microsavings mobilization.

HAS COMMERCIALIZATION LED TO INCREASED COMPETITION?

The process of commercialization has led to increased competition as existing commercial MFIs have expanded their outreach over time. In addition, the profitability that commercial MFIs have demonstrated has attracted new entrants to the market and, to a limited extent, seems to have encouraged downscaling by a few commercial banks. In some countries where the commercialization process has been occurring for some time, such as Bolivia, the microfinance market has become highly competitive, especially in urban and peri-urban areas, as a variety of financial institutions have entered the market. In contrast, competition in Bangladesh has been heating up in the last few years in more highly populated rural areas, primarily by additional microfinance NGOs. Many other countries have localized competition that is intensifying as MFIs vie for similar target clientele in populated areas. In the process of commercializing, MFIs generally increase their lending interest rates above their cost recovery level and adjust their interest rate spreads to ensure profitability. As competition increases, MFIs come under pressure to cut costs (increase efficiency), lower their lending interest rates, and develop new demand-driven products and services, all of which benefit clients.

In the Philippines, given the fact that only about 20% of the market is currently served, competition among MFIs is still several years off, except in a handful of urban and highly-populated rural areas where there is some localized competition. Even in Indonesia, there has been a lack of competitive pressure to ensure broad market efficiencies. However, competition in some districts and subdistricts has caused some Indonesian MFIs to sharpen their commercial focus, which has led to efficiency gains (e.g., with formal institutions, such as the BRI Units and BPRs operating predominantly at the subdistrict level and above, especially around more populated regional capitals). Below the subdistrict level, competition is not yet a factor and the BRI Units enjoy near monopoly power to maintain lending interest rates substantially above cost, essentially acting as the price leader for the market. Sufficient competitive pressures to increase efficiency in microfinance intermediation below the subdistrict level are still a few years away. As the BPR industry expands its microfinance client base in additional villages, more benefits to clients from increasing competition between commercial MFIs can be expected.

However, too much competition, especially resulting from government subsidies, can discourage and crowd-out commercial entities. Such is the case in Sri Lanka. Several commercially-oriented MFIs there complain that the Government's expansion of SBSs has eroded their potential client base. They also lament that ad hoc debt relief programs and other unsustainable cheap credit programs undermine the repayment culture that commercial MFIs have been working to cultivate.

Similarly, in Bangladesh at least 18 separate microcredit programs continue to be carried out by as many as 13 different government ministries and divisions. Most of these programs essentially replicate the traditional Grameen model and report fairly high repayment rates despite being implemented directly by government staff. However, a closer look at Credit and Development Forum statistics reveals that cumulative repayment rates vary between an abysmal 19.6% and a more respectable 98.6%. In addition, the cap on onlending interest rates imposed by PKSF on its borrowers compounds the difficulties faced by MFIs wanting to adopt commercial operations in terms of cost recovery.

Even competition between commercial providers without sufficient checks and balances can harm the industry. In Bolivia, as many consumer lending institutions entered the market, microloan clients became overly indebted, resulting in defaults to many of the long-standing MFIs there (Rhyne 2001). Some MFIs in Bangladesh have been experiencing such a decline in their loan recovery rates as well as client desertion as competition has increased. The clients appear to show little loyalty to the MFI when it does not fully meet their demands and when there are better alternatives at low switching costs. Such drop-outs are expensive for MFIs. Mibanco of Peru, for example, estimates that it manages to cover the cost of marketing to and identifying a client only after the client's fourth loan. Having an effective credit bureau that captures client microcredit history information and levels of indebtedness is a possible solution to curb these potentially negative impacts of competition.

HAS COMMERCIALIZATION ATTRACTED PRIVATE RISK CAPITAL?

Commercial MFIs have not yet attracted many international investors with private risk capital (including equity and debt), but there

is evidence suggesting that international quasi-risk capital⁹ and local private risk capital are being attracted to fund commercialized microfinance operations and that the amount is increasing. The rural banks in the Philippines and the BPRs in Indonesia are two examples of private sector, for-profit unit banks that have used local equity investment and been able to attract local savings to support commercial microfinance intermediation. MFIs have enjoyed less success in attracting loans from commercial banks as a source of commercial funds because of the relative low transparency of their operations and lack of standards and ratings. In addition, the prevalence of concessional loan funds, especially for good MFIs, has discouraged the demand for commercial loans from some MFIs.

