Microfinance

A. Introduction

In East Timor, poverty is pervasive. The latest data from the ADB-funded *Study on Economic and Social Conditions, 2000* indicates a rapid increase in poverty between 1999 and 2000, with about 37 percent of the population living below the poverty line. Per capita gross domestic product (GDP) in 1999 was estimated at $395. Population growth is rapid and life expectancy is low at 55–58 years. Literacy level was estimated to be about 51 percent.

Recently, however, business has started to improve. Small businesses are growing rapidly in Dili and other district towns. As at 15 May 2001 there were 4,286 businesses registered with the ETTA, of which over 80 per cent were local investors. Another indicator is the high demand for loans under the World Bank administered Small Enterprise Project, which initially attracted over 2,100 applicants with a total potential loan value of $30 million, against project funds of $4.5 million. As of 30 April 2001, a total of 266 loans have been approved, valued at $2.83 million (69 percent of the funds available under the credit line), while disbursements reached $2.49 million.

B. Financial Sector

Prior to the conflict, Indonesian commercial banks had 18 branches in East Timor, comprising 15 branches of state and regional government banks, and 3 of private national banks. There were no licensed private rural banks in East Timor prior to the crisis. In March 1999, the banks' aggregate loan portfolio was about $18.2 million and total outstanding savings were about $68.4 million, typical of many Indonesian provinces, where branches have consistently been net fund providers for their head offices, mostly based in Jakarta.

After the referendum, all of the banks ceased their East Timor operations but opened special desks in their Kupang, West Timor branches to service East Timorese depositors, a large majority of whom were able to withdraw their deposits with these banks. Still, quite a number could have lost their savings with the destruction of bank records and passbooks, although simplified systems were installed to allow withdrawals by mere proof of identification that could be traced in the banks' records.

Presently, banking services are severely limited and confined to Dili. Two offshore branches of foreign banks, ANZ of Australia and Banco Nacional Ultramarino (BNU) of Portugal, now operate in Dili. Both banks offer banking services but do not provide loans from their own funds. BNU is the conduit bank for the WB Small Enterprise Project, on a risk-free, fee-based arrangement.

C. Development of Microfinance

The first credit union in East Timor was established in 1990. A year later, the apex organization of Indonesian credit unions, the Credit Union Coordination of Indonesia, actively promoted credit unions in East Timor. In 1994, these credit unions formed a credit union federation (CUF) in East Timor as a secondary-level organization. The CUF focused on promoting new credit unions and providing basic credit union education and training. It also offered audit services. In 1996, the CUF was incorporated under the Indonesian Cooperative Law. By August 1999, 27 credit unions had been established in the 13 districts of East Timor.

About 7 credit unions (4 old and 3 new) are currently operating, the rest having their resources and records lost during the crises. The active CUs and 13 dormant ones want to be rehabilitated to improve services to their members, largely of poor and low-income households. These 21 credit unions have a total aggregate demand of approximately $1.5 million for the next 3 years to serve an estimated 7,350 members (about 350 members/credit union).

D. Demand for Microfinance

Recent ADB studies have shown that about 60 percent of the households reported a monthly income of about $20 and demand for credit ranges from $11 to $110 by women and from $100 to $1,000 by men. There are no formal lending facilities and informal lenders charge as much as 100 percent interest per month. Most of the demand for loans in rural areas is for agricultural production, small livestock, and other household-based income-generating activities.

Only a few organizations are providing semi-institutionalized microfinance services to the poor in East Timor. At present, three NGOs are providing credit assistance and limited (compulsory) savings mobilization. Two of these have their major presence in Dili while another operates in Bobonaro, Maliana. Their outreach and capacity appear negligible compared to demand. Their major constraints are funding and maintaining operational self-sustainability. With the current tight monetary situation, the absence of rural financial institutions, and lack of resources for collateral, the poor have virtually no access to loans even at high interest rates. Indeed, a few emerging moneylenders have been charging up to 100 percent per month interest. Some informal village groups have started pooling their resources, reviving several forms of social savings, such as village savings associations that existed before the crisis. Thus, a few moneylenders, NGOs, and self-help groups offering very limited financial services and insignificant outreach now characterize the rural finance sector of East Timor.

E. Constraints in Microfinance Development

1. Limited financial services in the country

The contraction of the banking network from a high of 18 commercial and rural bank branches existing before referendum to just 2 foreign banks with limited services and outreach creates a serious gap in the banking system. In particular, the closure of Bank Rakyat Indonesia subdistrict branches or *unit desas* that provided loans to and mobilized deposits from low-income groups created a void in the rural financial system. Presently, the two operating foreign banks are geared mainly to cater to bigger and to international businesses. It is highly unlikely that these and similar banks to be set up in the future would engage in micro or rural finance. Almost 70 percent of surveyed respondents have no access to any form of financial services, and almost all have no access to formal financial institutions.

