ADB

Finance for the Poor: Microfinance Development Strategy

Asian Development Bank

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Contents

Abbreviations

ADB	-	Asian Development Bank
AfDB	-	African Development Bank
AMINA	-	African Development Fund Microfinance Initiative for Africa
ASA	-	Association for Social Advancement
BRI	-	Bank Rakyat Indonesia
CGAP	-	Consultative Group to Assist the Poorest
COS	-	country operational strategy
DMC	-	developing member country
IADB	-	Inter-American Development Bank
MFI	-	microfinance institution
NGO	-	nongovernment organization
OFI	-	other financial institution
Tk	-	Taka

NOTE

In this report, "$" refers to US dollars.

Introduction

The interest in microfinance (*defined in Box 1*) has burgeoned during the last two decades: multilateral lending agencies, bilateral donor agencies, developing and developed country governments, and nongovernment organizations (NGOs) all support the development of microfinance. A variety of private banking institutions has also joined this group in recent years. As a result, microfinance services have grown rapidly during the last decade, although from an initial low level, and have come to the forefront of development discussions concerning poverty reduction.

Despite this growth, as concluded in the recently completed Rural Asia Study, "rural financial markets in Asia are ill-prepared for the twenty-first century."[1] About 95 percent of some 180 million poor households in the Asian and Pacific Region (the Region) still have little access to institutional financial services. Development practitioners, policy makers, and multilateral and bilateral lenders, however, recognize that providing efficient microfinance services for this segment of the population is important for a variety of reasons.

(i) Microfinance can be a critical element of an effective poverty reduction strategy. Improved access and efficient provision of savings, credit, and insurance facilities in particular can enable the poor to smoothen their consumption, manage their risks better, build their assets gradually, develop their microenterprises,

1 Asian Development Bank (ADB). 2000. *Rural Asia Study: Beyond the Green Revolution*. Manila: ADB.

Box 1: Definition of Microfinance

Microfinance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and, their microenterprises. Microfinance services are provided by three types of sources:

- formal institutions, such as rural banks and cooperatives;
- semiformal institutions, such as nongovernment organizations; and
- informal sources such as money lenders and shopkeepers.

Institutional microfinance is defined to include microfinance services provided by both formal and semiformal institutions. Microfinance institutions are defined as institutions whose major business is the provision of microfinance services.

enhance their income earning capacity, and enjoy an improved quality of life (*Box 2*).[2] Microfinance services can also contribute to the improvement of resource allocation, promotion of markets, and adoption of better technology; thus, microfinance helps to promote economic growth and development.

(ii) Without permanent access to institutional microfinance, most poor households continue to rely on meager self-finance or informal sources of microfinance,[3] which limits their ability to actively participate in and benefit from the development opportunities.

(iii) Microfinance can provide an effective way to assist and empower poor women, who make up a significant proportion of the poor and suffer disproportionately from poverty.

(iv) Microfinance can contribute to the development of the overall financial system through integration of financial markets.

2 M.S. Robinson asserts that "if it were widely available, institutional commercial microfinance could improve the economic activities and the quality of life of hundreds of millions of people in the developing world." See "Addressing Some Key Questions on Finance and Poverty." *Journal of International Development*. Special Issue. 1996. Vol. 8, No. 2. p. 154. However, it is generally agreed that microcredit given to those of the poor who do not have a capacity to repay can increase their poverty.

3 The extensive reliance of poor households on informal arrangements reflects the importance of financial services for their lives.

Box 2: Microfinance poverty reduction nexus

Financial service	Results	Impact on poverty
Savings Facilities of microfinance institutions (MFIs)	More financial savings Income from savings Greater capacity for self-investments Capacity to invest in better technology Enable consumption smoothening Enhance ability to face external shocks Reduce need to borrow from money lenders at high interest rates Enable purchase of productive assets Reduce distress selling of assets Improve allocation of resources Increase economic growth	Reduce household vulnerability to risks/ external shocks Less volatility in household consumption Greater income Severity of poverty is reduced Empowerment Reduce social exclusion
Credit Facilities	Enable taking advantage of profitable investment opportunities Lead to adoption of better technology Enable expansion of microenterprises Diversification of economic activities Enable consumption smoothening Promote risk taking Reduce reliance on expensive informal sources Enhance ability to face external shocks Improve profitability of investments Reduce distress selling of assets Increase economic growth	Higher income More diversified income sources Less volatile income Less volatility in household consumption Increase household consumption Better education for children Severity of poverty is reduced Empowerment Reduce social exclusion
Insurance Services	More savings in financial assets Reduce risks and potential losses Reduce distress selling of assets Reduce impact of external shocks Increase investments	Greater income Less volatility in consumption Greater security
Payments/Money Transfer Services	Facilitate trade and investments	Greater income Higher consumption

Developing countries in the Region have used microfinance services to reduce poverty. About 21 percent of the Grameen Bank borrowers and 11 percent of the borrowers of the Bangladesh Rural Advancement Committee, a microfinance NGO, managed to lift their families out of poverty within about four years of participation.[4] These services also had a significant positive impact on the depth (severity) of poverty among the poor. Extreme poverty declined from 33 percent to 10 percent among Grameen Bank participants, and from 34 percent to 14 percent among Bangladesh Rural Advancement Committee participants. Without exclusively targeting the poor, the unit desas of the Bank Rakyat Indonesia (BRI) have also assisted "hundreds of thousands of households in lifting themselves out of absolute poverty over the past decade."[5] A 1988 sample survey of unit desa borrowers showed that microcredit has had a major impact on their families' standards of living. The study estimated that net household incomes of borrowers increased by about 76 percent and employment increased by 84 percent with three years of program participation.[6] The studies have, in general, shown that microfinance services have also had a positive impact on specific socioeconomic variables such as children's schooling, household nutrition status, and women's empowerment.[7] Microfinance institutions (MFIs) have also brought the poor, particularly poor women, into the formal financial system and enabled them to access credit and accumulate small savings in financial assets, reducing their household poverty. However, researchers and practitioners generally agree that the poorest of the poor are yet to benefit from microfinance programs in most countries partly because most MFIs do not offer products and services that are attractive to this category.[8] Thus, to increase the overall impact of microfinance on poverty reduction, it is essential to extend a wide range of services on a continuing basis to the poor who are still excluded from the benefits of microfinance.

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4 Khander, S.R. 1998. *Fighting Poverty with Microcredit: Experience in Bangladesh*. New York: Oxford University Press.

5 Sugianto. 1998. "The Role of the BRI in Microfinance: The Experience of Bank Rakyat Indonesia," in *The New World of Microfinance*. Manila:The Coalition for Microfinance Standards. p. 112.

6 Bank Rakyat Indonesia (BRI). 1990. Kupedes Development Impact Survey. BRI, Jakarta.

7 Johnson, S. and B. Rogaly. 1997. *Microfinance and Poverty Reduction*. Oxfam, Oxford.

8 Hulme, D. and Paul Mosley. 1996. *Finance Against Poverty. Vol. 1*. London: Routledge. Chap. 5.

Providing microfinance services efficiently to this excluded segment of the market remains a major challenge in the Region. However, given that the Asian Development Bank (ADB) has adopted poverty reduction as its overarching objective, ADB must respond to this challenge effectively. Supporting the development of sustainable MFIs that can reach the poor provides ADB an opportunity to respond to this challenge and make a significant contribution to its poverty reduction objective and the development of the overall financial system in its developing member countries (DMCs).

This paper, which was prepared through extensive consultation involving ADB's DMCs, other funding agencies, and external experts in microfinance (*Appendix 1*), proposes a development strategy for institutional microfinance covering the services provided by both formal and semiformal sources. The paper addresses three major concerns:

(i) What should be the strategic directions in ADB's assistance to its DMCs to expand the frontier of institutional microfinance to include the poor who are currently excluded and those who are likely to be excluded in the future?
(ii) How should ADB support improvement of the quality of microfinance services in the Region?
(iii) How can ADB help expand microfinance services to achieve the maximum development impact, including a reduction in the incidence of poverty?

Thus, the strategy defines ADB's role in the development of microfinance in the Region and covers qualitative and quantitative dimensions. The strategy is formulated within ADB's overall strategy for poverty reduction.

Need for a development strategy for microfinance

During 1988-1998, ADB approved 15 microfinance projects totaling about $350 million, 6 projects with microfinance components valued at about $53 million, and 34 technical assistance activities for about $18 million to support microfinance operations. ADB has, however, provided this assistance without a well-defined strategy and, as a result, has not been able to fully harness the potential of microfinance for poverty reduction.