Major Impediments Exist to Attracting Private Equity Capital

Cheap microcredit provided by governments, some sponsored by donors, continues to be prevalent in some Asian countries, in particular Bangladesh and Sri Lanka. The supply push of subsidized, directed credit dampens profitmaking opportunities for commercial MFIs and, therefore, lowers their attractiveness to equity investors. Inconsistent and frequently changing government policies regarding the financial sector in general and microfinance specifically raise the risk of investing in commercial MFIs. Legal barriers to equity investment also exist in some countries. For example, in the Philippines, rural banks, unlike thrift banks, are not allowed to have foreign equity investors. The existence of significant risk and the inability to insure against it pose perhaps the greatest challenges to commercial MFIs' achieving high enough risk-adjusted profits to attract foreign equity investment.

Finally, underdeveloped financial mechanisms impede investment. Transactions between investors and MFIs are unique, with varying characteristics and conditions in terms of interest rate (and method of determination), maturity, and custodianship. The lack of standard instruments and transaction mechanisms means that transaction costs are unnecessarily high, that instruments cannot be pooled, and that transparency is less than ideal (Pouliot 2002).

⁹ Quasi-risk capital refers to funds from socially-oriented investors.

A Few Specialized Microfinance Funds are Overcoming Barriers to Private Equity Investment

In recent years, several commercial and social investment funds have been established to satisfy commercial MFI funding needs. For example, IMI, a private equity fund owned by the German consulting firm IPC and its employees, and a mix of other commercial and socially-minded international investors has placed funds in the startup of commercial MFIs around the world, including MicroEnterprise Bank (MEB) in the Philippines. MEB was established in the underserved area of Davao City as a microfinance-oriented thrift bank in October 2001 on the initiative of several multilateral, bilateral, and local institutions (MEB 2001) (Box 3.5). In addition, approximately 49% of the Opportunity Microfinance Bank in the Philippines comes from social investors, as does 49% of the equity for ACLEDA Bank in Cambodia (Fernando 2003a, p. 5). Social investors have also made equity investments in other commercial microfinance institutions, such as Ennattien Moulethan Tchonnebat (EMT) in Cambodia and First Microfinance Bank in Pakistan.

Rural Banks in the Philippines and Indonesia are Funded by Local Private Risk Capital

Feeling competitive pressures from above (commercial and thrift banks) and below (pawnshops, lending investors, and finance companies), many rural banks are expanding their provision of specialized microfinance services (e.g., Box 3.6). Many rural banks have adopted various microfinance methodologies, including individual, solidarity, and variants of the Grameen's group lending model so that they can serve high-risk borrowers of small amounts at a low cost. Many rural banks have also created special credit windows for salaried people in rural areas whose families are engaged in small and cottage enterprises. All this indicates that rural banks are steadily enhancing their capabilities to assess credit risks as they seek to provide specialized microfinance services for their clients (Lamberte 2000, p. 16).

The BPR industry in Indonesia is providing microfinance on a commercial basis through predominantly local private ownership and by funding microcredit almost wholly from deposits. At end-September 2003, there were 2,143 licensed BPRs (BI 2003). Changes in the law

Box 3.5: The MicroEnterprise Bank's Ownership Structure

The MEB was incorporated in the Philippines with a total authorized share capital of P100 million (US\$2.0 million), with an initial capitalization of P60 million (US\$1.2 million) to be followed by a second capital subscription of P40 million (US\$0.8 million). International shareholders, who together hold 60% of the total share capital are the Doen Foundation and FMO from the Netherlands; the International Finance Corporation (IFC), which is a member of the World Bank Group; and IMI, a private, for-profit investment company based in Germany. Planters Development Bank (Plantersbank), a reputable commercial bank based in Manila with experience in lending to medium-sized enterprises, is the bank's local investor, holding the remaining 40% of the shares.

