COMMERCIALIZATION OF MICROFINANCE

PERSPECTIVES FROM SOUTH AND SOUTHEAST ASIA

Stephanie Charitonenko

Anita Campion

Nimal A. Fernando

Asian Development Bank, Manila, Philippines
2004

About the authors: Stephanie Charitonenko is Project Manager and Anita Campion is Senior Manager at Chemonics International, Washington, DC. Nimal Fernando is Lead Rural Finance Specialist, Regional and Sustainable Development Department, Asian Development Bank, Manila.

This publication is available in the Asian Development Bank's microfinance website:
http://www.adb.org/microfinance

ISBN 971-561-537-6

Publication Stock No. 040104

Published by the Asian Development Bank, 2004.

FOREWORD

The gap between the potential demand for, and the actual supply of, microfinance services remains large. Bridging this gap remains a major challenge. Microfinance reduces financial exclusion and can have a significant impact on poverty reduction. Commercialization of microfinance is a possible solution for expansion of microfinance.

The Microfinance Development Strategy of the Asian Development Bank (ADB), approved in June 2000, and formulated through an extensive consultative process involving many industry stakeholders, recognizes the importance of commercialization, not as an end in itself but as a means to expand financial services to poor and low-income households and their microenterprises on a sustainable basis. Thus, an element of the strategy is to "support development of viable microfinance institutions that can set in motion a process of commercialization of microfinance services." To facilitate this, in November 2000, ADB approved a regional technical assistance project on Commercialization of Microfinance. The project was funded from the Japan Special Fund and its main objective was to improve understanding of the process of microfinance commercialization as well as its challenges, implications, and prospects. The project consisted of country studies, in-country workshops to discuss the findings of the country studies and institutional experiences, a regional study, and a regional workshop.

This publication is the report of the regional study, which was based primarily on the country studies–covering Bangladesh, Indonesia, Philippines, and Sri Lanka–enriched by observations on industry developments in other countries in the region and in Latin America. The report highlights the different perspectives on commercialization of microfinance and identifies issues and challenges relating to commercialization in the region. The report also recommends a range of approaches to promote the process of commercialization. Overall, the study provides excellent insights into the issues of commercialization of microfinance.

It is hoped that this publication will contribute to a better understanding of the issues involved in commercialization of microfinance and lead to better approaches to minimize the financial exclusion that characterizes the financial system, not only in the developing countries of the Asia and Pacific region but also in similar countries in other regions.

Jan P.M. van Heeswijk
Director General
Regional and Sustainable
Development Department

ACKNOWLEDGMENTS

The authors would like to thank all the representatives of governments, banks, nongovernment organizations, donors, and microfinance clients who shared their valuable time and experience in providing information for the four country reports–on Bangladesh, Indonesia, Philippines, and Sri Lanka, respectively–that formed the basis of this regional synthesis. We are grateful to S.M. Rahman, Ismah Afwan, and Dulan de Silva, co-authors on the country studies on Bangaldesh, Indonesia, and Sri Lanka, respectively, for their valuable inputs and insights.

CONTENTS

ABBREVIATIONS

ACLEDA	Association of Cambodian Local Economic Development Agencies
ADB	Asian Development Bank
ASA	Association for Social Advancement
BDB	*Bank Dagang Bali*
BKD	*Badan Kredit Desa*, or village credit association
BPR	*Bank Perkreditan Rakyat*, or people's credit bank
BRAC	Bangladesh Rural Advancement Committee
BRI	*Bank Rakyat Indonesia*, or People's Bank of Indonesia
CARD	Center for Agriculture and Rural Development
CRB	cooperative rural bank
CUES	Credit Union Empowerment and Strengthening Project
FOCCUS	Finance Organizations Achieving Certified Credit Union Standards
FSS	financial self-sufficiency
GDP	gross domestic product
HNB	Hatton National Bank
IPC	Internationale Projekt Consult, GmbH
LDKP	*Lembaga Dana Kredit Pedesaan*, or Rural Fund and Credit Institution
LPD	*Lembaga Perkreditan Desa*, or Village Credit Institution, LDKP in Bali
MABS	Microenterprise Access to Banking Services
MBB	MicroBanking Bulletin
MCUB	Model Credit Union Building
MEB	MicroEnteprise Bank
MFI	microfinance institution
NCC	National Credit Council
NGO	nongovernment organization
PKSF	*Palli Karma-Sahayak* Foundation
PP	*Perum Pegadaian*
RDB	rural development bank
SBS	Samurdhi Banking Society
SEEDS	Sarvodaya Economic Enterprise Development Services
TCCS	Thrift and Credit Cooperative Society
TSPI	*Tulay Sa Pag-Unlad*, Inc.
USAID	United States Agency for International Development
WOCCU	World Council of Credit Unions