Once almost exclusively the domain of donors and experimental credit projects, institutional microfinance has evolved during the last decade into an industry with prospects for financial viability, offering a broader range of services and significant opportunities for expansion. The prospects for financial sustainability are revolutionizing the microfinance field and suggest that a large proportion of the millions of poor people can be provided access to institutional microfinance.

This change has important implications for ADB. ADB needs to take cognizance of the challenges and prepare to effectively harness the opportunities in its DMCs. Given the diverse requirements in the sector, the competing demands for ADB funds, the increasing pressure on resources in the Asian Development Fund, and the growing complexities and challenges of improving the quality of life of over 900 million poor people in the Region, ADB must reinforce its emphasis on efficient allocation and use of resources at its command. A strategy is necessary to ensure that ADB addresses these concerns effectively and consistently within its objective of poverty reduction. A strategy can also (i) provide a clear and consistent link between ADB's microfinance operations and its overarching objective of poverty reduction; (ii) facilitate promotion of a common approach to microfinance operations throughout ADB, which will also contribute to better coordination with other funding agencies; (iii) provide a consistent basis for policy dialogue with the DMCs on microfinance and related issues; (iv) assist ADB's ongoing efforts to improve the quality of project design, processing, and implementation of microfinance operations; and (v) facilitate adoption of a longer term perspective than in the past in providing assistance for microfinance.

Microfinance in the Asian and Pacific Region

Over 900 million people in about 180 million households in the Region live in poverty. Most of the Region's poor (i.e., those who earn less than $1.00 a day) or more than 670 million people, live in rural areas (*footnote 1*), although urban poverty is also a growing problem in virtually all DMCs. Most rural poor people are engaged in agricultural or related activities as laborers or small-scale farmers. Many are also involved in a variety of microenterprises. In many countries, women, who are a significant proportion of the poor and suffer disproportionately from poverty, operate many of these microenterprises.

Most formal financial institutions do not serve the poor because of perceived high risks, high costs involved in small transactions, perceived low relative profitability, and inability of the poor to provide the physical collateral usually required by such institutions. The business culture of these institutions is also not geared to serve poor and low-income households. Lacking access to institutional sources of finance, most poor and low-income households continue to rely on meager self-finance or informal sources of microfinance. However, these sources limit their ability to actively participate in and benefit from the development process (*Appendix 2*). Thus, a segment of the poor population that has viable investment opportunities persists in poverty for lack of access to credit at reasonable costs. The poor also lack access to institutional credit for consumption smoothening and to other services such as payments, money transfers, and insurance.

Most of the poor households also find it difficult to accumulate financial savings without easy access to safe institutions that provide deposit services.

Demand for microfinance services

The poor and low-income households and their microenterprises in the Region are a diverse group. Their demand for microfinance services also reflects this diversity (*Appendix 3*). The collective demand of these groups for financial services is large and the types of services they demand vary across households and microenterprises and over time. This large demand and the heterogeneity of services needed across households and microenterprises and over time have created scope for commercial financial intermediation.

Poor and low-income households and their microenterprises in the Region have a large demand for safe and convenient deposit services. This demand reflects the importance of savings for these households and microenterprises for a variety of reasons. The poor need to save for emergencies, investment, consumption, social obligations, education of their children and many other purposes. They have the capacity and willingness to save. Savings are important for microenterprises and provide them with a major source of investment funds. The large demand for deposit services among the poor is confirmed by empirical evidence. For example, the number of savings accounts in unit desas of BRI increased, from 5.0 million in 1988 to 16.1 million in 1996. Most of these accounts belong to poor households. The cooperative rural banks in Sri Lanka had 4.7 million deposit accounts at the end of 1998; while the Association for Social Advancement, a microfinance NGO in Bangladesh, had over 1.4 million active savings accounts of poor households at the end of 1999. Extensive use of informal savings arrangements by poor households is another indicator of their demand for savings facilities. In some countries, the poor pay high prices to those providing deposit services.[9] The demand for deposit services is particularly strong among poor women in the Region.

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9 Rutherford, S. and S.S. Arora. 1997. *City Savers*. Urban Poverty Office. New Delhi: Department for International Development.

The demand for microcredit that originates both from households and microenterprises is also large. Poor households in the Region require microcredit to finance livelihood activities, for consumption smoothening, and to finance some lumpy nonfood expenses for purposes such as education (e.g., school fees and books), housing improvements, and migration. Many Asian countries have numerous small farms and their operators also require microfinance services. The other source of demand is nonfarm microenterprises, which cover a wide array of activities such as food preparation and processing, weaving, pottery, mat and basket making, furniture making, and petty trading.[10]

The demand for other financial services among poor and low-income households and their microenterprises could also be significant. A good share of rural households borrow, many more save, but all seek to insure against the vagaries of life and therefore the demand for insurance services among the poor is vast.[11] A private insurance company in Bangladesh that started to provide micro-insurance services to low-income households on a commercial basis, for example, found that its client base was expanding rapidly. At the end of 1999, this company had over 800,000 clients, about 50,000 of which are considered poor. This experience shows that the supply of such services creates its own demand because the real demand for such services remains hidden when suitable products are not available in the market.

Supply of microfinance services

The market structure in microfinance varies significantly across countries in the Region depending on their stage of financial development, level of economic development, policy environment, and other factors (*Appendix 4*). However, aspects of the supply, particularly about different types of suppliers, may be usefully discussed.

10 The demand cannot, however, be quantified because the purposes and the time period for which households demand credit is diverse and complex and the demand for credit for different purposes varies with the price and over time. That there are over 180 million poor households in the Region, however, indicates that the demand could be large.

11 Zeller, M. and M. Sharma. 2000. Many borrow, more save, and all insure: implications for food and microfinance policy. *Food Policy 25*.

The microfinance services are supplied mainly by informal sources. Their collective outreach, both breadth and depth, is vast in most countries. They supply mainly short-term credit and charge higher interest rates than semiformal and formal sources. Because of the relatively greater bargaining power enjoyed by the informal suppliers in general, the terms and conditions under which services are provided do not enable the clients to fully harness economic opportunities. The informal sources operate in highly localized areas. Therefore, their contribution to financial intermediation and improvement of resource allocation is also limited. For example, informal sources do not allow savings to be collected from more than a small group of individuals well known to one another, and they do not move funds over large distances. Most informal insurance mechanisms are typically weak, particularly against repeated shocks, and often provide only inadequate protection to poor households.[12]

The involvement of formal sources in microfinance has increased during the last two decades. This greater involvement has stemmed from (i) the expansion of the scope of formal institutions into microfinance through downscaling and establishment of linkage programs with semiformal sources of different types; (ii) the emergence of new formal institutions focused on microfinance, such as the Grameen Bank of Bangladesh; (iii) reforms of state-owned financial institutions such as unit desas of BRI; and (iv) the introduction of new microfinance programs by the governments through nonfinancial institutions. However, the formal operations concentrate mostly on providing credit facilities, and savings mobilization has yet to receive adequate attention, with few exceptions.

Formal microfinance has changed to some extent with increasing involvement of private sector institutions. The Bank Dagang Bali in Indonesia has expanded its microfinance operations and increased its clientele. Badan kredit-desas, owned by Indonesian villagers, now reach 1.7 million clients, and the Grameen Bank in Bangladesh, owned largely by its borrower members, operates in over 38,000 villages with 1,140 branches and reaches about 2.4 million clients.

12 Morduch, J. 1999. Between the State and the Market: Can Informal Insurance Patch the Safety Net? *The World Bank Research Observer*. Vol. 14. No. 2.

Cooperatives are also playing a significant role as financial intermediaries in the Region, particularly in India, Sri Lanka, Thailand, and Viet Nam. The thrift and credit cooperative societies in Sri Lanka reach about 800,000 households while primary agricultural cooperative societies in India have about 89 million members. These cooperatives, among other things, provide microfinance services.[13] In many countries, the cooperatives have begun to explore possibilities for deeper penetration into the microfinance market and show a greater concern about their financial viability than they did in the 1980s.

A major feature of semiformal microfinance sources in the Region is the extensive involvement of NGOs. In virtually all DMCs (except for transitional economies such as the People's Republic of China and Viet Nam) NGOs have become important providers of microfinance services (*Box 3*). Their involvement is important because their clients in general are poorer than those reached by many formal institutions, their services are targeted in most countries to serve poor women, and their credit services are provided largely on the basis of social collateral. The small average loan sizes of NGOs, which usually range from about $30 to $150 per active loan account, suggest that their clients include the poorest.[14] NGOs in some countries are trying to organize themselves into national coalitions to improve the industry standards and self-regulation. A few NGOs in the Region have plans to transform themselves into formal financial institutions.[15]

Major achievements in microfinance

The MFIs and other financial institutions (OFIs) providing microfinance services have expanded their outreach from a few thousand clients in the 1970s to over 10 million in the late 1990s. The developments in microfinance in the Region have set in motion a process of change from an activity that was entirely subsidy dependent to one that can be a viable business.