The shareholders are convinced that microlending can and should be conducted on a profitable basis. MEB management supports the view that by creating a lasting and reliable supply of microfinance in a supportive institutional setting, lending to poor and low-income households and their microenterprises can be donor independent and have significant ongoing developmental impact. The shareholders selected an experienced management team backed by Internationale Projekt Consult (IPC), which has more than 20 years of experience in microfinance and promotes a commercial approach. While not all MEB's shareholders are true commercial investors, IMI is primarily owned by individuals who work for IPC. Because several of IPC's consultants also have a stake in IMI and, therefore, the performance of MEB, strong incentives exist for the management of MEB to develop a commercially-viable microfinance operation. As with other IMI investments, it is expected that MEB's reliance on IPC consultants will be phased out over time to be replaced by local professionals equally committed to following a commercial approach to microfinance.

Source: Charitonenko 2003,

and classification of BPRs over time has allowed them to take several legal forms and at end-2002, 62% were registered as limited liability companies (private), 35% as regional government enterprises (public), 3% as cooperatives (private), and the remainder as other legal forms.

Box 3.6: Rural Bank Attracted to Microfinance Profit Potential

“The success of microfinance for the poor in the Philippines for the past decade has encouraged us to venture into a new field of banking: lending to the extreme poor.”

Marilou Genuino
President, BMS Rural Bank.

Source: Maekawa 2002.

Transformation is Increasing Access to Private Equity and Savings

Where the supply of easily accessible, concessional funds is low, microfinance NGOs are increasingly seeking to expand their outreach by transforming to formal, commercial financial institutions as a way to access private equity capital and savings. A microfinance-oriented rural bank established by an NGO in the Philippines is gradually attracting local private ownership through the bank’s issuance of shares of stock. A group of 15 rural development practitioners organized CARD as an NGO in 1986 with the basic objective of improving the quality of life for the landless rural poor. Part of that original mission was to establish a bank created for, owned by, and managed by the landless rural poor. In 1997, CARD Rural Bank received its operating license from the central bank. With an initial capitalization of P5 million (equal to about US\$167,000 at the time), 12 of CARD’s 25 branches were converted into CARD Bank while the remaining branches continued to operate as CARD NGO.

Initially, CARD Bank was owned by CARD NGO (27%), a few members of the board of directors, and management staff (73%). This ownership has shifted over time away from board and staff ownership to client ownership through the issuance of stock—a process that started in 2000 (Box 3.7). At the end of May 2002, CARD Bank’s ownership structure was CARD NGO (44.2%), CARD Bank and NGO staff and board membership (26.5%), and clients (29.3%). CARD’s transformation experience resulted in substantial increases in scale because it has been able to diversify and expand its funding base. This is expected to result in eventual full, private ownership through

**Box 3.7: CARD Bank – Creating a Vehicle
for Asset Ownership by the Poor**

“Day by day, the vision that we set for CARD that aims ultimately to empower the poor people, especially women, serves as our guiding light and inspiration in everything that we do. Currently, we have two women members who are representing our more than 50,000 client-members on the Board of Directors of CARD Bank...[and] more than 1,500 members have been issued Certificates of Stocks of CARD Bank, a certificate that says that they are not just borrowers but they are now owners and stockholders of a bank that is dedicated to eradicating poverty.”

Dolores Torres
President and CEO, CARD Bank
2002

additional issuance of preferred stock shares to qualified clients-investors. CARD plans to transfer full ownership to the landless poor, consistent with the CARD vision. While the empowerment of landless poor women is a noble aim, one concern is that such owner-investors lack the “deep pockets” that may be necessary to access additional sources of funds in times of the Bank’s financial hardship (Campion and White 1999, p. 83.)

In 1998, ACLEDA NGO in Cambodia began to transform into a regulated commercial bank as a way to expand its access to capital including equity, debt, and access to savings. In October 2000, ACLEDA Bank received its banking license and brought in a mixture of quasi-risk capital investors and NGO investors. As of 28 February 2003, ACLEDA Bank had 21,938 voluntary savings accounts with a total value of US\$6.9 million. While this includes a number of large accounts from big companies, government, and NGOs, many small savers also use the facility (Fernando 2003a, p. 15). Hence, transformation has been a successful strategy for increasing access to capital.

However, transformation from a microfinance NGO into a regulated financial institution is not a guarantee that the MFI will operate more efficiently and commercially thereafter. After the transformation of Grameen into a bank, for example, it continues to be dependent on donor funding and has yet to achieve financial self-sufficiency.

