

ASIAN DEVELOPMENT BANK

REG: OTH 33537

**TECHNICAL ASSISTANCE
(Financed from the Japan Special Fund)**

FOR THE

COMMERCIALIZATION OF MICROFINANCE

November 2000

ABBREVIATIONS

ADB	–	Asian Development Bank
AWAR	–	Agriculture and Rural Development Division West
DMC	–	developing member country
MDS	–	Microfinance Development Strategy
MFI	–	microfinance institution
NGO	–	nongovernment organization
TA	–	technical assistance

NOTE

In this report, “\$” refers to US dollars.

I. INTRODUCTION

1. The Asian Development Bank (ADB) approved its Microfinance Development Strategy (MDS) in June 2000.¹ The MDS emphasizes the importance of developing sustainable microfinance to fully harness the potential of microfinance for poverty reduction in the Asian and Pacific Region. The extent of poverty reduction impact of microfinance will depend mainly on the scale and scope of services. The outreach of service providers can be expanded on a sustainable basis only if they adopt a commercial approach. However, neither the commercialization, defined as the expansion of profit-driven, market-based financial institutions serving the microfinance market, nor its various facets and implications for the microfinance industry are well understood by microfinance stakeholders in the Region. This paper outlines a regional technical assistance (TA) designed to facilitate a better understanding of the process of commercializing microfinance, and its many facets and implications.

2. The TA paper is based on a review of the microfinance market developments in the Region carried out during the preparation of the MDS. Further information for preparation of the paper was gathered during the TA Fact-Finding Mission during 12–25 July 2000 in Bangladesh and Indonesia.² The Fact-Finding Mission conducted consultations with microfinance practitioners, nongovernment organizations (NGOs), policymakers, and representatives of other funding agencies on the concept of commercialization and the scope of the TA.³

II. BACKGROUND AND RATIONALE

3. Microfinance is considered an important tool in poverty reduction. Microfinance can make a potentially significant contribution to poverty reduction by, among other things, enabling an increasing number of poor households to access financial services on a continuing basis to make better use of investment opportunities, build assets, and smoothen household consumption (footnote 1, pp. 2-3). Currently, it is estimated that, despite the growth of microfinance operations over the last two decades, no more than 10 percent of poor households in the Region have access to institutional sources of finance. Over 90 percent of clients with access to institutional microfinance are concentrated in Bangladesh and Indonesia.⁴ Many microfinance institutions (MFIs), including those in Bangladesh and Indonesia, still provide only limited services. For example, few MFIs provide microinsurance services. Microcredit operations of many microfinance or credit institutions are also limited in scope. In many cases, initial loan amounts and subsequent increases to the loan amounts are predetermined by the lending institutions and applied uniformly to all borrowers. The maturity of loans is fixed by the lending institutions without taking into account client preferences. The menu of credit products is not diversified to reflect the diversity of demand. Often loans are not given for purposes such as housing and consumption. It is also generally recognized that even microenterprises have been excluded from the services of many MFIs, with the exception of the unit desas of the Bank

¹ R106-00: *Finance for the Poor: Microfinance Development Strategy*, 6 June.

² Fact-finding missions to the Philippines and Sri Lanka were considered not necessary because a substantial amount of information was collected on the microfinance industry of these countries by the mission during formulation of the MDS in 1999.

³ The TA first appeared in the *ADB Business Opportunities* in December 1999.

⁴ It is tentatively estimated that about 7 million in Bangladesh and 10 million households in Indonesia have access to institutional microfinance services.

Rakyat Indonesia, in part due to self-imposed loan ceilings.⁵ Many MFIs adopt lending methodologies that impose high transaction costs on their clients.

4. Most MFIs do not adopt a commercial approach to pricing their products and services, and consider their operations as commercial. The dominant view among the service providers in many developing member countries (DMCs) appears to be that social considerations should predominate and overshadow profit concerns because their operations target poor households. As a result, interest rates charged by many MFIs are insufficient to cover their operating costs. The pricing policies do not aim to protect the erosion of capital from inflation.⁶ Similarly, the emphasis on operational efficiency is inadequate. Therefore, many MFIs require continued subsidies if they are to remain in business. Another important aspect is the heavy reliance on concessional funds for lending operations. For example, by 31 December 1999, such funds accounted for about 43 percent of the loanable funds for the microfinance industry in Bangladesh. The policy environment in some DMCs is also an impediment to adopting commercial practices. The ceilings on interest rates in the People's Republic of China and Viet Nam for microcredit are a case in point.