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13 According to the Association of Asian Confederation of Credit Unions, the credit unions and other cooperatives outside India in the Region provide microfinance services to about 3.5 million poor households.

14 The poorest of the poor is defined as those in the bottom 50 percent of the households below a country’s poverty line.

15 In Bangladesh, a few NGOs have grown to become giant MFIs. These include Association for Social Advancement, Bangladesh Rural Advancement Committee, and Proshika, which have client bases of 600,000 to over 2 million. They illustrate the potential value of the NGO modality for expanding the services to a large number of poor households.

(i) MFIs and OFIs mobilizing voluntary savings have shattered the myth that poor households cannot and do not save, and proved that savings can be successfully mobilized from poor households. This is perhaps a more important achievement of microfinance in the Region than the expanded outreach in access to credit.

(ii) MFIs, OFIs, and their clients have shown that the poor are creditworthy (poor women, in particular) and financial services can be provided to and accessed by the poor on a profitable basis at low transaction costs without relying on physical collateral, if it is done with appropriate financial technology and a commitment to achieve efficiency.

Box 3: Outreach with Sustainability: The Case of Association for Social Advancement (ASA) in Bangladesh

ASA, an NGO, has been providing microfinance services since 1991. ASA had 326,200 active borrowers in 1995; this number increased to 1.084 million at the end of 1999. ASA's loans outstanding increased from Taka (Tk) 559.7 million ($11.2 million) to Tk 3.679 billion ($73.6 million) during the same period. Despite the rapid growth in portfolio and outreach, ASA maintained its on-time loan recovery rate at over 98 percent. The small average loans (22 percent of per capita gross domestic product) and savings balances (6 percent of per capita gross domestic product) indicate that ASA's clients are poor households. Women account for over 90 percent of the clients.

Until the end of 1996, ASA offered only compulsory savings service. In 1997, ASA began to offer voluntary savings facilities as well. With this, the number of active savings accounts increased from 561,530 at the end of 1996 to 1.467 million at the end of 1999. The outstanding savings of ASA increased from Tk 442.8 million ($8.9 million) to Tk 1.269 billion ($25.4 million) during the same period, with voluntary savings accounting for about 50 percent of the latter amount.

ASA is a cost-efficient MFI with a simple organizational structure, a simple operating system, and a very lean head office. Its staff are committed to provide low-cost, quality financial services to the poor. Thus, ASA's operating cost ratio declined from 17.2 percent in 1995 to 9.6 percent in 1999 while profits increased from Tk 3.1 million ($62,000) to Tk 89.6 million ($1.8 million). During 1991-1995, ASA charged a flat interest rate of 15 percent per year, which is approximately equal to 30 percent per year on reducing balance basis. Since late 1995, ASA has been charging a lower flat interest rate of 12.5 per year. (With the flat interest rate method, interest is calculated on the original loan for the entire period of the loan.)

Source: Jain, P.S. 2000. *Maturing of Micro-credit Movement*. Dhaka: ASA.

(iii) Microfinance services have triggered a process toward broadening and deepening of rural financial markets.

(iv) Microfinance services have strengthened the social and human capital of the poor, particularly women, at the household, enterprise, and community level.

(v) Sustainable delivery of microfinance services on a large scale in some countries has generated positive developments in microfinance policies and practices among all stakeholders: governments, central banks, microfinance service providers, and external funding agencies.

Challenges

The achievement in microfinance in the Region has been impressive relative to the status in the 1970s. However, a number of major problems remain.

Policy environment

Despite general improvement in the policy environment for financial sector programs, the policy environment for microfinance in many countries remains unfavorable for sustainable growth in microfinance operations. For example, in countries such as People's Republic of China, Thailand, and Viet Nam, and the ceilings on interest rates limit the ability of MFIs to provide permanent access to an increasing segment of the excluded households.

Furthermore, DMC governments inappropriately and extensively intervene in microfinance to address the perceived market failure through channeling microcredit to target groups that are considered to have been underserved or not served by existing financial institutions. With subsidized interest rates and poor loan collection rates, these interventions undermine sustainable development of microfinance. As a result, most DMCs are crowded with poorly performing government microfinance programs that distort the market and discourage private sector institutions from entering the industry.

Inadequate financial infrastructure

Inadequate financial infrastructure is another major problem in the Region. Financial infrastructure includes legal, information, and regulatory and supervisory systems for financial institutions and markets. Most DMC governments have focused on creating institutions or special programs to disburse funds to the poor with little attention to building financial infrastructure that supports, strengthens, and ensures the sustainability of such institutions or programs and promotes participation of private sector institutions in microfinance.

The other major financial infrastructure-related problems include lack of (i) a legal framework conducive for emergence and sustainable growth of small-scale financial institutions, (ii) regulatory and supervisory systems for microfinance in countries where the microfinance subsector is approaching a level of maturity, and (iii) emphasis on development of accounting and auditing practices and professions. These are important for the development and expansion of market-based microfinance services because to serve clients who are outside the frontier of formal and semiformal finance, MFIs must have access to funding far beyond what external agencies and governments can provide. MFIs and microcredit portfolios cannot be safely funded with commercial sources in the long term, especially public deposits, unless appropriate performance standards and regulation and supervision regimes are developed and enforced and measures are introduced to protect public deposits.[16] In most DMCs, formal and semiformal microfinance service providers are not supervised and regulated. While this may not be necessary for all types of MFIs, the lack of a system for supervision and regulation and the lack of adequate measures to protect public deposits impede development and integration of formal microfinance with the broader financial system.

Limited retail level institutional capacity

Most retail level institutions do not have adequate capacity to expand the scope and outreach of services on a sustainable basis to most of the potential clients. Many institutions (i) lack capacity to leverage funds, including public deposits, in commercial markets; (ii) are unable to provide a range of products and services compatible with the potential clients' characteristics; (iii) do not have an adequate network

16 Ledgerwood, J. 1999. *Microfinance Handbook: An Institutional and Financial Perspective.* Washington DC: The World Bank. p. 21.

and delivery mechanisms to cost-effectively reach the poorest of the poor, particularly those concentrated in resource-poor areas and areas with low population densities; (iv) do not show a vision and a commitment to ensure their financial soundness and sustainability within a reasonable period, and become subsidy independent; and (v) do not have the capacity to manage growth prudently.

Most of the state-sector institutions or programs that provide microfinance services have been created within and nurtured by a distorted policy environment characterized by various degrees of financial repression. They do not have a business culture. Even new institutions created by the governments in most DMCs are unable to provide good quality services, let alone expand their services on a sustainable basis.

Most NGOs are also characterized by a high level of operational inefficiency, and have a very limited capacity to serve an increasing segment of the market on a continuing and sustainable basis. They suffer from governance problems mainly because they lack "owners" in the traditional sense of the term, and their management assumes a great deal of power. Heavy reliance on and relatively easy access to donor funds have aggravated the governance problems of some NGOs.

Inadequate emphasis on financial viability is the most serious problem of MFIs in the Region. This prevails among many NGOs, government-directed microcredit programs, state-owned banks, and cooperatives providing microfinance services. As a result, only a few MFIs are sustainable; most are not moving toward sustainability. In a context where resources are limited, "without self-sufficient financial institutions, there is little hope for reaching the numbers of poor firm-households that are potential borrowers and depositors."[17] Viability is also important from an equity perspective because only viable institutions can leverage funds in the market to serve a significant number of clients and contribute to broad-based development (*Appendix 5*). Viability is fundamental to reach a larger number of the poor which in turn is essential to have a significant impact on poverty reduction.

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17 Gonzalez-Vega, C. 1998. "Do Financial Institutions Have a Role in Assisting the Poor?" M. Kimenyi et al. (ed) *Strategic Issues in Microfinance*. London: Ashgate. p. 17.

