

4 Approaches to Promote Microfinance Commercialization

Microfinance commercialization can be pursued regardless of country context. The microfinance markets of countries in the Asia and Pacific region are far from saturated with demand-driven, sustainable microfinance. The experience of commercial MFIs has shown that commercialization facilitates large-scale outreach in its many dimensions of breadth, depth, scope, and sustainability. The only differences between countries regarding the commercialization of microfinance are the specific measures required to increase the level of commercialization while increasing outreach to the poor. This section elaborates on approaches to promote the commercialization of microfinance that preserve the traditional social objective of MFIs expanding access by the poor to demand-driven, sustainable financial services.

GOVERNMENTS SHOULD BE CONSISTENT IN SUPPORTING COMMERCIALIZATION

Government interventions should be appropriate and consistent in their support of microfinance commercialization, treating microfinance as an integral part of the financial sector. While most governments have liberalized their financial sectors, the legislative environments in many Asian countries remain unfavorable to commercialization of microfinance. For example, usury laws in the People's Republic of China (PRC) have been hindering sustainable microlending. Other countries in the region continue to impose directed credit requirements, whereby banks are required to lend a certain proportion of their loan portfolio to particular sectors. The largest impediment to commercialization may be the persistence of large, subsidized microcredit programs, which continue to be promoted by donors and governments alike (Box 4.1).

The main role the government should play in the commercialization of microfinance is to create and maintain an enabling macroeconomic and sectoral policy environment and an appropriate legal and

Box 4.1: Continued Subsidization of Microcredit Undermines Commercialization

Many governments in the Asia and Pacific region continue to implement subsidized microcredit programs directly. For example, at least 18 separate microcredit programs are being carried out in Bangladesh by as many as 13 government ministries and divisions. Most of these programs essentially follow the traditional Grameen model and report fairly high repayment rates despite being implemented directly by government staff. A closer look at CDF statistics, however, reveals that repayment rates vary between 19.6% and 98.6%. Also, there are many government and donor-funded rural credit programs in Sri Lanka. Most of these programs provide subsidized funds for onlending to poor rural borrowers through state banks and other financial institutions at highly concessional interest rates. With subsidized interest rates and poor loan collection, these interventions undermine commercial microfinance by existing MFIs (by introducing market distortions) and new entry by commercial banks.

regulatory framework for microfinance. Supply-led, subsidized microcredit should be replaced by demand-led microcredit with interest rates that at least cover the costs of financial intermediation. The government should shift resources from subsidized program credits to capacity building for expanded outreach and sustainability by microfinance providers including banks, as well as for operators of microenterprises and small businesses. One means to achieve greater consensus on the importance of market-driven microfinance and to build the political will to cease all subsidized microcredit programs might be to develop a national strategy for promoting sustainable microfinance, as the Philippines did in 1997. This strategy required key public and private stakeholders to come together to develop a comprehensive vision for commercialization of the microfinance industry as an integral part of general financial sector development and to build the political will needed to push for the policy, legal, and regulatory changes needed to make it truly effective.

Even in the Philippines, the country with one of the most conducive environments for commercial microfinance, the threat of policy reversal remains (Box 4.2). The convenient nature of directed credit provision by government makes it politically very expedient and tempting for policymakers to revert back to the previous policy of

Box 4.2: Potential for Backsliding

"Section 43 [of the 2000 General Banking Law] mandates that 'the Monetary Board shall regulate the interest imposed on microfinance borrowers by lending investors and similar lenders, such as, but not limited to, the unconscionable rates of interest collected on salary loans and similar credit accommodations.' This provides regulators the dangerous authority, especially if political pressure is brought to bear, to regulate microfinance interest rates. Low, non-market interest rates prevent the recovery of operational and financial costs, plus an adequate margin for risks and long-run sustainability. In addition, the possibility of even imposing such limits adds a new dimension to the risks of entering the field of microfinance."