5. The supply-driven approach is coming under increasing pressure in countries where competition in the market place has improved. Thus, in Bangladesh, client desertion has become a serious problem for some major MFIs. The clients appear to show little loyalty to the institution when it does not fully meet their demand and there are better alternatives at low switching costs. Also in a competitive environment, clients tend to obtain credit from a number of institutions and become overindebted with adverse consequences on their loan repayment capacity. Some MFIs in Bangladesh have thus been experiencing a decline in their loan recovery rates, which have been generally over 95 percent and the hallmark of their operations.

6. MFIs are also being subjected to increasing pressure to improve the depth of their outreach in line with increasing concerns for poverty reduction. The call to enhance the depth of outreach is made in a context where financial sustainability is also emphasized. The strong demand for financial viability of service providers suggests that the long-term prospects for concessional external funding for MFIs that are not committed to achieving financial viability may be bleak. Traditionally the MFIs in the Region have not been subjected to this kind of pressure. Many operated in a noncompetitive market situation with relatively easy access to concessional funding. They perceived the potential market as unlimited, given the extensive use of informal sources by the poor for their financial services and the very high interest rates charged on microcredit by the informal sector suppliers. The MFIs primarily see their mission as a social one based on paternalistic approaches. High loan recovery rates were seen as an adequate measure of their operational efficiency.⁷ This perception of their operations did not require MFIs to adopt cost recovery interest rates or pursue operational efficiency with a significant commitment.

7. The microfinance industry in most countries in the Region began with grant funds or funds provided at highly concessional interest rates by various funding agencies and

⁵ A few large NGOs in Bangladesh have recently introduced new programs to provide loans to microenterprises.

⁶ Calmeadow. 2000. *The Microbanking Bulletin*, No. 4. Calmeadow, Washington, DC.

⁷ However, many MFIs did not correctly measure and report loan recoveries. See CGAP. 1999. *Measuring Microcredit Delinquency: Ratios Can be Harmful to Your Health*. Occasional Paper No. 3. CGAP, Washington, DC.

governments. Most MFIs continue to rely on such funds to sustain their operations. However, this approach does not encourage them to achieve financial viability. As highlighted in ADB's Rural Asia Study,⁸ it is evident that a commercial approach is essential for microfinance development if the services are to be expanded to reach a majority of the excluded clients and to provide a wide array of services to those who currently have access to a limited range of services on a sustainable basis. In the absence of commercial approaches, the prospects of reaching a majority of the potential clients with quality and diverse services on a permanent basis will decline over time.

8. Although the commercialization of microfinance can potentially contribute to the expansion of the outreach over time, it is not a simple, straightforward process of rapidly increasing the degree of market reliance of MFIs and replacing their supply-driven approach with a demand-driven approach. Commercialization means dramatic changes for existing MFIs in their approach to the provision of microfinance services and mobilization of resources; internal organizational structure including delivery mechanisms, type of services, and governance; and pricing policies. The domestic resource mobilization through public voluntary deposits raises major operational and legal issues in particular where NGOs play a dominant role in the industry.

9. The commercialization of the Region's microfinance industry may also require new institutions to enter this market based on its profit potential. Although it has generally been assumed that the increasing level of competition in the formal banking sector will drive the traditional regulated financial institutions to enter this segment of the market, these institutions have been slow to penetrate this market segment. In most countries the regulated financial institutions with private risk capital do not seem to show a noticeable interest in this market.⁹ Many MFIs have also not been able to establish significant commercial links with private commercial banks.¹⁰ It is possible that this may be due to the lack of knowledge of commercial prospects in the market by the traditional regulated institutions, or predominance of noncommercial operators that undermine the incentives for private capital to enter the market. Obviously, MFIs with access to adequate grants or subsidized funds have little incentive to establish commercial links.

10. Given the status of the microfinance industry, three broad sets of issues appear to be important for commercializing microfinance in the Region. The first set relates to how the existing microfinance NGOs can be motivated to increase their commercial orientation while expanding their services to the poor. The second set relates to how private, commercially oriented financial institutions can be encouraged to enter this market based on its profit potential. The third set relates to the impact of commercialization on providing services to an increasing segment of the poor. To address these issues, MFIs, potential investors, and funding agencies require a better understanding of the process of commercialization with its implications and challenges.

⁸ ADB. 2000. *Rural Asia Study: Beyond the Green Revolution*. Manila: ADB.