1 Introduction

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

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

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

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

METHODOLOGY AND ORGANIZATION

The four country studies upon which this report is based integrate theoretical considerations drawing from the "financial systems" paradigm[2] and practical field experience for analyzing the commercialization of microfinance. The examination of issues draws from extensive stakeholder consultations in each country of study through individual and group meetings as well as country workshops. In addition, the main findings and recommendations incorporate data and analysis from relevant local studies and international publications, as noted throughout.

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

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

Table 1.1: Comparison of Country Contexts[a]

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

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

Source: World Bank 2002; UNDP 2002.

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

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

FRAMEWORK FOR UNDERSTANDING COMMERCIALIZATION OF MICROFINANCE

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

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

MFI Commercialization

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

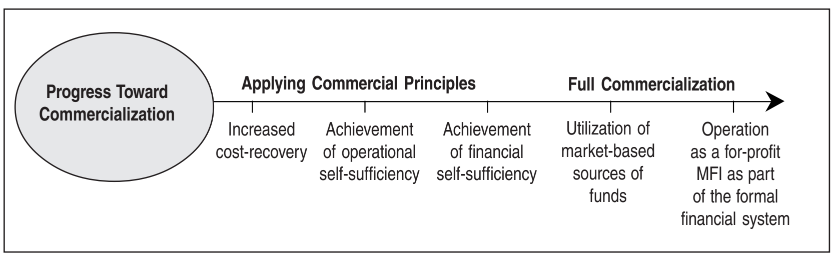
- Adoption of a professional, business-like approach to MFI administration and operation, such as developing diversified, demand-driven microfinance products and services and applying cost-recovery interest rates.

- Progression toward operational and financial self-sufficiency by increasing cost recovery and efficiency, as well as expanding outreach.

- Use of commercial sources of funds; for example, nonsubsidized loans from apex organizations (wholesale lending institutions) or commercial banks, mobilization of voluntary savings, or other market-based funding sources.

- Operation as a for-profit, formal[3] financial institution that is subject to prudential regulation and supervision and able to attract equity investment.

Figure 1.1: Illustrative Attributes of MFI Commercialization



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

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

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

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

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

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

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

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

Commercialization of the Microfinance Industry

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

1. **Policy Environment**
   - Absence of government policies that impede the ability of MFIs to make progress toward commercialization (examples of policies that may hamper MFI commercialization are interest rate caps and selective, ad hoc, debt-forgiveness programs).

   - Absence of subsidized (government or donor-supported) microcredit programs that may inhibit the development and growth of commercial MFIs and hinder competition.

2. **Legal Framework**
   - Presence of the legal framework for secured transactions (the creation [legal definition], perfection [registration], and repossession [enforcement] of claims) as well as for microenterprise formation and growth (Fleisig 1996, p. 45; Lyman 2000, p. 39–41).

   - Licensing options available to new MFI entrants or semiformal MFIs interested in transforming into formal financial institutions.