Source: Gomez, Fitzgerald, and Vogel 2000, p. 29.

regulating interest rates and supporting directed credit programs. The challenge lies not only with the government but also with private sector MFIs. It is imperative for all types of MFIs to close ranks and actively advocate for the government to continue moving away from outright credit provision and to focus its intervention where it has distinct comparative advantage (e.g., creating an appropriate policy, legal, and regulatory environment, and provision of basic economic infrastructure, as well as selected social services, such as education and health).

Empirical evidence indicates, for example, that in most countries, microfinance is increasingly concentrated in areas with relatively better physical infrastructure and the poor are highly concentrated in areas with poor physical infrastructure. A case in point is India, where industry development is highly lopsided geographically with about 75% of the outreach in southern states. The three states—Bihar, Madhya Pradesh, and Uttar Pradesh—that jointly account for more than one third of the population and nearly 50% of the poor in the country, severely lack microfinance services because the poor physical infrastructure means unacceptably high risks and transaction costs.

Governments also have a role in developing institutions that support the microfinance industry and facilitate efficient market operations. Improving the information base for commercial lenders as well as MFIs can facilitate market development by reducing risks and transaction costs. Governments should create measures to provide

accurate and timely information regarding collateral including (i) expansion, modernization, and unification of public registries, particularly for land; (ii) improvement and modernization of titling and registration procedures; and (iii) promotion of default registries and credit bureaus (World Bank 2003, p. 29). In these areas, government may have a role in fostering and regulating the development of information bases to be utilized by the private sector for establishing credit history, insurance, and other risk management mechanisms. Government participation in microfinance associations and networks may also play a role in setting standards and improving the availability of information by establishing systems for collecting, benchmarking, and reporting data on MFI performance.

DONORS SHOULD PROMOTE COMMERCIALIZATION

Donors should promote the gradual commercialization of microfinance to significantly expand access to a wide range of demand-driven microfinance products in a sustainable manner over time, and not take a short-term approach by increasing the availability of microcredit quickly. This implies that donors have several roles to play in microfinance commercialization at both the macro and micro levels.

At the macro level, donors should work with governments to ensure that their policy environments and legal and regulatory frameworks are conducive to MFI progress toward commercialization. This includes advising on macroeconomic and sectoral policies as well as the legal, regulatory, and supervisory framework. Regarding policy, perhaps the most important contribution donors can make is to encourage governments to stop implementing subsidized microcredit programs, to cease imposing directed credit requirements on banks, and to avoid debt-forgiveness programs. In terms of the legal and regulatory framework, the most critical areas of donor assistance are strengthening the legal basis for secured transactions, developing appropriate regulation and supervision for microfinance operations, and establishing measures to protect voluntary deposits and integrate formal MFIs with the broader financial system.

At the micro level, the top priority of donors should be to provide capacity-building assistance to promote the development of efficient, viable MFIs capable of delivering appropriate products including

savings, insurance, and payment services as well as credit. Any grants provided to MFIs should be performance based and accompanied by quantitative, time-bound indicators to monitor MFIs' progress in achieving efficiency and outreach in a viable and sustainable manner. Donors should regularly evaluate whether a continued subsidy is justified, with the ultimate objective of moving the MFI toward financial self-sufficiency and market-based sources of funds (World Bank 2003, p. 22).

Donors must resist the strong temptation to disburse large amounts of funds quickly through an apex organization unless their onlending policies facilitate a commercial approach to microfinance intermediation. Experience to date has shown that an MFI's ability to mobilize savings and access other forms of commercial funds are extremely important for achieving sufficient scale to contribute to closing the demand-supply gap for demand-driven, sustainable microfinance services.

Throughout much of Asia, however, a credit bias exists in the microfinance market at the expense of savings mobilization. While much of this is due to early widespread adoption of the traditional Grameen model, the historical focus of donor interventions is also to blame. Multilateral development banks, in particular, are in the business of providing large loans for strategic country investments and more often than not, these have translated into substantial amounts of subsidized loan capital for many MFIs ill-equipped to efficiently absorb such massive inflows relative to their scale of operations. In other cases, pushed by disbursement pressures, donors have channeled large loans through apex organizations, such as PKSF in Bangladesh. In 2001, the World Bank fueled PKSF's growth by approving a US\$150 million (taka equivalent) International Development Agency (IDA) credit as a follow-up loan to a 1996 IDA credit of US\$105 million in support of MFIs. Easy access to PKSF funds seems to undermine incentives for MFIs to develop reliable and safe voluntary deposit services.