⁹ However, Indonesia is an exception to this, where many small privately owned financial institutions play a relatively significant role in this market. Bank Dagang Bali is an example. Bank Dagang Bali entered this market in 1970 and has been playing a significant role particularly in mobilizing microsavings. See ADB. 2000. *Finance for the Poor*, 1 (1).

¹⁰ Foundation for Development Cooperation 1999. *The Role of Commercial Banks in Microfinance*. Foundation for Development Cooperation, Brisbane.

III. THE TECHNICAL ASSISTANCE

A. Objectives

11. The objectives of the TA are to (i) carry out a thorough analysis of commercialization of the microfinance industry; (ii) provide an opportunity for the stakeholders in microfinance to discuss the issues involved in commercialization; and (iii) make recommendations on appropriate approaches to the commercialization of microfinance. The TA framework is presented in Appendix 1.

B. Scope

12. The TA covers four countries: Bangladesh, Indonesia, Philippines, and Sri Lanka. These countries are selected to represent ADB's East and West regions and different stages of commercialization. The TA consists of three components: (i) country studies on the status, process, and implications of commercialization of microfinance; (ii) in-country workshops to discuss the country studies and country-specific institutional experience in the commercialization of microfinance; and (iii) a regional workshop to discuss each country-study and institutional experiences in a comparative context.

13. The country studies will focus on the historical process and the current status of the commercialization of the microfinance industry; major factors that have influenced the process; constraints on, and prospects for, commercialization; and the medium-term outlook for, and the implications of, commercialization. The country studies will also examine different perspectives of major stakeholders on commercialization through focus group discussions.

14. The country-level workshops will provide an opportunity for a broad range of microfinance stakeholders in each country included in the TA to discuss the respective country studies and country-specific institutional experiences with commercialization. The specific institutional experiences will be presented by key staff of the concerned MFIs at the invitation of ADB.

15. The regional workshop will focus on comparative aspects of the commercialization of microfinance in the four countries covered by the TA. For this purpose, a comparative study paper will be prepared for presentation at the regional workshop, based on the country studies. The regional workshop will also discuss a selected case study from each country to enrich the discussion on comparative aspects and make recommendations on appropriate approaches to promote the commercialization.

C. Cost Estimates and Financing Plan

16. The total cost of the TA is estimated at \$700,000 and will be financed by ADB on a grant basis from the Japan Special Fund, funded by the Government of Japan. Detailed cost estimates are given in Appendix 2.

D. Implementation Arrangements

17. ADB will be the Executing Agency for the TA. The Agriculture and Rural Development Division West (AWAR) will be responsible for TA implementation. AWAR will coordinate closely with the Agriculture and Social Sectors Department East, and other

departments and offices involved in microfinance operations in the respective countries. ADB's resident missions in each of the countries included in the TA will assist AWAR in organizing the country workshops. In addition, the Indonesia Resident Mission will assist AWAR in organizing the regional workshop to be held in Indonesia.

18. The country studies and the comparative regional study will be placed on the ADB web site to provide access to the studies to a wide audience. The country-level workshops will allow for wider participation of stakeholders in microfinance including NGOs, potential private sector investors, and service providers. Representatives of other funding agencies involved in microfinance operations in the respective countries and staff of the Consultative Group to Assist the Poorest will be invited to the workshops.

19. The regional workshop will be held in Indonesia for three days. About 40-45 DMC representatives will participate. About 25 of these participants will come from the four countries in which country studies will be conducted, while the rest will come from about four other DMCs where ADB is involved in microfinance development operations. About 8 representatives of other funding agencies will also be invited to participate in this regional workshop. The DMC participants will be identified by AWAR staff in consultation with the other concerned departments and offices and the relevant resident missions. The results of the country studies and regional study will be disseminated to ADB staff through the microfinance newsletter and seminars.

20. The TA will require about 10 person-months of international and 8 person-months of domestic consulting services. The consultants will be experts in microfinance and selected on an individual basis. The international consultant will carry out the country studies and conduct the country workshops in association with the domestic consultants of the respective countries. The international consultant will also prepare the comparative study and conduct the regional workshop. Detailed terms of reference for the TA consultants are given in Appendix 3. In addition, four domestic resource persons will be engaged to assist in conducting each country workshop. ADB will invite a selected number of MFIs to prepare and present specific case studies on their institutional experience with commercialization at the country workshops. Two internationally recognized microfinance resource persons will be invited to assist the international consultant in conducting the regional workshop. The selection and engagement of consultants will be carried out by ADB in accordance with ADB's *Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB for the engagement of domestic consultants. The TA is expected to commence in March 2001 and be completed in April 2002.