Inadequate investments in agriculture and rural development

Agricultural growth, which underpins much of the growth in the rural nonfarm subsector, significantly influences rural financial market development. Thus, agricultural growth must be accelerated in much of Asia (*footnote 1*). However, many DMCs are not making adequate investments for agricultural growth and rural development. This is a major constraint on the development of sustainable microfinance services. The insufficient investments in physical infrastructure (especially irrigation; roads; electricity; and support services for marketing, business development, and extension) continue to increase the risk and cost of microfinance and particularly discourage private investments in the provision of microfinance services on a significant scale. Also, in the absence of economic opportunities created by growth-inducing processes, microfinance cannot be expected to play a significant role in poverty reduction.

Inadequate investments in social intermediation

The low level of social development, a distinctive characteristic of the poor in the Region, is a major constraint on the expansion of microfinance services on a sustainable basis. This is particularly true with respect to the poorest, women in poor households, poor in resource-poor and remote areas, and ethnic minorities. A vast amount of financial and human resources is required to address this issue. Private sector MFIs are not likely to invest in social intermediation[18] given the externalities associated with such investments. The development of sustainable microfinance to reach a large segment of the potential market requires supporting social intermediation on a large scale.

18 Social intermediation is defined broadly as a process in which investments are made in the development of human resources and institutional capital to enable the poor to access effectively and productively the financial services of the formal sector. Such investments, among other things, involve awareness building among the poor on basic formal financial services, basic literacy training required to access formal financial services, and basic record keeping for community-based financial service operations.

ADB's microfinance experience

Review

ADB recently reviewed its microfinance operations for 1988–1998.[19] A number of observations can be drawn from the review. (i) ADB has engaged in an increasing amount of microfinance activity over time. The number of projects and the total amount of loans for microfinance have increased since the first project was approved in 1988. Six of the 15 microfinance loan projects and 2 of the 6 microfinance component projects were approved during the last 3 years. These eight projects accounted for 49 percent of the total amount approved for microfinance during the last 11 years. ADB's microfinance loan assistance has been concentrated in a few countries. Two countries (Bangladesh and Indonesia) received about 62 percent of the total loan amount for microfinance projects; Philippines and Nepal, 33 percent; Kyrgyz Republic, 4 percent; and Mongolia, 1 percent.[20]

19 Dingcong, Clarence G. "Review of Asian Development Bank's Microfinance Portfolio," ADB, 25 March 1999.

20 Of the total assistance provided through component projects, 56 percent went to the Philippines, while Pakistan and Sri Lanka each accounted for 20 percent. The remaining 4 percent went to Viet Nam.

(ii) Technical assistance has been an important element in ADB's microfinance activities.[21] ADB approved 35 technical assistance between 1988 and March 1999, covering a wide array of activities. Project preparatory technical assistance have effectively helped to develop a pipeline of bankable projects. Advisory technical assistance have been used primarily for social mobilization of the poor, training of potential clients, and institutional strengthening of MFIs. Recent advisory technical assistance also address supervisory and regulatory issues. However, the technical assistance suffer from a number of drawbacks: (i) most project preparatory technical assistance lack adequate sector analysis, (ii) most advisory technical assistance are based on insufficient institutional analysis and lack a coherent long-term approach to institutional development, (iii) most technical assistance are designed with only limited stakeholder ownership and participation, and (iv) technical assistance lack measurable and monitorable indicators to assess performance.[22]

(iii) Policy dialogue and sector work have received increasing attention.[23] While microfinance policy issues did not figure importantly in the general policy dialogue on the financial sector in the late 1980s and early 1990s, ADB has recently been paying more attention to these issues. In countries where the policy environment was unfavorable (particularly where interest rate policies were repressive), ADB has refrained from assisting microfinance but has continued policy dialogue to improve the environment. ADB's microfinance operations include sector work in selected countries. The work has included studies of microfinance markets in Cambodia, Papua New Guinea, and Vanuatu and a study of urban microfinance in Bangladesh.

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21 Of the 15 ongoing TAs, 3 are project preparatory, 10 advisory, and 2 regional. The ongoing advisory TAs, among other things, cover reform of the rural cooperative system in the People's Republic of China, training of cooperative staff in Bangladesh, strengthening of rural microenterprises in the Philippines, and establishment of a framework for sustainable microfinance in Bangladesh. The current TA portfolio includes a regional TA for low-income women entrepreneurs in Asia, implemented by Women's World Banking, to strengthen the institutional capacity of women's NGOs to operate successful microfinance programs in Bangladesh, India, Nepal, Philippines, and Sri Lanka.

22 These are general problems and are not confined to microfinance TA. R119-97, *Review of ADB's Technical Assistance Operations*, 10 July.

23 ADB's policy dialogue on issues concerning microfinance is carried out in conjunction with broader activities such as country operational strategy studies, country programming exercises, preparation of country assistance plans and TA and project processing involving the financial sector in general and the microfinance subsector in particular.

(iv) ADB's microfinance projects have improved over time. The early projects in general (a) focused on microcredit delivery, (b) allowed subsidized interest rates, (c) paid little attention to financial viability, and (d) were poorly targeted.[24] The lending operations in recent years support a wider array of institutions, go beyond credit services to promote voluntary savings on a limited scale, emphasize market-oriented interest rates, and pay more attention to financial viability than did earlier projects. The projects have shown a distinct bias toward reaching women in poor households and most included social mobilization components to enhance women's capacity to access financial services delivered through project supported mechanisms. More recent microfinance projects, such as the Rural Microfinance Project in Nepal,[25] have been designed to encourage greater participation of the private sector in microfinance.

Development impact

Although it is difficult to reliably measure the development impact of financial services, assessments of the seven completed microfinance projects and review of the ongoing projects offer some important insights on the development impact of ADB's microfinance assistance. In general, the early microfinance projects failed to make a significant contribution to poverty reduction because of their limited outreach. Some projects had a limited positive impact on a small number of clients, but there was no mechanism to sustain this impact beyond the project period. Poverty reduction requires continuous access to a broad range of financial services, not one-time access to loans. Poor infrastructure, sluggish agricultural growth, and limited markets imposed serious limitations on the potential for broad-based growth in rural areas and access to credit could contribute little to permanent improvements in income for clients of microfinance projects under such conditions. Thus, to maximize their development impact, it is essential to integrate microfinance services with other critical measures aimed to reduce poverty.

24 These problems are typical for operations in a new sector or a subsector because, like other multilateral lenders, ADB had very limited experience in designing these. More importantly, the global knowledge base of various facets of microfinance in general was also limited.

25 Loan 1650-NEP: Rural Microfinance Project, for $30.6 million, approved on 16 November 1998.

Lessons learned

ADB's microfinance operations continue to provide valuable lessons.[26] The lessons learned during the last 11 years include the following:

(i) Adoption of the financial system development approach is the key to achieving sustainable results and to maximizing development impact. This approach emphasizes an enabling policy environment, financial infrastructure, and the development of financial intermediaries that are committed to achieving financial viability and sustainability within a reasonable period and that can provide a variety of financial services, not just credit, to the poor.

(ii) Microfinance clients are more concerned about access to services that are compatible with their requirements than about the cost of the services.

(iii) Given the diversity of demand for financial services, a broad range of institutional types is required to expand the outreach.

(iv) Strong retail institutions committed to outreach and sustainability are essential for extending the permanent reach of financial services and to have a significant impact on poverty reduction. Thus, building the capacity of institutions with a commitment to reach the poor is vital.

(v) Financial institutions committed to provide microfinance services in most DMCs require considerable technical assistance for capacity building. This is particularly true for institutions that target potential clients in resource-poor areas and the poorest of the poor.

(vi) The demand for savings services by poor households and microenterprises is as strong as or stronger than the demand for credit. Expansion of the outreach of savings services can have a potentially significant impact on both institutional sustainability and poverty reduction.

(vii) Because microfinance is primarily targeted to the poor who are disadvantaged, social mobilization is necessary to introduce them to a formal or semiformal, market-oriented institutional environment. This is particularly true for poor women and the poorest of the poor. It is important, however, to distinguish between financial intermediation and social intermediation in designing support programs.

26 The lessons from ADB's activities are similar to those from activities of other funding agencies. For example, see Inter-American Development Bank (IADB). 1997. Microenterprise Development Strategy. Washington DC: IADB. p. 9

Other agencies' microfinance experience

The surge of interest in microfinance development during the last two decades has led many funding agencies to support microfinance operations (*Appendix 6*). The collective experience of these agencies confirms that microfinance can play an important role in poverty reduction, and the economic and social benefits of microfinance can be large. The challenge is to mainstream good practice in microfinance operations and increase the outreach to the poor on a sustainable basis. The agencies agree that (i) greater focus is essential on policy framework and building retail institutions that can provide a wide range of services, not just credit; and (ii) the trend toward commercialization must be supported. Their experience also indicates the importance of integrating microfinance operations with the broader financial system to sustain the outreach. There is also a consensus among funding agencies that their role needs to be essentially catalytic.[27]

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27 IADB. 1997. *Microenterprise Development Strategy*. IADB. Washington DC. World Bank. A Review of the World Bank's Micro-Finance Portfolio FY91-FY96. Washington DC: World Bank.