Although the World Bank is the largest funder of PKSF, other agencies contribute to its operation under similar terms. ADB's 1997 Participatory Livestock Development Project provided US\$17.2 million (taka equivalent) to PKSF for participating NGOs to onlend to the ultimate clients for "smallholder poultry, beef-fattening, and goat rearing (and other small animals)" (ADB 1998, p. 21). In addition, PKSF received funding support through the European Commission's

Integrated Food Assisted Development Project (PKSF 2000, p. 7). These projects and others continue despite the disincentive effects of PKSF operations on development of commercial microfinance markets.

If apex organizations are to play a useful role in commercialization of microfinance, several criteria must be met. They should operate as independent entities, establish and enforce appropriate performance and reporting standards for the MFIs that they fund, support MFIs based on the standards they achieve rather than the model they follow, avoid restrictive interest rate policies, and develop appropriate criteria for funding expansion, institutional development, and equity (Maguire, Conroy, and Thapa 1998).

STRATEGIES ARE NEEDED TO INCREASE COMMERCIALIZATION

To increase the region's level of commercialization, several strategies are needed. There are two broad sets of approaches. The first set relates to how the existing MFIs (especially NGOs) can be motivated to increase their commercial orientation while expanding their services to the poor. The second set concerns how private, commercially-oriented financial institutions can be encouraged to enter this market based on its profit potential.

Increasing Commercialization of microfinance NGOs

The lack of owners in nonprofit NGOs means that a commitment to accomplishing social aims by achieving commercial viability must be what drives microfinance NGO board members and senior management to take important internal steps toward commercialization. Chief among these are championing the cause, guiding the MFI strategically toward financial self-sufficiency, and holding management accountable to performance objectives based on systems that provide transparency (Table 4.1). To impart or augment internal commitment to achieving commercial viability, different forms of subsidies can be used as external "carrots or sticks" to hasten a microfinance NGO's progress toward commercialization.

**Table 4.1: Internal Actions Needed for Microfinance
NGO Commercialization**

Key Constraints	Appropriate Responses
Sole focus on social mission and achieving outreach targets results in a weak, subsidy-dependent institution.	<ul style="list-style-type: none"> • Build strong, internal commitment to achieving institutional financial self-sufficiency and improving efficiency. • Board members and senior managers need to raise their awareness of the benefits of institutional viability as a means to accomplishing their social mission.
Once commercial viability is considered as an institutional priority, the path to achieving it is unclear.	<ul style="list-style-type: none"> • Develop strategic and business plans that have quantifiable and time-bound targets. • Adopt cost-recovery interest rates, set reasonable growth targets, and monitor efficiency and other indicators closely so that periodic policy or operational improvements can be made. • Use grants to build capacity and improve efficiency. • Establish clear lines of authority and responsibility for board members, senior managers, and line officers to meet or exceed financial self-sufficiency, outreach, and efficiency targets; install incentive systems based on targets.
Strategic and business plans may elaborate clear paths toward commercial viability, but lack of institutional transparency prohibits tracking progress.	<ul style="list-style-type: none"> • Strengthen management information system and internal control systems. • Prepare financial statements (income statements and balance sheets) in accordance with disclosure guidelines of the Consultative Group to Assist the Poorest and have them audited.
Availability of grants and subsidized funds diminishes incentives for microfinance NGO to access commercial sources of funds.	<ul style="list-style-type: none"> • Refuse donor grants and subsidized sources of funds when they limit the MFI's autonomy and commitment to commercial viability. • Diversify funding sources to include market-based funding sources so as to ensure stability in availability of funds over the medium and long term.
Lack of owners prohibits the microfinance NGO from accessing certain types of commercial sources of funds, such as savings deposits.	<ul style="list-style-type: none"> • Evaluate options for transformation into a formal financial institution.