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

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

4. Money Markets and Capital Markets

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

5. Support Institutions

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

2 Progress Toward Microfinance Commercialization

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

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

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

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

Table 2.1: Attributes of Microfinance Commercialization

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

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

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

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

BANGLADESH

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

Table 2.2: Microfinance Supply in Bangladesh

As of end-2002, unless otherwise noted

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

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

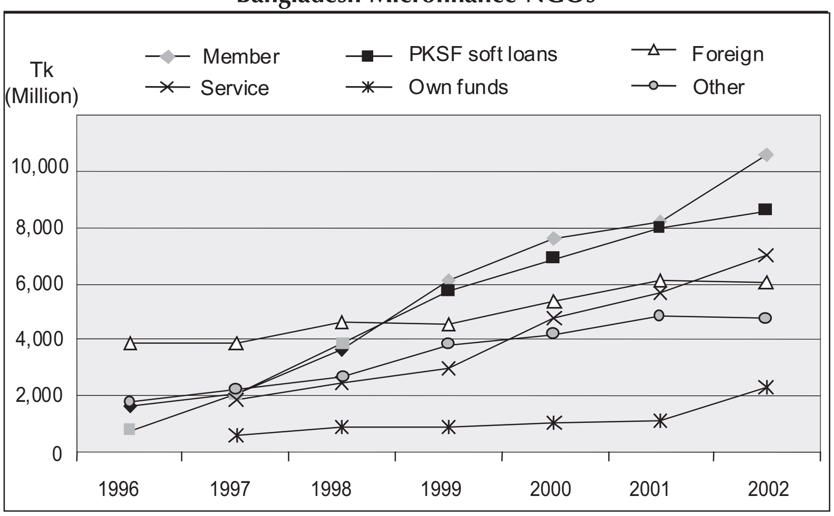
ASA = Association for Social Advancement; BRAC = Bangladesh Rural Advancement Committee; BRDB = Bangladesh Rural Development Board; NGO = nongovernment organization; PDBF = *Palli Daridro Bimochon* Foundation; WEDP = Women Entrepreneurship Development Programme.

Source: CDF 2003.

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

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

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



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

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

INDONESIA

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

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

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

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

Table 2.3: Indonesian Microfinance Supply Data, 2000–2002

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

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

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

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

PHILIPPINES

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

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

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

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

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

SRI LANKA

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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	MFIs 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 onlent 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/SLoan/ 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 capital[9] 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 Ennatien 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 ratio[10] 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.

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. Mutlilateral 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.	• 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.	• 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.	• 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.	• 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.	• 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 COOP[11] administrative standards and PESOS[12] 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 countries[15] 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 PEARLS[16] 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.

Meeting the Demand for Additional Capital

Undercapitalization is the third hurdle that most small-scale unit banks have to address to penetrate deeply into the microfinance market on a commercial basis. An assessment of CRBs in Sri Lanka carried out by ADB in 2003 indicated that most of them are seriously undercapitalized. Many rural banks in the Philippines also need additional equity capital if they are to expand their role in deposit mobilization and microlending. However, if unit banks are to attract new equity, it is essential that they improve transparency of their operations and establish industry standards. At the same time, governments need to liberalize restrictions on equity investments by foreigners in rural banks. At least, this could be done initially for socially responsible investor groups. Such liberalization is likely to bring in not only more equity but also much needed new technological applications, new ideas, and improvements in governance to these banks.

Attracting Commercial Banks to Microfinance

Although one might assume that the increasing level of competition in the formal banking sector would drive financial intermediaries to enter the micro segment of the market, these institutions have been very slow to expand into microfinance. Low financial depth[18] in the banking sector in Bangladesh and Sri Lanka indicates that while they are largely liberalized in terms of removing interest rate restrictions, they are not yet adequately developed (because of the predominance of inefficient state banks, limited professional banking skills, lack of technological advances, and other factors) to spur intense competition in traditional financial intermediation (Table 4.6). For example, in Bangladesh, inefficient nationalized banks account for about 80% of total banking sector assets and in Sri Lanka, two state-owned commercial banks account for around 55% of total banking sector assets. The lack of competitive environment means that formal financial institutions in these two countries have little incentive to scale-down their product offerings. Until these microfinance industries are freed

[18] Financial depth is defined here as the ratio of liquid liabilities in a financial system to GDP.

from supply-led microcredit and commercial MFIs demonstrate more profit potential, new entry by banks and other institutions funded with private risk capital is unlikely.

Table 4.6: Comparative Indicators of Financial Depth, 1999

	Domestic credit provided by the banking sector (% of GDP)	Liquid liabilities (% of GDP)
Bangladesh	33.5	31.4
Indonesia	60.5	57.2
Philippines	68.8	67.5
Sri Lanka	34.5	40.4
Low-income countries (average)	43.3	43.7
Middle-income countries (average)	70.5	66.1
High-income countries (average)	147.8	79.8

GDP = gross domestic product.

Notes: **Domestic credit provided by banking sector** includes all credit to various sectors on a gross basis, with the exception of credit to the central government, which is net. The banking sector includes monetary authorities and all banks for which information is available.

Liquid liabilities are also known as broad money, or M3. They are the sum of currency and deposits in the central bank (M0), plus transferable deposits and electronic currency (M1), plus time and savings deposits, foreign currency transferable deposits, certificates of deposit, and securities repurchase agreements (M2), plus travelers checks, foreign currency time deposits, commercial paper, and shares of mutual funds or market funds held by residents. The ratio of liquid liabilities to GDP indicates the relative size of these readily available forms of money—money that the owners can use to buy goods and services without incurring any cost.

