Financial Sector

Microfinance

A. Introduction

The field of microfinance has developed substantially in the last 25 years and has seen significant growth in the last decade. From the simple credit delivery schemes for the poor in support of their livelihood, microfinance has evolved to be considered as an important part of the financial sector to serve a market niche long deprived of access to responsive, reasonably priced, sustainable and broad-ranged financial services, including savings, loans, remittances, transfer payments, and insurance (Table 1). Thus, microfinance issues can no longer be confined within the narrow context of short-lived project objectives, but now transcend a spectrum of concerns covering the aptness of policies, institutional sustainability, responsiveness of financial products and services, the mitigation of risks and moral hazards inherent to the financial sector, and the viability of the micro and small enterprises.

Learning from its own extensive experience in its developing member countries, ADB has adopted a holistic microfinance strategy that supports (i) the creation of a policy environment conducive to microfinance; (ii) developing the financial infrastructure; (iii) building viable institutions; (iv) supporting pro-poor innovations; and (v) supporting social intervention (Figure).

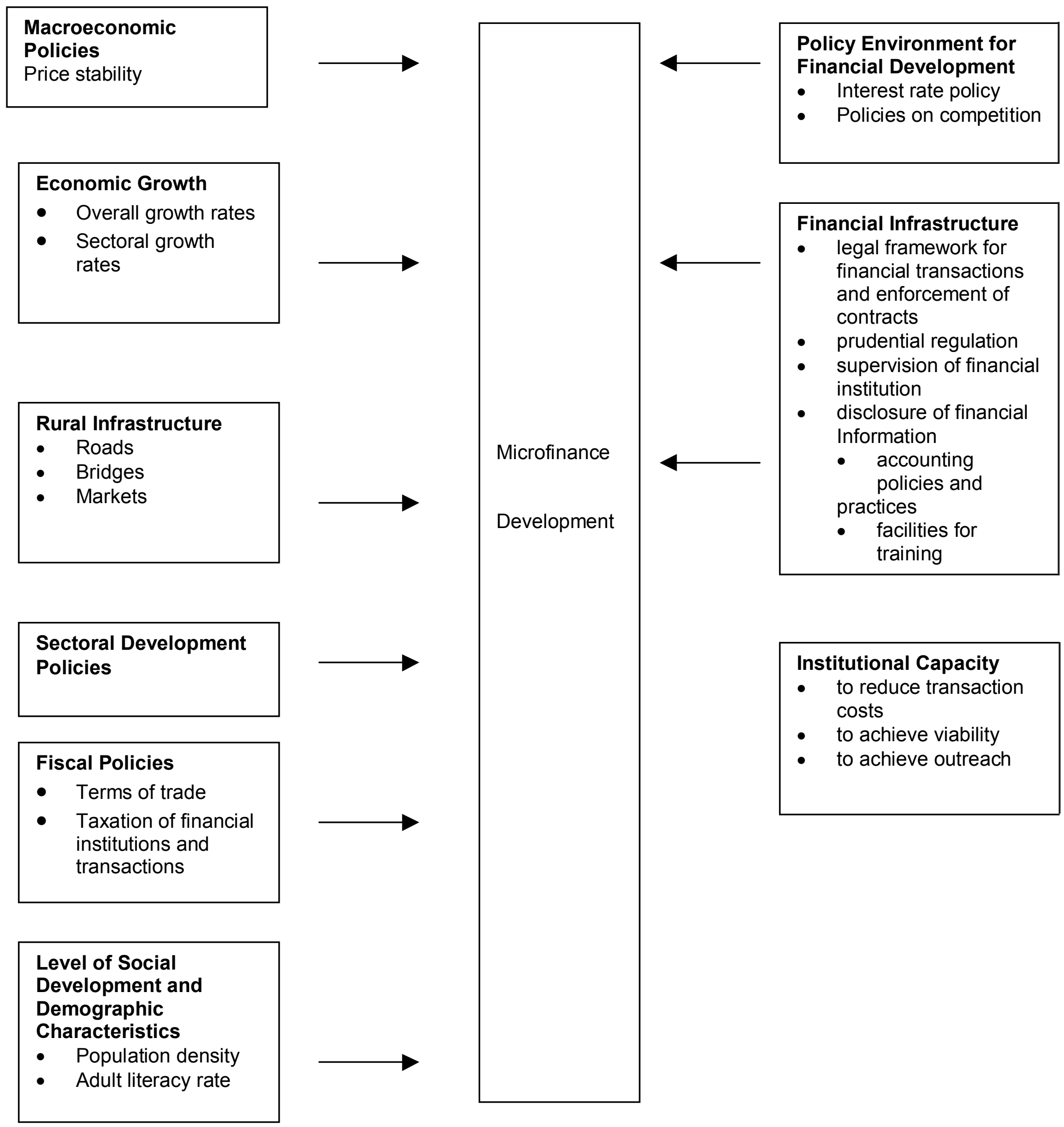
Nonetheless, the design of a microfinance project for East Timor had to hurdle a difficult choice between: designing a simple credit delivery scheme with performance measured against disbursement goals within the project period; or, initiating the development of a microfinance system that would last beyond the Trust Fund for East Timor (TFET). There were strong justifications and even a sense of urgency to launch a quick-disbursing project to help poor households cope from the shocks of the postreferendum destruction and help reverse the economic standstill given (i) the disruption of agriculture and displacement of people; (ii) the massive loss of key economic resources and production inputs; (iii) a sharp fall in demand for goods and services as the economy stagnated; (iv) the outmigration or lack of confidence of entrepreneurs and the private sector; and (v) the closure of banks.