Internal Actions

Increasing the commercialization of microfinance NGOs must begin with a strong internal commitment on behalf of the board and senior managers to accomplish social aims by moving toward financial self-sufficiency through a combination of strategic and business planning and adoption of cost-recovery interest rates. In effect, microfinance NGOs have to balance their social and commercial objectives. MFIs are vulnerable to social mission drift if they do not have a clearly defined target market and monitoring mechanisms to ensure they are providing appropriate financial services to the intended clients. MFIs are exposed to commercial mission drift if they do not set interest rates (and fees) high enough to cover costs and if they are not managed as a business. The large microfinance NGOs, such as ASA and BRAC, have proven, even in the difficult operating environment of Bangladesh, that only through achievements in financial self-sufficiency can outreach be expanded in a substantial and sustainable manner. They have also shown that commercial practices are not a deterrent to the achievement of their social mission.

An important part of this commitment to commercialization is striving for increasing cost efficiencies. The emphasis on efficiency is in line with microfinance NGOs' social objectives in that increases in efficiency allow for reductions in the interest rate charged on microloans and free up funds to fuel expansion for greater outreach. ASA's ability to reduce costs and keep interest rates low is proof that very high efficiency can be attained even when serving poor clients.

Institutional capacity in the vast majority of microfinance NGOs is extremely weak. Most do not have the ability to expand their outreach on a sustainable basis. Improvements in several areas should take priority. Mission statements should be clarified to incorporate a commitment to sustainability. Efficiency of operations should be emphasized to enable accountability to funders as well as clients. Institutional weaknesses in ownership and governance should be acknowledged and addressed through the establishment of clear lines of authority and responsibility, staff incentives that promote increasing and sustainable outreach, and adequate systems to monitor progress toward financial self-sufficiency and higher levels of operational efficiency.

Increased attention should be given to building human resource capacity in financial analysis and banking, in particular to improve strategic and business planning. Ensuring that board members

understand business and finance is crucial. MFIs should charge nonsubsidized interest rates while being market competitive. Interest rates need to be high enough to sustain the MFI's operations. Further, because the administration of many small loans is a costly operation, microfinance NGOs need to charge interest rates higher than those of commercial banks, yet lower than those of moneylenders. Preparing income statements and balance sheets in accordance with guidelines of the Consultative Group to Assist the Poorest and having them audited will increase the transparency of microfinance NGOs' operations and enable performance monitoring. These improvements will help microfinance NGOs to access commercial sources of capital.

External Carrots and Sticks

External subsidies can also play an important role in the commercialization of microfinance NGOs. In different forms, subsidies can be designed as carrots or sticks used to motivate existing microfinance NGOs to increase their commercial orientation while expanding their services to the poor. Access to donor subsidies in the form of outright grants or different types of matching grants to increase an MFI's level of commercialization and professionalism can act as a carrot to move it further along the commercialization continuum. Donor support of key industry support institutions, such as networks and training centers, to disseminate international and local success stories and best practices may also help to persuade microfinance NGOs to adopt a commercial approach. When profit potential can be demonstrated along with the interrelationship between sustainability and enhanced ability to expand outreach, microfinance NGOs will be more willing and able to move further along the commercialization continuum. Evidence of this may be most notable in the Philippines, where the demonstration effects of the transformation of CARD from an NGO into a bank have prompted numerous other NGOs to follow suit and have even helped to develop a trend of new entry by rural banks and thrift banks.

Diminishing access by microfinance NGOs to government or donor grants and subsidized loans increasingly acts as a stick to motivate microfinance NGOs to transform into formal financial institutions to gain access to consumer deposits as a reliable source of funds. For example, although funds are available in the Philippines through the government apex organization, the People's Credit and Finance

Corporation, many microfinance NGOs find the terms too expensive or short term. There, the graduated or tiered bank licensing system has been an indispensable element in substantially expanding the ability of MFIs to mobilize financial resources beyond traditional grants and donations (Gallardo 2001, p. 19). Thus far, there have been four cases of NGO transformation: CARD Bank in 1997, Opportunity Microfinance Bank in 2001 (OMB 2002), ARDCI's Vision Bank in April 2002, and *Banco Ng Masa* in mid-2002. In addition to these transformations, an October 2001 survey of institutional plans conducted by the Microfinance Council of the Philippines indicated that although most respondent rural banks are content to maintain their institutional form, 14 microfinance NGOs (out of 23 respondents that arguably represent most of the leading microfinance NGOs in the industry) are planning to establish a bank. Interestingly, there were also 12 cooperatives that expressed intent to transform into a bank (Microfinance Council of the Philippines 2002, p. 13).