Source: UNDP 2001, p. 282–285.

Poor infrastructure also contributes to commercial banks' reluctance to engage in microfinance operations. Weaknesses in telecommunications, and electrical and road networks pose significant challenges to bank branch expansion in a cost-effective manner. Infrastructure deficiencies increase risk and transaction costs not only for the banks but also for clients.

There are also socioeconomic and cultural barriers preventing more banks from entering the microfinance market. Microenterprise and small enterprise clients have difficulty approaching a bank because they lack education and do not possess business records to demonstrate cashflow. In many developing countries, social, cultural, and language barriers do not allow for an easy relationship with a modern banking institution.

The internal structures and systems of most private commercial banks are not geared to the small scale of microfinance operations. For example, senior managers and board members of commercial banks tend to focus on overseeing the greatest risks facing the bank, which tend to be the larger loans. This focus often results in inadequate attention being paid to the development of microfinance operations.

In terms of internal culture and operating systems, private commercial banks are generally better suited to providing larger loans, which makes them more apt to assist in the commercialization of microfinance by lending funds to MFIs for onlending, instead of directly serving microenterprise clients themselves. However, significant accounting and reporting impediments by MFIs limit loans to them; in other words, transparency of MFI performance remains an issue. Assistance to increase the transparency of some MFIs as good lending prospects has been provided by the Indonesian central bank and these efforts have led to increased access to commercial funds by MFIs (see Box 3.8). Additional assistance along these lines will be necessary before lending by commercial banks to MFIs can be expected to increase significantly.

However, even large commercial banks in some countries are beginning to take MFIs more seriously than before. The ICICI Bank, the largest private sector commercial bank and the second largest financial institution in India, for example, bought Rs42.1 million worth of crop loan portfolio from Samruddhi, an MFI operating in Andhra Pradesh (Box 4.5). This was the first securitization transaction in the microfinance industry.

Increasing competition is essentially what drove several commercial banks in Latin America to enter the microfinance market in the early 1990s. Many countries in Latin America at the time had experienced a decade or two of stable and positive economic growth, moderate inflation, and financial liberalization (which freed interest rates and reduced barriers to entry of new commercial banks and finance companies). The role of the State had been reduced and private sector activity had increased. These important changes led to an increase in the number of formal financial institutions targeting the microenterprise market.

Banco Solidario, S.A., or BancoSol, started operations in Bolivia in February 1992 as one of the first private commercial banks in the world to cater specifically to microentrepreneurs. It was founded by several leaders in the Bolivian business community, the Calmeadow

Box 4.5: Securitization Enters the Microfinance Industry

Securitization of loan portfolios of financial institutions is not something that attracts any special attention because it is so widely practiced in the broader financial sector. But that is not the case in the microfinance industry. Until November 2003, no MFI was able to securitize its loan portfolio and attract funds from a commercial entity. The ICICI Bank-Samruddhi securitization deal in India changed this and demonstrated that the industry is gradually entering into a new phase of commercialization.

The ICICI Bank bought Rs42.1 million (about US$900,000) of the crop loan portfolio from Samruddhi, a nonbank microfinance company registered with the Reserve Bank of India and operating in Andhra Pradesh.

The securitization transaction covers loans maturing between 1 December 2003 and 31 August 2004, with no payments of principal and interest so far and no overdues.

The main feature of the deal include:

- The seller, Samruddhi, assigns absolutely and irrevocably all receivables along with all rights, titles, and interests in and to such receivables, to the ICICI Bank, the buyer.
- Purchase consideration of Rs42.1 million shall be paid by the ICICI Bank.
- Samruddhi, as the collection agent, shall ensure collection of the receivables from the borrowers and payment of the same to ICICI Bank on the predetermined pay-out dates (12th of every month, starting in January 2004).
- Samruddhi shall provide a detailed report on each payment date regarding collections, shortfalls, and prepayments, if any, of the receivables during the period.
- The aggregate minimum amount to be received by ICICI Bank shall be the purchase consideration of Rs42.1 million together with yield thereon at 8.5% per annum compounded monthly.
- The remaining 15.5% (24.0–8.5%) shall accrue to Samruddhi for the collection expenses and as service charges.
- Samruddhi, as the guarantor, shall provide ICICI Bank with a first loss deficiency guarantee with respect to the amounts due and timely performance by the borrowers of their obligations, and the aggregate liability of Samruddhi in this regards shall not exceed 15% of the aggregate amount of the receivables.