ADB's microfinance development strategy

Goal and purpose

The goal of ADB's proposed Microfinance Development Strategy is to ensure permanent access to institutional financial services for a majority of poor and low-income households and their microenterprises. The purpose is to support the development of sustainable microfinance systems that can provide diverse services of high quality. Therefore, the strategy focuses on

(i) creating a policy environment conducive to microfinance,
(ii) developing financial infrastructure,
(iii) building viable institutions,
(iv) supporting pro-poor innovations, and
(v) supporting social intermediation.

Strategy

A large amount of financial resources is required to provide institutional microfinance services to over 95 percent of the potential clients who are currently outside of formal finance in the Region. Given the amount of resources needed, ADB and other agencies cannot meet the demand individually or as a group. However, without reaching a large number of the poor households on a permanent basis, microfinance is not likely to generate a significant overall development impact. Hence, ADB will catalyze expanding the supply of microfinance and strengthen the capacity of the potential clients to access the services. On the supply side, the strategy focuses on building financial systems that can grow and provide financial services on a permanent basis to an increasing proportion of the poor, and promotion of pro-poor innovations. On the demand side, the strategy supports investments in social intermediation.

To play this catalytic role effectively, ADB must

(i) provide and leverage its assistance to bring about policy reforms essential for development of microfinance,
(ii) support development of critical financial infrastructure,
(iii) support development of viable MFIs that can set in motion a process of commercialization of microfinance services,
(iv) support social intermediation required for sustainable microfinance development, and
(v) support innovative programs and financial technology to ensure that the poorest of the poor will also have access to the financial services.

ADB needs a broad strategy because of the diversity of microfinance issues in its DMCs and the flexibility required to address these issues in different country contexts. However, the strategy emphasizes selectivity in application due to the constraints on ADB's resources for microfinance, the various stages of microfinance development in DMCs, and the relative priority of microfinance in the context of ADB's overall strategy for poverty reduction and country operational strategies. In addition to selecting the appropriate countries in which to focus on microfinance activities and emphasizing the rural sector, ADB will act selectively regarding the type of activities to be supported, modalities of assistance utilized, and the type of institutions eligible to participate in ADB-supported projects in particular countries. The focus on the rural sector is justified mainly by the overwhelming concentration of the poor in rural areas. However, given the increasing recognition of potential for microfinance development in urban areas, ADB will also explore the opportunities in and build its capacity for extending support to urban microfinance.

ADB’s strength for supporting microfinance in general stems from its extensive involvement in agriculture and rural development focusing on low-income groups, urban development involving low-income groups, the institutional knowledge base of informal microfinance operations, and accumulated experience in a wide range of rural and microfinance institutions. The considerable involvement in financial sector reforms also provides ADB with ample opportunities for providing support for microfinance in a coherent manner. These factors, together with the type and extent of involvement of other agencies, will be taken into account in selectively determining ADB's assistance for microfinance.

Strategic focus

Policy environment

Financial sector reform programs have resulted in a general improvement of the policy environment in the Region. However, in many countries, lack of an enabling policy environment for microfinance continues to be a major constraint. Hence, this issue must be addressed effectively. Thus, ADB will broaden the scope of financial sector reform programs to include issues concerning microfinance. The policy reforms will focus on interest rate reforms relevant for microcredit and savings within the broader financial sector reforms, creating an environment sufficiently flexible to accommodate a wide range of MFIs and OFIs to meet the diverse demand, and redefining the role of the state and the central banks in microfinance development to facilitate participation of private sector financial institutions. Given that nonfinancial policies such as agricultural pricing and taxation of microenterprises also have a critical role in sustainable development of microfinance, the policy reforms will be extended to address such issues where they constitute significant constraints. ADB will not go beyond policy-related operations in countries where the policy makers are not committed to adopting appropriate reforms for sustainable development of microfinance. When policy reforms are built into specific projects, exit conditions will be clearly spelled out and enforced in the event of noncompliance.

Policy reforms may be effectively carried out when commitment to and ownership of reforms are generated within DMCs and a long-term partnership is established between ADB and the DMCs. Thus, it is necessary to closely consult with all major stakeholders in formulating microfinance policy reform programs for DMCs.

Financial infrastructure

Underdeveloped financial infrastructure continues to constrain the deepening and broadening of microfinance services and participation of private institutions as service providers. While MFIs in some DMCs, such as Bangladesh, have grown without a proper financial infrastructure, such growth, based partially on public deposits, can pose a systemic risk within the microfinance subsector. MFIs can develop sustainable commercial services on a permanent basis, and expand their scope of operations and outreach, only if they operate within an appropriate financial infrastructure. The improved financial infrastructure contributes to the development of the entire microfinance subsector, not just one specific institution. Therefore, ADB's assistance will focus on critical elements of financial infrastructure, such as information systems and training facilities necessary for microfinance development. In some countries, legal barriers also prevent banks from establishing business relationships with informal or semiformal bodies such as community-based organizations or self-help groups. The legal framework and supervision and regulation of MFIs are important mainly because they facilitate sound growth and improve the capacity of MFIs to leverage funds in the market and provide competition. However, ADB will ensure that legal and regulatory systems will not discourage financial innovations, stunt institutional growth, and prevent emergence of a diverse set of dynamic institutions. Depending on country contexts, ADB will also support development of self-regulation and performance standards for MFIs.

Institutional development

ADB, in consultation with its DMCs, has identified institutional capacity building as an important requirement for sustainability and expanding outreach.[28] Strong institutions with good governance are required to

28 As noted in the Rural Asia Study (footnote 1, p. 7), "even well-conceived strategies and policies will not achieve their desired goals if the institutions that are to implement the strategies are inefficient."

provide quality services to the poor on a permanent basis. A good MFI with a commitment to provide microfinance services to the poor should have the capacity in particular to

(i) mobilize resources in the market, including public deposits, to meet its resource requirements;
(ii) provide products and services that are attractive to the poor at minimal transaction costs to the clients and the institution itself; and
(iii) offer competitive prices to the clients.

Financial viability is critical for expanding the outreach. Only viable financial institutions involved in microfinance can ensure permanency of services to an increasing number of the poor and contribute significantly to poverty reduction. Thus, financial viability of the institutions committed to serve the poor is seen as a tool to achieve the primary objective of outreach. For the same reasons, the strategy emphasizes institutions providing a broad range of financial services to the poor and low-income households, and microenterprises. These diversified institutions have a better chance to (i) achieve viability within a short period than the institutions that focus exclusively on the poorest clients, and (ii) reach more of the very poor than exclusively-focused institutions. However, ADB needs to support institutions to develop and offer products and services compatible with the socioeconomic characteristics of the poor to improve their access to permanent services and to reach the poorest of the poor.

ADB's institutional development activities will focus largely on existing MFIs and other financial institutions with a commitment to provide microfinance services to the poor. In countries where state-owned agricultural and rural development banks continue to undermine development of sustainable microfinance operations, ADB will explore possibilities for and support reforms of such banks (*Box 4*). However, in some circumstances, especially in transitional economies that lack appropriate institutions to efficiently provide microfinance services, new institutions may be needed. The establishment of such new institutions will be based on the potential for financial viability and capacity to expand the outreach to a significant number of the poor. ADB will also support development of apex microfinance organizations where necessary conditions for their sustainable operation exist.[29]

The institutional development activities also need to encompass

(i) development of training facilities for the microfinance sector,

(ii) ownership and governance of financial institutions involved in microfinance,

(iii) development of a diversified menu of products and services attractive to the poor,

Box 4: The Unit Desas of the Bank Rakyat Indonesia

The Bank Rakyat Indonesia (BRI), with its unit desa system, is a successful rural financial institution with a large microfinance portfolio. Before 1984, BRI unit desas were channelling subsidized credit, and mobilized very little savings. The Bank Indonesia provided funds to BRI at 3 percent per year for onlending at 12 percent per year to rice farmers under the Government's rice intensification program, known as Bimas. In addition, the Government subsidized the administrative costs of BRI unit desas.