Commercializing Cooperatives' Microfinance Operations

Cooperatives throughout Asia have suffered from decades of heavy government interference and developed a negative image among the general public, particularly the poor. Nonetheless, they can be potentially dynamic and sustainable players in the industry. Their historically strong social orientation and recurrent abuse for political ends make commercializing cooperatives' microfinance operations a difficult prospect and a goal that may only be realized over a long time horizon. While cooperatives can make significant contributions to microfinance given their private, local ownership in mostly rural locations, most are constrained by weak administrative and regulatory structures stemming from the problems highlighted above.

The cooperative sectors of Indonesia and Sri Lanka are still generally held back by inefficiencies associated with continued heavy government involvement and by internal governance problems. However, the commercialization of cooperatives appears to have made significant headway in the Philippines because of a few recent donor-supported projects there. Efforts to commercialize the Philippines cooperative sector are being carried out at two levels—at the national federation level and with selected primary cooperatives. These efforts provide insights into potential approaches to commercialization of cooperative microfinance.

Strategies to Commercialize Cooperatives at the National Level

At the national level, two donor-funded projects are attempting to overcome the lack of transparency that has historically been a major difficulty in assessing cooperative performance, by working with the largest of the four national federations of cooperatives, the National Confederation of Cooperatives or NATCCO (Box 4.3). Recent efforts have focused on creating a standard chart of accounts and an accompanying manual of accounts as well as COOP¹¹ administrative standards and PESOS¹² financial standards. The Cooperative Development Authority Board of Administrators issued a circular requiring all cooperatives engaged in credit activities to use the standards by January 2003. The remaining challenge lies in their widespread adoption and use. Other donor-supported efforts to strengthen the cooperative movement at the national level include capacity-building assistance to raise the overall professional capability and profitability of participating cooperatives by improving their financial management information systems, operating efficiency, product diversification including the development of microfinance products and services based on local and international best practices, and marketing.

Strategies to Commercialize Cooperatives at the Primary Cooperative Level

Donor-supported projects at the primary cooperative level are ongoing as well. One of the most successful is the USAID-funded CUES project implemented by the World Council of Credit Unions (WOCCU),¹³ implemented in 1996–2002 with 18 partner cooperatives in Mindanao; it is now working with 29 more cooperatives, including several in the Visayas region. CUES-Philippines transfers microfinance technologies to partner cooperatives through two approaches: (a) savings and credit with education, and (b) model credit union building.

¹¹ COOP stands for Compliance to administrative and legal requirements, Organizational structure, Operation and management, and Plans and programs.

¹² PESOS is the acronym for Portfolio quality, Efficiency, Stability, Operations, and Structure of assets)

¹³ Credit unions are not-for-profit financial cooperatives, owned by the people who save and borrow there. WOCCU is the largest of several international credit union apex organizations whose purpose is to provide advocacy, technology, and development services to its members (Richardson and Lennon 2001, p. 2).

Box 4.3: NATCCO and Recent Efforts to Commercialize Cooperative Microfinance

NATCCO was formed primarily to coordinate the provision of training and educational services at the national level, and serves as the voice of cooperatives belonging to the NATCCO network. Today, NATCCO is the strongest national federation of cooperatives in the country in terms of geographical reach, membership, financial capacity, and array of services. At the core of the NATCCO network are the 1,200 affiliated primary cooperatives comprising more than a million individual members.

“We are trying to professionalize our savings and credit operations to raise our level of competitiveness and competence to be at par with big commercial and international banks. We do this through the use of internationally accepted prudential ratios, common standard chart of accounts, computerization, and capability-building. We continue to test, develop viable and innovative enterprises that provide livelihood, income opportunities and basic products and social services to families and individuals.”