Source: CEO, Bhartiya Samruddhi Finance Ltd., India.

Foundation and ACCION International. It grew directly out of the success of PRODEM (*Fundacion para la Promocion y el Desarrollo de la Microempresa*), a nonprofit microlending program that was created in 1986 as a joint venture between business leaders (who provided leadership and funding) and ACCION International (which provided a viable lending methodology and ongoing technical assistance). The decision to transform PRODEM from an NGO into a commercial bank arose out of the desire to meet the overwhelming demand for microcredit through a commercial approach and to provide a wider range of financial services including savings.

The profitability of BancoSol and other transformed NGOs during the 1990s prompted consumer finance companies, which were imported into Bolivia from Chile, to enter the microcredit market. Unlike the established microfinance providers, the consumer lenders were lax about repayment, predatory with their pricing, and aggressive in marketing to existing microcredit clients. This led to a crisis in Bolivian microfinance, which many consumer finance companies did not survive (Box 4.6). Among the more established MFIs, defaults rose to unprecedented heights, but they were able to recover due to their fundamentally sound microfinance operations and financial positions.

Although adequate incentives may not yet exist for numerous private commercial banks to enter the microfinance market, a few have developed significant microfinance programs. Notable examples include BDB in Indonesia as well as HNB and Seylan Bank in Sri Lanka.

BDB was one of the oldest private commercial banks offering microfinance on a commercial basis in the world. It was originally established in 1970 by a husband and wife team of professional moneylenders to better serve the Balinese community of local traders and produce merchants (Robinson 2002, p. 147–149). Although BDB was a relatively small bank, it had regional significance, with 31 branches and offices located mainly on the island of Bali. It was important in that it remained dedicated to microfinance and small business lending. While commercially oriented, BDB retained its family ownership structure. This proved to be a significant, weak aspect when the pioneers' children began to exert more influence on BDB's operations; governance of the institution weakened as a result. BDB's closure by the Indonesian central bank in April 2004 because of noncompliance with prudential regulations illustrates that close

Box 4.6: Crisis in Bolivian Microfinance

Since the early 1990s, Bolivia has boasted successful MFIs that have transformed from NGOs into regulated commercial institutions including BancoSol. Bolivia's commercial microfinance experience took on a new dimension in the late 1990s, as transformed MFIs grew and consumer lenders began overlapping with microfinance markets. This increase in competition converged with a major recession in Bolivia. These events led to a crisis in which borrowers became overindebted and institutions suffered client desertion, falling profits and dangerously high delinquency rates.

On 2 July 2001, this situation came to a head as associations of poor fruit vendors, cobblers, and farmers took Bolivia's Superintendency of Banks hostage. Laden with dynamite, they demanded forgiveness or reduction of the debt they incurred through microlenders and consumer lenders. The situation was resolved, but over-indebted microfinance clients and the sour taste of revolt remain.

Source: Adapted from Rhyne 2001.

attention must be paid to governance and effective supervision of MFIs, and that private investments do not necessarily ensure sustainability.

In Sri Lanka, HNB and Seylan Bank provide additional examples of private commercial banks offering microfinance. However, their combined number of microloans outstanding was only about 1% of the industry total at the end of 2000. Both have found it difficult to deliver microfinance services in a sustainable manner, although HNB has had more success in running its programs at only a minimal annual loss. The main constraint has been the Government's subsidized microcredit programs and frequent debt-relief packages in the microfinance market, which, these banks say, makes it difficult for them to compete for clients and damages the general repayment culture.

Commercial banks can be active partners in sustainable microfinance through equity investments in specialized microfinance institutions. Several commercial banks in Latin America have resorted to this method. For example, when Mibanco was established in 1998 through transformation of the NGO Acción Comunitaria del Perú (ACP), two commercial banks invested in its equity (Fernando 2003b, p. 7). The Planters Bank in the Philippines played a key role in the establishment of the Microenterprise Development Bank in Mindanao and took a significant equity stake. Commercial bank involvement in microfinance in this manner will also enable them to understand better the microfinance market and can be a stepping stone to direct service provision at a later stage.