The unit desas incurred large operating losses and experienced increasing default rates. In 1983, the default rate was about 50 percent. With large losses and default rates, the Government was compelled to terminate the Bimas program in 1983. Discontinuation of Bimas meant that BRI faced the problem of what to do with about 3,600 unit desas and 14,000 employees. The financial reforms of 1983, which liberalized interest rates, provided the opportunity for the Government to reform the unit desa system.

Under the reform program, the unit desas adopted market-oriented interest rates on loans (about 33 percent per year), and were transformed into full-service rural banking outlets. BRI also started to treat each unit desa as a profit or loss center. New savings products were introduced under the reform measures.

The reforms produced dramatic results, transforming unit desas into profitable rural financial intermediation outlets. The unit desas, which incurred a $28.0 million loss in 1983, made a profit of $34.0 million in 1991. As of the end of 1999, unit desas had 24.2 million deposit accounts with a total outstanding deposit of about $2.27 billion equivalent and 2.5 million borrowers with a total outstanding loan amount of $781 million equivalent. The average outstanding deposit size was about $94, while loan size was about $318. Despite the crisis in the financial sector, during 1999, unit desas generated a profit of about $153 million.

The unit desas continue to operate as an integral part of the state-owned BRI.

Sources: ADB. 2000. *Rural Asia Study: Beyond the Green Revolution*. Manila: ADB and Bank Rakyat Indonesia.

29 These conditions include demonstrated government willingness to provide a high level of autonomy to apex bodies and existence of an adequate number of retail level MFIs committed to provide services on a sustainable basis.

(iv) management information systems and accounting policies and practices,
(v) management of portfolio quality and growth, and
(vi) systems and procedures and financial technology for reducing transaction costs.

Pro-poor innovations

The development of sustainable financial institutions will contribute to the expansion of their outreach to the poor. However, while improving the institutions' capacity in general to serve a wide spectrum of the poor is important, this is not sufficient to ensure that their services are made available to certain categories of the poor, such as those in resource-poor and low-population density areas, the poorest of the poor, and ethnic minorities. Often, financial institutions tend to exclude these categories due to risk-return considerations, although the social returns to reaching these clients may be high. Private institutions are, in general, reluctant to invest in financial technology and innovative programs oriented to the poor because they tend to believe that the market among the poor is limited and externalities will not allow them to profit from their investments. Therefore, to ensure that the financial institutions will continue to expand the services to these categories, ADB will support innovative programs and development of financial technology that contribute to breaking these barriers through pilot projects and other measures that aim at establishing sustainable linkages between formal financial institutions and informal service providers. ADB will also support development of pro-poor products and services and delivery mechanisms because these are essential to attract the poor into the formal sector.

Social intermediation

Social intermediation is necessary to increase the capacity of the majority of the poor to access and productively use microfinance services. Hence, the strategy emphasizes supporting investments aimed to improve the capacity of the poor to actively participate in microfinance markets. Such investments will cover, among other things, (i) awareness building programs on a broad range of microfinance services; (ii) information dissemination on service providers; (iii) basic literacy, numeracy, and skills training for women, ethnic minorities, and other disadvantaged groups; and (iv) social mobilization for formation of community-based organizations and solidarity groups to actively participate in microfinance markets.

Implementation of the strategy

To achieve the objectives of the strategy effectively and efficiently, ADB will integrate microfinance into its operations, make better use of current modalities, enhance the involvement of its private sector operations in microfinance, build its internal capacity for microfinance activities, coordinate with other agencies involved in microfinance, monitor the progress of microfinance activities, and review its microfinance strategy in 2003.

Mainstreaming microfinance

The effective implementation of the strategy requires integrating microfinance assistance into ADB's overall operations aimed at poverty reduction, as follows:

(i) Microfinance assistance will be an important tool in achieving ADB's overarching objective of poverty reduction. Therefore, microfinance subsector analysis will be an integral part of the poverty analysis of each DMC. Microfinance system development will be an integral part of operations for countries selected for such assistance.

(ii) Microfinance policy issues will be incorporated into broader financial sector reform programs supported by ADB to address critical policy constraints more effectively and comprehensively.

Better use of existing modalities

A major effort is needed to improve the effectiveness and efficiency with which ADB uses its modalities of assistance—policy dialogue including sector work, loans, TA, and equity investments. These modalities provide significant potential capacity and a sufficiently broad framework and flexibility for ADB to assist microfinance development in its DMCs. To achieve this objective, ADB will

(i) base assistance on a thorough financial sector review and a country-level sector development strategy;
(ii) provide assistance through long-term partnerships rather than as one-time project operations;
(iii) emphasize the catalytic effect and the potential development impact in considering assistance;
(iv) take into account the conditions under which microfinance can play a significant role in promoting pro-poor, broad-based economic growth;
(v) consult major stakeholders including NGOs and potential clients of microfinance projects extensively, and coordinate closely with other funding agencies;
(vi) focus on development of sustainable institutions within an enabling environment, and appropriate financial infrastructure;
(vii) systematically monitor the progress of MFIs toward achieving their sustainability, and insist that they adopt best practices; and
(viii) specify how ADB will stop supporting MFIs that do not clearly comply with conditions for assistance, and effectively cease such support as appropriate.

ADB will introduce measures to improve country programming in microfinance. Poverty analysis of DMCs will cover microfinance. The country operational strategy (COS) will identify whether ADB can meaningfully contribute to the development of the microfinance sector in a given country. Based on country-level poverty analysis, COSs, sector studies, and operations of other funding agencies, the country assistance plans may propose a medium-term plan of assistance for the countries chosen for intervention in microfinance. In using the modalities, ADB will pay special attention to the specific problems of small Pacific economies where the small scale of financial system calls for different approaches, and to the transitional economies where the shift to market-based financial systems needs to be gradual.

Policy dialogue and sector work

Given its critical importance, ADB will pay more attention than in the past to policy reforms to create a better policy environment for the development of sustainable sources of microfinance. Once the countries that may receive microfinance assistance are identified through the COSs, country programming missions will discuss major policy issues in the subsector with the stakeholders (such as the central banks, ministries of finance, MFIs, and civil society). Comprehensive subsector studies will underpin these discussions. The policy dialogue will be a continuing process through which a country moves from a less enabling to a more enabling policy environment. In countries where sustainable growth in microfinance is constrained by nonfinancial policies, the dialogue will encompass a broader agenda to include such policies. Because effective implementation of policy reforms requires substantial involvement and ownership from the major stakeholders, ADB will bring on board the major stakeholders during the process of policy dialogue. For this purpose, ADB will promote establishment of high level rural finance policy groups and workshops, in close coordination with other funders and in consultation with major stakeholders at the country level, where such a mechanism is deemed relevant.

Financing modalities

Loans will continue to be important in ADB's assistance for microfinance. However, the emphasis of loans will shift from providing funds for onlending to developing sustainable microfinance systems that can efficiently mobilize domestic resources to expand the outreach of services. Among other things, ADB’s loans will be used to (i) catalyze needed policy and institutional reforms; (ii) promote domestic savings mobilization and insurance services; and (iii) develop cooperatives and link community-based, autonomous savings and loans associations with sustainable formal and semiformal financial institutions to expand the services. ADB loans will not be used to support institutions that are not prepared to implement meaningful reforms to move toward market-based systems and achieve financial viability, or to subsidize interest rates to the clients of MFIs.

To improve project design, systematic use of the financial system development approach and incorporation of best practices into project design will be ensured. ADB will carry out extensive consultations with the poor and other potential stakeholders. The consultations will be held at the project design stage to ensure project quality at entry and that projects are client-focused, demand-driven, and designed to reach the poor and the poorest effectively. To improve project administration, the focus of microfinance project administration will be shifted to monitoring (i) institutional sustainability; (ii) extent of leverage; (iii) the extent to which project services reach the poor, poorest, and women; and (iv) the development impact of assistance from current practices focusing on a narrowly defined set of project inputs and activities.

To enhance the effectiveness of microfinance technical assistance, ADB will:[30] (i) ensure that technical assistance are prepared based on a longer term perspective than in the past; (ii) design advisory technical assistance based on comprehensive institutional analysis and in partnership with concerned institutions, and ensure their focus on capacity building and policy reforms; (iii) increase effective stakeholder participation and ownership in designing technical assistance; and (iv) use measurable and monitorable indicators to assess performance.