Yet, there were encouraging signs of a slow but steady economic recovery, albeit fueled mainly by donors' assistance and a large expatriate community. More importantly, however, the transition from humanitarian aid to developmental pursuits needed to be supported and sustained. Clearly, setting up a microfinance system would be a far more vital legacy for an independent East Timor than a palliative quick-disbursing microcredit project that will not survive after TFET.

Table 1: Demand for Microfinance: Structure and Characteristics

Demand	Products and Services and Characteristics Sources of of Demand
1. Households a. Poorest (Rural and Urban)	convenient access to safe and liquid deposit services passbook savings with unlimited withdrawal facility strong demand for consumption and emergency loan with no collateral small size loans for livelihood activities occasional loans to finance lumpy expenditures such as school fees service outlets at close proximity simple procedures low transaction costs
a. Poor (Rural and Urban)	convenient access to safe, liquid deposit facilities return on savings passbook savings with easy withdrawal facilities term deposits with small denominations and regular interest payments money transfer services, payment services insurance services for livestock consumption and emergency loans small loans for livelihood activities loans to finance lumpy expenditures low transaction costs
2. Enterprises a. Microfarms (Rural)	small loans for working capital (fertilizer, seeds) small loans for fixed capital (purchase of simple tools, land improvements etc. below informal market interest rates easy access and minimal transaction costs seasonal demand deposit facilities (safe, liquid, convenient) return on deposits
b. Fisheries, Livestok and Poultry (Mainly Rural)	working capital loans for feed fixed capital loans (for tools, purchase of chicks) small loan size substantial demand from livestock sector deposit services (safe, liquid, convenient) insurance services
c. Nonfarm (Rural and Urban)	deposit services (safe, liquid, and convenient) money transfer, payment services insurance and leasing services a wide range of enterprises demand for loans is not seasonal demand is large for working capital loans relatively large loans within the confines of microcredit minimal transaction costs and easy access

Figure: Determinants of Microfinance Development



B. Key Constraints

East Timor offers a daunting challenge to the development of its microfinance sector, considering (i) an economy ravaged by the destruction of the postreferendum violence; (ii) poor infrastructure, with limited communications and transport facilities for market access; (iii) a nation in transition lacking vital laws, regulations, and policies for economic activities; (iv) the absence of a formal financial infrastructure, especially in the rural areas; (v) limited local expertise; and (vi) a growing culture of donor dependence.

C. Microfinance Operational Strategy

Notwithstanding the formidable challenges, East Timor also offers a rare opportunity for adopting proven best principles and practices in microfinance developed from costly lessons learned elsewhere. The first two of the above-mentioned constraints are being dealt with by the collective efforts of government and the donors. However, the Microfinance Operational Strategy adopted for East Timor directly addresses the last four constraints as it focuses on:

- creating an enabling policy environment for the viable delivery of a wide range of financial services to the poor, especially women and in the rural areas (Table 2);
- fostering a sustainable microfinance infrastructure through the establishment of a viable microfinance institution (MFI or bank) and the rehabilitation of credit unions (CUs);
- Intensive capacity building of East Timorese to manage the MFI and CUs, and to provide effective social intervention for skills and values formation among clients;
- Adopting and promoting best practices in microfinance including (i) customized replication of the Grameen Bank model, and (ii) universal practices of CUs and MFIs;
- Promoting private initiative and autonomy among CUs and MFI (bank), with a divestment scheme for the latter to East Timorese citizens, civil society, CUs, etc.

Table 2: Microfinance Services and its Impact on Poverty

Channel	Direct Impact	General	Non-poor
Access to Poor	Microfinance services reduce poverty as access to financial service leads to investment and higher household income. Access to savings services stabilizes consumption patterns and lessens dependency on debts.	Legislative, regulatory and supervisory environment created for MFIs will allow poor in non-project areas to access and benefit from financial services.	MFIs will stimulate improved supply of financial services, which could be accessible to rural non-poor, particularly savings.
	Microfinance services accompanied with community organization, capacity building, and skills training enhances social capital and reduces poverty of opportunity.		
	Access to basic microfinance service improves livelihoods through efficient and productive use of local resources.	Similar arrangements will be encouraged either through commercial and/or donor involvement.	Could benefit from commercial interventions.
	Lessens financial and business risk of the poor.		

The strategy components are embodied in the design of the TFET-funded Microfinance Project[1] and the supporting technical assistance packages funded by ADB related to the strengthening of the microfinance policy framework and capacity building.[2]

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1 Grant 8186-ETM(TF): Microfinance Development Project approved for $7.72 million in December 2000, with firm commitment from Trustee for $4 million.

2 TA 3556-ETM: Strengthening the Policy and Legal Framework for $0.25 million approved in December 2000; and TA 3743-ETM: Microfinance Technology System for $0.15 million approved in October 2001.

Table 2: Microfinance Services and its Impact on Poverty *(cont'd)*

Channel	Direct Impact	General	Non-poor
Access for Women	All the above, places resources directly in the hands of the poor and provide services to their communities. Risk mitigation is provided for activities that are preferred by women borrowers.	Enhances role of women in rural society which has positive externalities for the household, community, and on the local economy.	–
Labor market	Increase in employment in rural areas resulting from borrower investments.	Through replication, other MFIs will stimulate rural employment.	–
Transfer	Credit line and interest revenue from microfinance operations will assist the poor and facilitate access to productive and social services.	– –	