Source: NATCCO 2002.

The Savings and Credit with Education (SCWE)¹⁴ program is an integrated financial and education delivery system implemented in cooperation with Freedom From Hunger. It seeks to expand access to financial services for poor rural women and provides informal education on various topics including the formation of savings and credit associations. The Model Credit Union Building (MCUB) component consists of credit union institutional strengthening, savings mobilization and marketing, credit administration, safety and soundness, and short-term technical assistance. The combination of the two approaches has sharpened the cooperatives’ commercial focus as well as their social focus, and demonstrates that pursuing both need not be mutually exclusive. Indeed, the Philippines case shows that moving toward commercialization and achieving social goals can be mutually reinforcing (WOCCU 2002).

¹⁴ The SCWE program is an innovation of Freedom From Hunger, an international NGO promoting “self-help” to address the incidence of chronic hunger and malnutrition.

Two things stand out in the CUES approach in the Philippines as in the other four countries¹⁵ where WOCCU is working to commercialize credit unions aggressively: (a) strict credit discipline and adherence to performance standards, and (b) emphasis on savings mobilization. In order to provide a safe and sound place for members to deposit their savings, WOCCU has promoted eight core financial disciplines and corresponding prudential standards (Table 4.2).

Table 4.2: Financial Discipline and Prudential Standards of Commercialized Credit Unions

Financial Discipline	Prudential Standard
1. Delinquency ratio	< 10% of total loan portfolio > 30 days delinquent
2. Loan loss provisions	100% of all delinquent loans > 12 months 35% of all delinquent loans > 1–12 months
3. Loan charge-offs	100% of all delinquent loans > 12 months
4. Institutional capital reserves ratio	> or + 10% of total assets
5. Liquidity reserves ratio	15–20% of savings deposits
6. Nonearning assets ratio	< 10% of total assets
7. Operating expense ratio	< 10% of average total assets
8. Return-on assets-ratio	> 1% of average total assets (country specific)

Source: Richardson and Lennon 2001, p. 4.

Use of the PEARLS¹⁶ financial ratios has been especially useful in pinpointing key financial weaknesses and improving the transparency of credit unions' progress in overcoming them. The experience with building model credit unions shows the significant impact of market-based policies and practices of CUES-Philippines. Table 4.3 gives the performance results of partner cooperatives in Mindanao. The result was the transformation of credit unions into commercially viable MFIs that reach many poor and low-income clients.

Another innovation introduced by WOCCU as part of the CUES Philippines project is the concept of cooperative branding. The Philippines is the first Asian country to adopt it. The brand name is Finance Organizations Achieving Certified Credit Union Standards (FOCCUS). A cooperative that is certified by FOCCUS means it has

¹⁵ The other four countries are Bolivia, Ecuador, Guatemala, and Romania.

¹⁶ PEARLS measures the key areas of credit union operations: Protection, Effective financial structure, Asset quality, Rates of return and costs, and Liquidity and Signs of growth.

Table 4.3: Impact of Model Credit Union Building on Participating Credit Unions in Mindanao, Philippines

Measure (all expressed in %) [target]	Dec 1998	Dec 1999	Dec 2000	Mar 2003
Delinquency ratio [< or = 5%]	63.0	19.6	12.4	7.1
Provisions for loans > 12 months delinquent [100%]	10.3	44.8	100.0	100.0
Provisions for loans 1–12 months delinquent [100%]	0.0	61.0	100.0	100.0
Net institutional capital / total assets [min. 10%]	-16.9	2.0	4.2	11.4
Liquidity ratio [min.15%]	24.0	31.7	36.3	38.1
Nonearning assets / total assets [<7%]	20.4	28.6	18.6	9.3
Net operating expense / average assets [3–10%]	8.1	9.9	10.6	9.7
Return-on-assets ratio [>1% but varies by country]	2.1	4.1	5.1	5.2
Savings / total assets [70–80%]	35.1	48.0	54.5	58.8
External credit / total assets [max. 5%]	7.0	2.9	1.5	0.5

Source: Llanto and Fukui 2003, p. 7.

achieved certain international prudential financial ratios geared towards providing members the best financial service. Similar movement-wide branding strategies are being implemented in Australia, Central and Latin America, Poland, and the US. To achieve a FOCCUS brand, a cooperative must adhere to a set of prescribed ratios and other operational criteria. The introduction of cooperative branding has given a large boost to the objective of maintaining the financial condition and soundness of the cooperatives, thereby generating trust and confidence in the sector (Llanto and Fukui 2003, p. 8). The key international prudential standards adopted by FOCCUS are shown in Table 4.4.