IV. THE PRESIDENT'S DECISION

21. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance, on a grant basis, in an amount not exceeding \$700,000, for the purpose of the Commercialization of Microfinance, and hereby reports such action to the Board.

TECHNICAL ASSISTANCE FRAMEWORK

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
Goal <ul style="list-style-type: none"> • Increased outreach of microfinance institutions (MFIs) 	<ul style="list-style-type: none"> • Increased number of households served by financially self-sustainable microfinance institutions 	<ul style="list-style-type: none"> • Reports on MFI operations and performance • Microbanking Bulletin statistics 	Assumptions: <ul style="list-style-type: none"> • Macroeconomic stability will continue.
Purpose <ul style="list-style-type: none"> • Increase understanding of the stakeholders in microfinance of the process and implication of, and issues in, commercialization. 	<ul style="list-style-type: none"> • Increased reliance of MFIs on market-based pricing policies • Increased reliance on demand-driven approaches to services 	<ul style="list-style-type: none"> • Statistics from MFIs • Microbanking Bulletin statistics 	Risks: <ul style="list-style-type: none"> • Subsidized microfinance programs will continue to undermine the process of commercialization
Outputs <ol style="list-style-type: none"> 1. Country studies completed 2. Country workshops conducted to discuss country studies with the stakeholders and key issues in commercialization are identified by the stakeholders 3. Regional workshop conducted and a set of recommendations on how to approach the commercialization is formulated 	<ul style="list-style-type: none"> • Each country study completed within two months from commencement • Stakeholders in microfinance actively participated in workshops • The understanding of the stakeholders on the issues involved in the commercialization is enhanced • Stakeholders from at least eight developing member countries (DMCs) actively participate in the workshop 	<ul style="list-style-type: none"> • Technical Assistance (TA) review missions • TA review missions • TA review missions 	Assumptions: <ul style="list-style-type: none"> • Competent international and domestic consultants are recruited • Stakeholders will actively participate in the workshops • Appropriate stakeholders will participate in the regional workshop • Resource persons will make a significant contribution to the workshop deliberations

(Reference in text: page 4, para. 11)

<p>Activities</p> <p>1.1 Select the international and domestic consultants.</p> <p>1.2 Prepare the framework for country studies.</p> <p>1.3 Carry out the country studies.</p> <p>2.1 Conduct the country workshops.</p> <p>3.1 Prepare the comparative study paper on commercialization.</p> <p>3.2 Conduct the regional workshop.</p> <p>3.3 Place the country and regional studies on the ADB web site for wider access.</p>	<ul style="list-style-type: none"> • One international consultant and four domestic consultants • The international consultant works in close consultation with the concerned staff 	<ul style="list-style-type: none"> • Country study papers • TA review missions • TA review missions 	<p>Assumptions:</p> <ul style="list-style-type: none"> • Consultants complete their work on time • Resident missions provide adequate assistance • The comparative study is completed on time • Regional workshop is organized successfully • Indonesian Resident Mission provides support to organize the workshop
<p>Inputs</p> <ul style="list-style-type: none"> • Consultants \$308,000 • Domestic resource persons \$ 20,000 • Institutional case studies \$ 20,000 • Country workshops \$ 80,000 • Regional workshop <ul style="list-style-type: none"> - resource persons \$ 23,000 - other costs \$153,000 • Staff travel \$ 16,000 • Contingency \$ 80,000 			

COST ESTIMATES

Item	Total Cost (\$)
A. Country Studies	
1. International Consultants	
a. Remuneration and Per Diem	205,000
b. International and Domestic Travel	36,000
c. Reports and Communications	4,000
2. Domestic Consultants	
a. Remuneration and Per Diem	49,000
b. Domestic Travel	4,000
c. Reports and Communications	2,000
3. Focus Group Discussions	8,000
Subtotal (A)	308,000
B. Country Workshops	
1. Domestic Resource Persons	20,000
2. Institutional Case Study Preparation	20,000
3. Workshop Facilities and Related Costs	34,000
4. Workshop Participants	
a. Per Diem	20,000
b. Travel	12,000
5. Administrative and Other Support Costs	14,000
Subtotal (B)	120,000
C. Regional Workshop in Indonesia	
1. International Resource Persons	
a. Remuneration and Per Diem	10,000
b. Travel	8,000
2. Domestic Resource Persons	
a. Remuneration and Per Diem	4,000
b. Travel	1,000
3. Regional Workshop Participants	
a. Travel	72,000
b. Per Diem	26,000
4. Workshop Facilities and Related Costs	19,000
5. Support Staff	8,000
6. Field Trip, Transportation, Photocopying, etc.	6,000
7. Editing of Papers and Publications	10,000
8. Administration and Support Costs	12,000
Subtotal (C)	176,000
D. Travel for ADB Staff Resource Persons	16,000
E. Contingency	80,000
Total	700,000

ADB = Asian Development Bank.
Source: Staff estimates.