Another emerging modality for commercial bank involvement in microfinance is what ACCION International calls "the service company model," in which a commercial bank establishes a separate nonfinancial company, depending on the legal framework that "provides loan obligations and credit administration services to a bank. The service company does all the work of promoting, evaluating, approving, tracking, and collecting loans; however, the loans themselves are on the books of the banks" (ACCION International 2003, p. 6). This model has been put into practice in Haiti by SOGE Bank through SOGESOL, a nonfinancial company. ABN AMRO/ Banco Real in Brazil, through its service company Real Microcredito, and Banco del Pichincha in Ecuador, through its service company CREDIFE, also use this model.

5 Conclusions

Commercialization of microfinance in the Asia and Pacific region holds the promise of capitalizing on the achievements in outreach that MFIs have made to date. General improvements in MFIs' financial self-sufficiency and efficiency are promising, but the industry is far from achieving all the potential benefits of microfinance commercialization.

The largest impediment to commercialization may be the persistence of large, subsidized microcredit programs, which continue to be promoted by governments and donors alike. Continuance of these programs is mainly due to a negative perception of commercial microfinance. Many Asian policymakers and practitioners continue to have paternalistic attitudes and hold the false belief that microborrrowers are too poor to pay cost-recovery interest rates. This notion appears to have a very strong influence on the speed with which the microfinance industry is moving toward a higher level of commercialization (Fernando 2002, p. 6).

Favorable attitudes toward commercialization in Indonesia and the Philippines have contributed to greater levels of microfinance commercialization in Southeast Asia than South Asia. The long history of microfinance in the region yields ample evidence that commercialization has contributed to substantial and sustainable increases in outreach in terms of breadth, depth, and scope. Mission drift, commonly assumed to be associated with increased commercialization, has not occurred in some of the most commercial MFIs in the region. Although significant impediments still exist to inflows of private equity and debt capital, progress toward commercialization has led many leading MFIs to expand savings mobilization dramatically, both as a valuable service to their predominantly poor clients and as a source of funding. By tapping into savings, the most commercial MFIs have achieved scale and efficiency, while providing an important financial service to the poor. As examples like these of the benefits of commercial microfinance become more widely disseminated, attitudes may change, allowing the commercialization of the industry to progress more rapidly.

The two countries that offer the greatest potential for microfinance outreach are the PRC and India, with their large and growing populations. To date, however, MFIs in these countries have not yet achieved significant outreach, mostly because of the lack of enabling environments. Most of the microfinance programs in the PRC are either government controlled or government influenced, and usury laws have impeded MFIs from charging cost-recovery interest rates. In India, banks have provided access to deposit services for a large number of small savers, but total demand for microfinance is far from being met. The rapid growth of self-help groups and other community-based intermediaries is still insufficient to meet the ever-increasing demands of microborrowers (Titus 2002, p. 303). The number of poor households with demand for microcredit in India is estimated to be 75 million, of which less than 4% (3 million) are currently served (Fisher and Sriram 2002, p. 41). Microfinance expansion in India has been stalled by government-sponsored and donor-subsidized credit programs and poor physical infrastructure, which have hindered commercial microfinance from taking root. Until these issues are addressed, microfinance in the Asia and Pacific region will be far from achieving its full impact.

While NGOs have played a key role in demonstrating that the poor can save and repay loans, a significant amount of microfinance outreach has been and will continue to be provided by commercial MFIs. A few microfinance NGOs have been able to achieve vast outreach, primarily because of charismatic leaders with strong commitments to serving the poor. However, most have not been able to achieve scale, mainly because of difficulties in accessing funds to fuel their growth. Nonetheless, microfinance NGOs can still play a role in expanding microfinance by experimenting with new methodologies to reach further down-market, especially to the rural poor. Difficult terrains, low population densities, and limited infrastructure predominant in rural areas all pose a challenge to commercial microfinance. With donor support, microfinance NGOs should continue to seek ways to reduce transaction costs and increase efficiencies through innovation and experimentation, without undermining market mechanisms. Once more efficient and profitable models are identified, it is likely that commercial financial institutions will be attracted to serve poor and low-income segments of rural markets as well.

Implementation of the recommendations contained in this report would assist the movement of each of the countries in the Asia and Pacific region further along the commercialization continuum, which should result in expanding access to microfinance for the poor as well as higher-income clients. Clients will likely be offered an increasing variety of products and services that are more customized to their specific needs and preferences, resulting in greater customer satisfaction. In turn, clients' businesses will be able to grow, yielding more income and creating jobs for other low-income individuals. This is a model that is likely to lead to economic growth for each of the countries as a whole and create more wealth from which to pay for necessary social services, including those that reach the poorest segment of society.

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