The strategy also supports (i) the use of the technical assistance cluster approach for microfinance where this approach is more suitable to promote microfinance development; (ii) wider use of technical assistance for pilot testing in microfinance; and (iii) innovative use of technical assistance to provide direct small grant assistance to MFIs and other relevant institutions to finance microfinance activities such as development of new products and services for the poor, workshops and training on thematic issues such as governance and development

30 TA, in its general sense, is defined as activities aimed at (i) enhancing the capacities of the recipient country by strengthening human resources, institutional frameworks, and organizations primarily through the transfer and use of knowledge, skills, and other nonphysical inputs; or (ii) filling gaps in DMCs in terms of knowledge, skills, technology, and organizations to carry out development activities. R119-97. *Review of ADB's Technical Assistance*. 10 July. p. 2.

impact assessment, and research on key issues in microfinance. To augment resources for technical assistance for microfinance development, ADB will make a concerted effort to enhance cofinancing from its donor member countries. ADB will also explore possibilities for mobilizing resources to meet the demand for capacity building in microfinance through other mechanisms.

Enhancing ADB's private sector operations

Given the increasing potential for the private sector to profitably and efficiently provide microfinance services, the scope for involving the private sector in microfinance development is expanding. Hence, ADB has to harness this opportunity. ADB's private sector operations will make a concerted effort to enhance private sector participation in public sector projects that have potential for such participation, and

(i) proactively seek equity investments to support new MFIs and transformation of NGOs providing microfinance services into regulated MFIs, and provide technical assistance for such efforts;
(ii) provide technical assistance to downscale operations of viable private commercial banks where clear commitment for such downscaling exists; and
(iii) consider direct support for developing microfinance industry infrastructure such as rating agencies and equity funds (e.g., Pro-Fund in Latin America) that support financial institutions involved in microfinance.

Building ADB's capacity

ADB will strengthen its human resources and knowledge base through adjustments in the staff skill-mix of operational departments and offices, increasing awareness of and training staff to improve and expand their assistance to microfinance. Specifically, ADB will

(i) improve awareness of staff involved in microfinance-related work at a general level, including managers of operational departments and offices in microfinance development issues;
(ii) thoroughly train staff involved in microfinance project processing and administration in various aspects of microfinance such as

governance, product development, financial institutional analysis, and design of projects focused on the poorest and resource-poor areas[31] to ensure an adequate number of microfinance specialists at the operational level;

(iii) improve the knowledge base of staff on pro-poor financial technology and institutional modalities; and

(iv) increase staff exposure to international best practices in microfinance.

ADB will strengthen the focal point for microfinance located in the Agriculture and Social Sectors Department (West) to support efforts aimed at improving the quality of its microfinance operations. The focal point group will function in close consultation and coordination with all departments and offices involved in microfinance operations. The group will:

(i) collect and disseminate among staff involved in microfinance operations, information on good practices, innovations in financial technology, institutional modalities, and operations of other funding agencies;

(ii) develop and maintain a separate database on ADB's microfinance operations and develop a monitoring system for ADB's microfinance operations;

(iii) provide technical guidance to staff involved in relevant sector work, and processing and administration of microfinance projects;

(iv) prepare progress reports on ADB's microfinance operations;

(v) assist the Human Resources Division of the Budget, Personnel, and Management Systems Department to provide training programs in microfinance; and

(vi) promote networking with international, regional, and national microfinance development institutions, and coordination among funding agencies.

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31 Consultative Group to Assist the Poorest (CGAP) has conducted training programs for operational staff involved in microfinance operations of other multilateral lending organizations such as the World Bank and the African Development Bank, and has gained experience in such training. Therefore, ADB will work with CGAP to provide these training programs.

Coordination among funding agencies

Because many funding agencies are involved in microfinance in ADB's DMCs and multiple benefits can be derived from it, ADB will increase its efforts to improve coordination among these agencies at the global and country levels. At the global level, ADB will continue to work with the Consultative Group to Assist the Poorest (CGAP)[32] to strengthen funding agencies' practices in microfinance. At the country-level, it is proposed that ADB will take the lead in organizing microfinance groups among funding agencies in countries where ADB will support microfinance development (if such groups do not already exist) to disseminate good practices and adopt consistent approaches. ADB will also work with other funding agencies in preparing financial sector strategies at the country level to ensure integration of microfinance into the broader financial system.

Monitoring implementation

ADB will develop a set of indicators before the end of 2000 to monitor implementation of this strategy. The indicators will focus mainly on improvements in the (i) environment for microfinance at the country-level, (ii) breadth and depth of outreach of ADB supported MFIs, (iii) financial viability of MFIs, (iv) extent of commercialization of the industry, and (v) development impact of assistance. ADB will report the progress of its microfinance operations to its Board of Directors annually through its report on poverty reduction efforts.

Review of the strategy

ADB will review this strategy after three years.

32 CGAP was formally established in June 1995 with the participation of 10 bilateral and multilateral donors including ADB, to significantly expand very poor people's access to quality financial services from sustainable or potentially sustainable MFIs. Currently, CGAP has 27 members. The CGAP Secretariat, responsible for implementing CGAP's mandate, is housed in the World Bank head office. In 1997, ADB hosted the Fourth Forum of the CGAP.

Appendixes

Consultation process during preparation of the strategy

In April 1998 an interdepartmental Task Force on Microfinance at the Asian Development Bank (ADB) prepared an interim action plan on microfinance.[1] The action plan, which was approved by the President in May 1998, recommended preparation of a microfinance development strategy to provide directions for ADB's operations in microfinance. The Task Force concluded that the proposed strategy should be formulated in close consultation with ADB's developing member countries (DMCs), other funding agencies, and external experts on the subject. To facilitate such consultations, the President approved a regional technical assistance in March 1999.[2]

The consultation process consisted of several steps and covered a wide range of stakeholders.

First, in-country consultations were carried out during May-August 1999 in 12 DMCs (Bangladesh, People's Republic of China, India, Indonesia, Kyrgyz Republic, Nepal, Pakistan, Papua New Guinea, Philippines, Sri Lanka, Vanuatu and Viet Nam) to provide an opportunity for stakeholders in these DMCs to participate in the process of formulating the strategy and to obtain their views on microfinance development issues and initial inputs for the preparation of a draft strategy paper. Over 500 representatives of organizations such as central banks, ministries of finance, commercial banks in public and private sectors, cooperatives, nongovernment organizations, academics, and representatives of other agencies participated in these consultation workshops and meetings and provided valuable initial inputs.

Second, a regional workshop was held during 1-3 September 1999 in Manila to review and discuss the draft strategy paper with a broad group of stakeholders. Forty-six participants from 13 DMCs and 14 representatives of other funding agencies actively participated in the regional workshop. The DMC participants included policy makers, senior staff of central banks, state-owned and private regulated financial institutions providing microfinance services, NGOs and a microfinance

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1 ADB. 1998. Microfinance: An Interim Action Plan. Manila: ADB.

2 TA 5836: *Consultations on the Bank's Microfinance Strategy*, for $400,000, approved on 1 March 1999.

rating agency. The regional workshop included long working group sessions in addition to plenary sessions and provided participants the opportunity to concentrate and deliberate on major areas of focus included in the draft strategy paper.[3]

Third, the draft strategy paper was sent to over 40 external experts and organizations, such as the World Bank, the Consultative Group to Assist the Poorest, and a number of bilateral aid agencies for review and comments. In addition, the draft was placed on a web site for review and comments by any interested parties.

Internally, the draft strategy paper was circulated to the task force members and other concerned departments and offices for review and comments. The paper also benefited extensively from the work carried out in ADB's recently completed Rural Asia Study.[4]

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3 ADB. 2000. *Toward an ADB Microfinance Development Strategy*. Manila: ADB.

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

Self-finance: advantages and disadvantages

Ronald McKinon defined self-finance "as the investment within a particular enterprise (or economic unit) of savings accumulated in that enterprise."[1] Self-finance takes place in all types of households and enterprises, from rich to poor people, and from microenterprises to the very large-scale multinational firms. However, among the poor in virtually all developing countries, self-finance is the dominant, or sole form of financing their investments. Financing from outside the household or enterprise is either unavailable or extremely limited for the poor for lack of collateral demanded by commercial banks and high transaction costs associated with borrowing from such formal sources.

Self-finance has some advantages and disadvantages.