The effort to instill brand recognition should strengthen the cooperatives' adherence to the accounting, COOP, and PESOS standards set forth by the Cooperative Development Authority Board of Administrators and lead to enhanced commercialization of cooperatives' microfinance operations. To further MCUB efforts of Philippine cooperatives, organization of an association composed of FOCCUS-branded cooperatives tasked to protect brand integrity is also planned to act as a model for longer-term supervisory and regulatory efforts. Such institutionalization should solidify the financial strengthening that cooperatives have made to date and expand the commercialization of cooperatives over time.

Table 4.4: Key International Prudential Standards of the FOCCUS Brand

Ratio	Silver	Gold	Platinum
LLP >12 months	100%	100%	100%
LLP 1–12 months	100%	100%	100%
Solvency	—	> or = 110%	> or = 110%
Net loans	> or = 60%	70–80%	70–80%
Savings deposits	> or = 50%	60–80%	70–80%
Net institutional credits	> or = 4%	> or = 8%	> or = 10%
Total delinquency	< or = 15%	< or = 10%	< or = 5%
Nonearning assets	Decreasing	< or = 10%	< or = 7%
Member shares	—	> or = inflation	> or = inflation
Operating expenses	< or = 12%	< or = 10%	< or = 10%
Liquidity	> or = 15%	> or = 15%	> or = 15%
Membership	> or = 5%	> or = 5%	> or = 5%
Total assets	> or = inflation	> or = inflation	> or = inflation

LLP = loan loss provision.

Source: Llanto and Fukui 2003, p. 8.

Expanding the Commercial Microfinance Operations of Unit Banks

Unit banks, because of their local, private ownership, low initial capitalization requirements, and rural locations are often referred to as community banks or rural banks. They are well-suited for engaging in the sustainable provision of microfinance (Box 4.4). They are widespread in Sri Lanka (311 CRBs with a network of 1,196 branches), Indonesia (2,143 BPRs), and the Philippines (786 rural banks, including 52 cooperative rural banks). While the number of unit banks is large, their potential has not yet been fully tapped as providers of commercial microfinance. Three main challenges confront rural banks in terms of their expansion of commercial microfinance. First, there is a need for unit banks to broaden and deepen their microfinance outreach, which takes commitment and ability from board members and senior managers. Second, unit banks must overcome hurdles associated with their unit structure in order to take advantage of economies of scale, in terms of risk diversification, liquidity management, and access to support services, such as training, product research and development, and marketing. Third, they need additional equity injections to strengthen their capital base and capacity to leverage commercial funds.

Box 4.4: Suitability of Rural Banks to Provide Commercial Microfinance

"Of all the banks, it is the rural banks that are the best placed to engage in microfinance. Rural banks are established to meet the credit needs of borrowers who are often outside the catchment areas of commercial banks and/or who may be considered poor risks by other banks...In addition, cooperative (rural) banks may be organized to perform banking and credit services for the cooperatives...The World Bank (1996, p. 64) comments that sufficient evidence exists of the profitable provision of savings and credit services to the poor by cooperative rural banks to suggest that '...these banks offer an interesting possibility for reaching the poor effectively without setting up alternative institutions'."

Source: Maguire et. al. 1998, p. 237.