MFIs Have Enjoyed Little Success in Borrowing from Commercial Banks

Most private commercial banks have been extremely tentative in their lending to MFIs. A study carried out in 1998 on *The Role of Commercial Banks in Microfinance* (Goodwin-Groen 1998) showed the limited record of commercial bank lending to MFIs in the Asia and Pacific region. The situation has improved only slightly since then. While there is a long tradition of government-subsidized loans channeled through banking systems, lending to MFIs as a profitable business is comparatively rare. This is mostly because of MFIs' relatively low levels of transparency and the lack of standards and ratings necessary to convince formal financial institutions that MFIs are credit worthy. The potential for microfinance lending in India alone is estimated to be in the range of US\$6–8 billion. Information asymmetries have kept the liquidity in the banking system from being channeled into microfinance, in terms of banks not understanding microfinance and MFIs lacking records to demonstrate sustainability. To address this issue, a credit rating system for MFIs was introduced by Micro-Credit Ratings International (M-CRIL). Of the 51 Indian MFIs rated by M-CRIL in 2000, only 9 were classified as highly credit worthy and 22 were classified as moderately credit worthy (Sinha and Sinha 2002).

Some NGOs in the Philippines have accessed loans from commercial banks but with many difficulties and personal guarantees from influential members of their boards of directors rather than on the basis of their financial strength or performance. In Bangladesh, access is often only facilitated by guarantees from some bilateral funding agencies. NGOs in Cambodia have experienced similar difficulties in borrowing from commercial institutions (Fernando 2003a, p. 4).

Good performance by certain NGOs has encouraged some banks to risk lending to them. For example, before the Asian financial and economic crisis hit the Philippines in 1997, the NGO TSPI Development Corporation had eight loans from three leading commercial banks and its financial performance was exemplary. TSPI's funders for 2000–2001 included Bank of the Philippines (BPI), the BPI Foundation, Inc., Development Bank of the Philippines, Land Bank of the Philippines, and Small Business Guarantee and Finance Corporation. Most loans that TSPI and other microfinance NGOs have recently accessed from private commercial banks are at interest

rates above prime and could be considered commercial or market based. However, interviews suggested that personal relationships between board members of TSPI and senior bank executives were the primary motivation for these arrangements (Goodwin-Groen 1998, p. 27). This example is indicative of commercial bank lending to MFIs. Loans issued in some cases were backed by collateral, such as real estate, and always facilitated by personal relationships.

However, increased disclosure and transparency of BPRs promoted by Bank Indonesia's BPR Supervision Department is leading to increasing access of BPRs to loans from commercial banks (Box 3.8). Around one third of the BPRs are estimated now to have established borrower relationships with commercial banks. For loans in excess of Rp500 million (US\$55,928), physical collateral is still generally required by commercial banks.

PP in Indonesia has successfully raised commercial funds through bond issuances. The bonds of this state-owned pawning company carry

Box 3.8: Increased Access of BPRs to Loans from Commercial Banks

Bank Indonesia's BPR Supervision Department has been facilitating linkages between commercial banks and BPRs over the last few years to enhance BPR eligibility to borrow commercial bank loans as a source of funds. To be eligible, BPRs must specify as part of their business plan the loan amount desired and how the funds will be utilized. Once this has been submitted along with usual financial disclosure and reporting, Bank Indonesia (BI) ranks the BPR as sound, fair, or unsound according to CAMEL (Capital, Asset, Management, Equity, and Liquidity) criteria. BI may informally recommend to the 15 commercial banks currently participating that the BPR is financially healthy and represents a good credit risk. BI also provides interested commercial bankers with two-week training courses on how to evaluate BPRs as prospective borrowers. When a match is made, loans of up to Rp500 million (US\$55,928) are lent by the commercial banks without collateral for one year rollovers at an annual interest rate around the current prime of 18–20% (declining basis) and re-lent by the BPR at annual interest rates of 24–30%.

Source: Interview with Mr. Santoso Wibowo, Manager of Research and Regulation of BPRs, Bank Supervision Department, BI.

the highest rating available in the country and are a favorite on the corporate bond market. Each time PP has issued bonds, they are among the most highly traded on the local secondary exchanges there.