TERMS OF REFERENCE

A. International Consultant (10 person-months)

1. The international consultant will be a microfinance specialist with wide experience in the microfinance industry in the Asian and Pacific Region. The consultant should have a thorough knowledge in operational and policy issues in microfinance in the region. The consultant will work together with the domestic consultants in each country. As the team leader, he/she will have overall responsibility for supervision of the activities of the domestic consultants. He/she will carry out the work in close consultation with the concerned staff of the Asian Development Bank (ADB) and ensure that all members of the team will use the results of the ADB study of the role of central banks in microfinance (completed under TA 5836: Consultations on the Bank's Microfinance Strategy) in carrying out this assignment. In addition, the consultants will make use of the findings of other technical assistance (TA) studies relevant to the subject including the studies carried out under the TA 5773: Secured Transactions Law Reform. The team leader will

- (i) prepare a general framework for the country studies on the commercialization of microfinance in consultation with the concerned ADB staff, and explain the framework to the domestic consultants to come to a shared understanding of the framework;
- (ii) consult the stakeholders in microfinance in each country, including the clients and potential clients, on various aspects of the commercialization and its implications for the poor, poorest, and the microfinance financial institutions (MFIs);
- (iii) identify gender aspects relating to the commercialization;
- (iv) collect data and information on operational and financial performance of MFIs at different stages of the commercialization;
- (v) identify perspectives of different stakeholders on the commercialization;
- (vi) on the basis of data and information collected, make an assessment of the historical process and the status of commercialization of the microfinance industry of each country;
- (vii) analyze how development assistance has affected the commercialization;
- (viii) review the policy, legal, and regulatory environment for commercialization;
- (ix) identify salient characteristics relating to the commercialization; and legal and other constraints on, and prospects for, the commercialization;
- (x) assess how the process of the commercialization has impacted on the poor households; the poorest of the poor, women in the potential microfinance market, and microenterprise operators;
- (xi) analyze whether there has been and will be a trade-off between the commercialization and providing access to financial services on a continuing basis to the poor and the poorest in each country, and comment on the extent of the trade-off;
- (xii) make recommendations on the desirability of promoting the commercialization within each country context, the time frame for increasing the current level of commercialization, and what specific measures are required to increase the level of the commercialization while increasing outreach to the poor;
- (xiii) in association with the domestic consultants of each country prepare a country-study paper on the commercialization of microfinance;
- (xiv) organize a country workshop in each of the countries covered in the TA in association with the ADB resident missions in the respective countries, and conduct the workshops;

(Reference in text: page 5, para. 20)

- (xv) prepare a comparative study paper on the basis of the country studies for presentation at the regional workshop on the commercialization, and document recommendations of the participants at the regional workshop; and
- (xvi) assist in organizing the regional workshop, and conduct the regional workshop in association with domestic and international resource persons.

B. Domestic Consultants (4 consultants, 2 person-months each)

2. The domestic consultants will be microfinance specialists with over five years experience in the microfinance industry. They should have a good knowledge of international best practices and the recent global developments in microfinance. Each domestic consultant is required to assist the international consultant in carrying out the country studies and conducting the respective country workshops. Each domestic consultant will

- (i) organize and participate in consultation meetings with stakeholders of microfinance;
- (ii) organize field work and assist the international consultant with logistical arrangements relating to the country study;
- (iii) collect data and information on operational and financial aspects of the commercialization of microfinance from microfinance institutions and other sources;
- (iv) identify perspectives of different groups of clients on various aspects of the commercialization including their capacity to bear cost recovery interest rates on microcredit, the deposit and other services they require, and the quality of services of different service providers;
- (v) assess gender aspects of commercialization;
- (vi) analyze the historical process of commercialization and its impact on various categories of the poor;
- (vii) assist the international consultant in preparing the country study paper by providing written inputs;
- (viii) help the international consultant with logistical arrangements relating to the country workshop and conduct of the country workshop; and
- (ix) provide any other assistance to the international consultant to successfully complete the country study and country workshop.