Building the Willingness and Ability of Unit Banks to Expand Microfinance Operations

Recent donor efforts in the Philippines are leading to an increasing number of rural banks engaging in sustainable microfinance. The Microenterprise Access to Banking Services (MABS)¹⁷ program is breaking new ground by demonstrating that commercial microfinance providers can profitably serve the rural poor. Since this USAID-supported program started in 1998, MABS participating banks had disbursed about US\$56.4 million to more than 106,000 microentrepreneurs by August 2003. The MABS program has worked with 113 rural banks and bank branches to help them serve the microenterprise sector profitably, not only by transferring knowledge but also by converting rural bankers into true believers in microfinance best practices and building their long-term capacity to successfully apply these practices. By creating systematic processes for introducing

¹⁷ The MABS program is implemented by the Rural Bankers Association of the Philippines (RBAP) with oversight provided by the Mindanao Economic Development Council (MEDCo) and USAID. Technical assistance in the implementation of the MABS program is provided by Chemonics International, Inc.

microfinance to rural banks, MABS has hastened the expansion of microfinance in the Philippines (Owens and Campion 2003, p. 33).

Using what has been called the “MABS approach,” the program provides technical assistance, training, and limited resource support to participating rural banks (and cooperative rural banks) so they can profitably and sustainably expand their loan and deposit portfolios to microenterprises. The MABS approach includes intensive one-on-one technical assistance, workshops, seminars, on-the-job coaching, and exposure and training visits to participant banks. Each bank is assigned a technical advisor who ensures that the training and technical assistance are being delivered properly and efficiently. Each participant bank receives focused attention and support, which includes

- institutional assessment,
- senior management orientation,
- market surveys,
- product development/enhancement,
- management information system enhancement,
- business planning,
- on-the-job training (cashflow-based lending, zero tolerance toward delinquency, etc.), and
- development of in-house training capacity.

As of August 2003, MABS rural banks had 43,226 active loan clients, with a total outstanding loan portfolio of P291.7 million (US\$5.8 million) (Table 4.5). Since the program started, microdeposit balances (accounts with balances of P15,000 [US\$300] or less) of MABS partner banks increased by P541 million (US\$10 million), corresponding to 482,000 additional depositors’ accounts. These results demonstrate how donor-funded institutional strengthening can help to substantially increase the commercial provision of microfinance by unit banks.

Means to Overcome Limitations of the Unit Structure

Lack of national branch networks poses perhaps the greatest institutional constraint to expansion of rural bank microfinance operations in terms of being able to distribute credit risk geographically, manage bank liquidity, and provide customers with possibilities to withdraw savings or otherwise access their accounts in other areas. While the rural banking system as a whole may have substantial

Table 4.5: Performance Highlights for MABS Rural Banks
As of 31 August 2003

Indicators	Total
Number of bank branches	113
Number of active borrowers	43,226
Number of loan officers	411
Amount of loans outstanding (P million)	291.7
Average loan balance (P)	6,747
Average loan portfolio per loan officer (P)	709,621
Portfolio at risk more than 30 days (%)	3.5
Depth of outreach (average loan balance/GNP per capita) (%)	12.4

MABS = Microenterprise Access to Banking Services; GNP = gross national product

Source: Data from RBAP-MABS Program.

liquidity, much of this may be needed to offset the high ratio of term deposits to passbook savings, to provide a cushion for increased lending, and to address the lack of an effective interbank liquidity transfer mechanism. To reduce the need to maintain high liquidity, the establishment of an apex bank for the rural banking systems in Indonesia and the Philippines could facilitate more microlending.

Also related to the unit-based structure of rural banks, access to support services is an additional challenge. The development of new microfinance products and services, the training of staff, and the enforcement of effective auditing and control mechanisms are expensive; the costs can hardly be borne by a single rural bank. This makes cost sharing with an apex bank or bankers' association important. For example, the Perbarindo network of BPRs in Indonesia has been providing microfinance training for years and is now developing capacity-building tools in coordination with the German Agency for Technical Cooperation (GTZ) and Bank Indonesia in order to strengthen BPR performance and increase access to market sources of funds. Five training modules are under development for account officers, internal auditors, bank office, management, and accountants, respectively. Those trained receive a certificate and BPRs that complete the training are recommended to commercial banks for market sources of funds, following examination of their financial status by Bank Indonesia's BPR Supervision Department.