2. Poor infrastructure and lack of transport

Inadequacy of rural infrastructure hinders access to markets and to technology. The road network was hardly maintained since three years preceding the conflict. Internal shipping, maritime facilities or cargo handling operations outside of Dili are almost nonexistent or in states of neglect. Power, water supply, and communications are grossly inadequate if not absent in most of the rural areas. All these make the costs of doing business high or result in low-quality, uncompetitive products. An emergency infrastructure rehabilitation program now being carried out could help arrest or even reverse the economic deterioration. However, the lack of transport and doubtful restoration of power in the rural areas even at pre-referendum level are still major concerns for attaining rapid economic recovery.

3. Reliance on grants from donors

There are currently over a hundred local NGOs (from about 20 prior to the conflict) and about 60 international NGOs/donors. Most of these NGOs provide social services, capacity building support, and, on a very limited scale, financial services. Most of the international NGOs focus on the health and education sectors. Local NGOs virtually flourished overnight with many having little capacity to deliver any form of services. The use of NGOs for microcredit schemes may be desirable as a stopgap emergency measure. However, experience elsewhere has consistently shown that NGOs are usually grant-driven, project-oriented, and unsustainable beyond the life of the projects that support them. Likewise, heavy reliance on donor-grants encourages a “social lending” syndrome (e.g., providing subsidized loans), discourages savings mobilization, or hinders the formation of desired values of thrift, self-reliance, and responsible borrowing among the target clientele.

4. Lack of local microfinance expertise

Anecdotal reports suggest that very few East Timorese were among the supervisory and managerial staff of Indonesian banks and, apart from the credit unions, there was hardly any nonbank microfinance institution (MFI) that operated in East Timor before 1999. Furthermore, there has been substantial out-migration of most of the educated and entrepreneurial gentry. There is a dearth of skilled or trainable staff to run microfinance entities or cooperatives. Thus, the building up of skills, confidence, and institutional capacity to operate MFIs would be a slow and tedious process.

Unfortunately, there is also strong political and social pressure to deliver credit, which is often seen as a panacea to hasten economic recovery. This and the lack of expertise is a potent mix that could result to pushing hastily designed grant or budget-funded credit schemes using ill-prepared credit conduits to deliver loans to an equally unprepared clientele. This in turn would repeat lessons learned elsewhere from cyclical, sporadic, and unsustainable credit schemes that consistently fail and eventually deprive the poor access to more permanent and sustainable financial services, while developing a dependency mode or “dole-out” mentality among them.

5. Lack of supportive microfinance policy

The existing Bank Licensing and Supervision Regulation is patterned after traditional banking laws designed mainly for regular commercial banking. It appears restrictive to the microfinance sector given the high minimum capital requirement of $2 million to establish a bank, as well as other operational restrictions to financial services allowable. Moreover, the absence of regulations governing credit unions and nonbank intermediaries, as well as the nonpassage of the Limited Liability Company Act, affects the promotion and orderly growth of micro financial structure and initiatives.

At present, where there is no specific East Timorese law or UNTAET regulation, Indonesian law applies, with some exceptions. However, it appears that little notice in fact is taken of applicable Indonesian laws, and in any case there is almost no machinery to apply these laws, e.g., there is no registrar of companies, no registrar of cooperatives, and no capacity to notarize documents that are vital for the incorporation of companies, banks, cooperatives, NGOs, etc. There appears to be no legal capacity to take collateral, and there is no registration system for collateral or for vehicles. The land registration system was destroyed after the 1999 conflict, title to land is disputed, and for improved buildings and for vehicles, there is no insurance. The National Council and the ETTA Cabinet will be dissolved on 15 July 2001, after which the Transitional Administrator may only opt to pass emergency laws in deference to the legitimate government. Following are the specific issues that hinder the growth of the microfinance sector:

(i) absence of an enabling legislation for credit unions necessary to rationalize and consolidate in one code all the rules applicable and/or peculiar to credit unions;

(ii) delays in the enactment of the Limited Liability Company Act, which is a prerequisite to the licensing of a financial institution under the rules of the Central Payments Office (CPO); and

(iii) restrictive hurdles under the existing Bank Licensing and Supervision Regulation that counters and, to some degree, would impede the development and growth of MFIs.

F. Microfinance Operational Strategy

The objective of ADB's strategy in East Timor is to support economic activities and infrastructures necessary for growth. Specifically, for its microfinance program, ADB aims to ensure access for the poor and rural areas to institutional financial systems that are sustainable and can provide diverse, high quality and responsive financial services. The strategic focus is on

(i) creating an enabling policy environment that would allow for the broadening and deepening of microfinance systems capable of viable delivery of a wide range of financial services to the poor and the rural areas;

(ii) fostering a sustainable microfinance infrastructure anchored on the rehabilitation or strengthening of credit unions and the establishment of a microfinance bank to specifically service microenterprises and low-income clientele;

(iii) initiating a vigorous capability building program that translates to human resource development and organizational strengthening through skills enhancement, exposure trips, systems development and installation, organizing and leadership training, and the like; and

(iv) promoting and adopting microfinance best practices, such as (a) customized replication of the Grameen Bank technology; (b) universal principles and best practices of credit unions; (c) Management Performance Evaluation System for Credit Unions following the PEARLS System of the World Council of Credit Unions; and (d) Microfinance Institution Performance Standards refined by the Philippine Coalition of Micro Finance Standards that seek to highlight self-reliance, operational viability, self-sufficiency, and effective outreach to low-income clients.