Commercial MFIs in Asia are Relatively Less Market-Oriented Than Those in Latin America

As shown above, commercially-oriented Asian MFIs are increasingly tapping into commercial sources of funding. However, their orientation toward such sources is not as strong as that in Latin America. At least two factors support this assertion. First, unlike some MFIs in Latin America, MFIs in the Asia and Pacific region have not yet begun to tap local capital markets through bond issues, either with guarantees by a third party or on the basis of their financials (Box 3.9). Second, Asian MFIs have been less active in the term-deposit market than their counterparts in Latin America. Relatively easy access to concessional finance, lack of industry standards, and inadequate transparency of MFI operations may explain these regional differences.

HAS COMMERCIALIZATION LED TO CONSOLIDATION?

MFIs take many different forms (commercial banks, cooperatives, NGOs, units, etc.) and sizes (small-scale operators, large-scale operators, etc.). Is there a trend toward increasing consolidation in the industry as a result of commercialization? This is possible, at least in theory, because larger institutions are expected to be able to harness economies of scale and be more efficient than most smaller institutions. There is some evidence for this in two of the largest MFIs in Asia, ASA (Bangladesh) and the BRI Units (Indonesia). With 1.9 million and 28.3 million active clients, respectively, their achievements in economies of scale have resulted in significant improvements in efficiency. ASA reported operating an expense ratio¹⁰ of only 8.7% at the end of 2000, and BRI Units, 13.5% for 2002. By comparison, the average operating expense ratio of all the 124 MFIs contained in the MicroBanking Bulletin in July 2003 was

¹⁰ A leading indicator of MFI efficiency, the operating expense ratio equals operating expense divided by average gross loan portfolio

Box 3.9: Latin American MFIs Tap Local Capital Markets

In a few Latin American countries, MFIs have accessed local capital markets to meet their demand for funds through bond issues. Some of these issues have been backed with a guarantee from USAID and others have no guarantees. The most notable and recent example is the bond issue of Financiera Compartamos in 2002. With the approval of Mexican authorities, Compartamos issued bonds for a total of US\$15 million in the Mexican capital markets on two separate occasions. The Standard and Poor's mxA+ rating fully backed these issues, the largest ever by an MFI and the first ever to be guaranteed strictly by the institution's financial strength rather than by its loan portfolio or an external guarantee. Individuals bought 70% of the first issue of US\$10 million and 50% of the second issue of US\$5 million while institutions bought the remaining amounts.

Financiera in Colombia also issued US\$2 million worth of convertible bonds in 2001, without a guarantee from a third party, to existing shareholders.

BancoSol issued bonds for US\$3 million in 1997, with a 50% guarantee from USAID. In December 2002, as part of its US\$30 million bond program to raise funds from capital markets, Mibanco issued bonds for US\$60 million with a 50% guarantee from USAID. Interestingly, local pension funds bought 82% of the bonds.

Source: Fernando (2003b).

29.4% and the ratio for the 66 MFIs that had attained financial self-sufficiency was 22.2% (*ibid.*, p. 60), significantly higher than the ratios for ASA and the BRI Units.

The BRI Units have reaped economies of scale, for example, by spreading the cost of expensive and specialized inputs across the national branch network. Some inputs, such as research and development, advertising, managerial expertise, and skilled credit officers and tellers, are expensive, but because of the possibility of increased efficiency with such inputs, they can lead to a decrease in the average cost of microfinance service provision. Because the BRI Units are able to spread the cost of such inputs over a large number of clients, the system realizes economies of scale and extreme efficiency.

Despite the potential advantages and the increased level of commercialization, the industry has not seen significant signs of consolidation. In most Asian countries, many service providers exist

in the microfinance market. In the Philippines, more than 300 microfinance NGOs operate and in Cambodia, more than 120. Even in Bangladesh where the industry competition level is higher, in excess of 1,000 NGOs are involved in the industry.

In most countries, a majority of the institutions operates in limited geographical areas. For example, in a survey of microfinance NGOs in the Philippines in 1997, it was found that only 3 of the 223 respondents were operating programs of nationwide scope; most respondents were operating only within the municipalities wherein they were located. Although five NGOs merged to establish the Opportunity Microfinance Bank in 2001, such mergers are unlikely to be the trend in the industry. In general, commercialization is unlikely to lead to a significant consolidation in the near future. In fact, commercialization is more likely to spur competition. In addition, it will be increasingly reflected in improved operations of the institutions and their practices.