- The main "advantage of self-finance is that, in combining the acts of saving and investing, it internalizes all the information, transaction, monitoring, and enforcement costs that would be involved if the resources were lent to someone else. No complex contracts, collateral, or other devices are required to reduce the risks inherent in lending."[2]
- The main disadvantage of self-finance is that a household's or enterprise's resources may not match those required to harness an investment opportunity within a reasonable time frame. Thus, a household or an enterprise may not be able to take advantage of a high-productivity investment opportunity. The scale of an economic activity or an enterprise will have to be limited by the amount of self-finance.
- The shortcomings of self-finance will be more pronounced when investments are characterized by indivisibilities. A poor household may require funds to buy cattle, a sewing machine, or a bag of fertilizer. The amount of funds required may be large relative to the income of a household living at subsistence level. Hence, the

1 McKinon, R.I. 1973. *Money and Capital in Economic Development*. The Brookings Institution: Washington DC. p. 30.

2 World Bank. 1989. "World Development Report." World Bank: Washington DC. p.29

household may not be able to finance the investment in one lump sum but may be able to do so in installments. Poor household that is not able to self-finance discrete increases in investments will be compelled to use traditional technology and continue with low-productivity activities. Thus, McKinon noted that

> poverty and the inability to borrow can be formidable barriers to the adoption of even the simplest and most productive innovations. The important point, however, is the virtual impossibility of a poor farmer's financing from his current savings the whole of the balanced investment needed to adopt the new technology. Access to external financial resources is likely to be necessary over the one or two years when the change takes place. Without this access, the constraint of self-finance sharply biases investment strategy toward marginal variations within the traditional technology.[3]

Self-finance limits specialization, adoption of better technology, growth in productivity, and thus economic growth and development.

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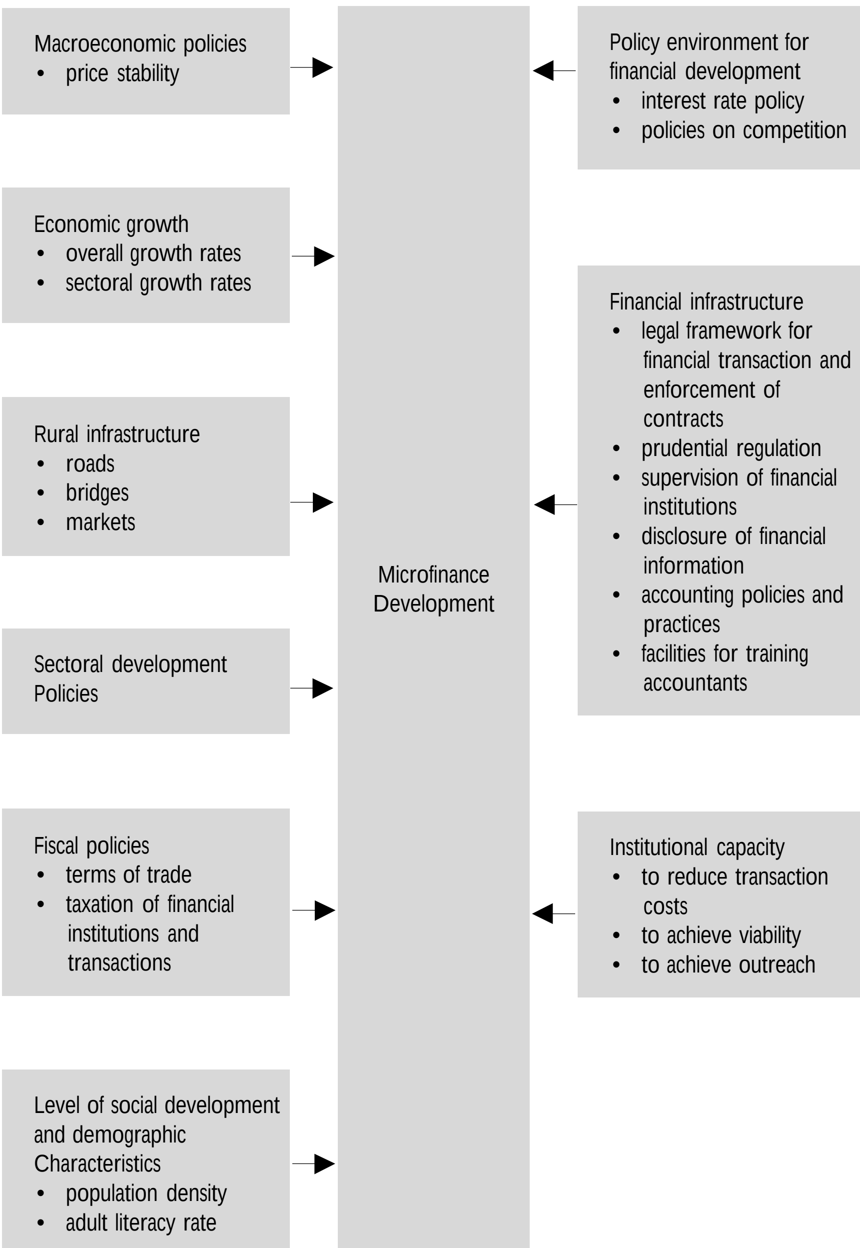
3 McKinon, R.I. 1973. *Money and Capital in Economic Development*. p.13

Demand for microfinance: structure and characteristics

Sources of demand	Products and services and characterisrics of demand
Households Poorest (Rural and Urban)	convenient access to safe and liquid deposit services passbook savings with unlimited withdrawal facility strong demand for consumption and emergency loans 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
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
Enterprises 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
Fisheries, Livestock 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
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 loan is not seasonal demand is large for working capital loans relatively large loans within the confines of microcredit minimal transaction costs and easy access

Appendix 4

Determinants of microfinance development



Viability-outreach relationship

Financial viability
- profits
- market confidence
- returns to investors
- capacity to grow

Need
- commitment to achieve viability
- design of institutions with appropriate incentives and governance
- cost-recovery interest rates
- efforts to contain cost at reasonable levels
- high portfolio standards

↓

Leverage funds in the market
- borrow from commercial sources
- mobilize deposits

Need
- transparency
- demonstrated commitment to achieve and maintain high performance standards
- development of overall financial systems
- creating confidence and image of permanency among potential clients, investors, and lenders

↓

Increase outreach
- permanent services
- increasing number of clientele
- greater impact on poverty reduction

Need
- strong financial institutions
- market-driven products
- orientation to a wider clientele
- risk and transaction cost reducing financial technology, systems, and procedures
- rural economic growth

Microfinance operations of other multilateral development banks

The World Bank

The World Bank has paid increasing attention to microfinance operations in recent years. The World Bank's microfinance portfolio from FY1991- FY1996 included 55 projects, with a total investment of $713.0 million. The number of projects approved with microfinance activities grew from 6 in 1995 to 12 in 1996 for a total of $88.0 million, indicating the growing interest. In 1997, the World Bank approved a loan of $105 million for Bangladesh to support an apex microfinance institution (MFI). A similar microfinance loan of $90.0 million was approved for Pakistan in 1999. The World Bank is recently showing a high level of interest in microfinance operations in very poor countries in Africa, Europe, and Central Asia.

The World Bank uses lending and nonlending modalities to support microfinance operations. The nonlending modalities include (i) technical assistance, (ii) policy dialogues, (iii) grants for pilot operations, and (iv) economic and sector work. The World Bank is also emphasizing the role of coordination among funding agencies through the Consultative Group to Assist the Poorest (CGAP).

In 1997, the CGAP reviewed the World Bank's microfinance operations, and made five strategic recommendations to improve its microfinance operations: (i) strengthen the experience and skills of staff working on microfinance; (ii) improve coordination and product development within the World Bank Group; (iii) coordinate with other funders experienced in microfinance; (iv) consider new instruments and procedures for microfinance; and (v) develop a World Bank strategy for microfinance. The CGAP also recommended that the World Bank's microfinance strategy "focus on borrower countries with appropriate financial sector policies, strong demand, and a commitment to long-term financial sustainability of retail microfinance institutions." In addition, the CGAP recommended that country departments and regions develop more coherent approaches to microfinance.[1]

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1 The World Bank. 1987. *A Review of the World Bank's Microfinance Portfolio FY91-FY96*, The World Bank. Washington DC. p. iv.

The World Bank is making an effort to move away from lines of credit as the primary instrument of its microfinance operations, shifting the focus to the fundamental policy framework and well-performing institutions. The World Bank also recognizes that development of a flexible enabling environment is critical to avoid overregulating MFIs. Institution-building efforts of the World Bank focus on helping MFIs develop sound commercial operations and increase outreach and sustainability. To improve the quality of its microfinance assistance, among other things, in September 1997 the World Bank created the Small Enterprise Development Unit in the Private Sector Development Department. The unit's goal is to be a center of expertise in small- and medium-scale enterprise development, microenterprise development, and microfinance.

The Inter-American Development Bank

The Inter-American Development Bank (IADB) is a pioneer and leader in microfinance and microenterprise development. IADB's support for microfinance began with the Small Projects Program in the late 1970s, and has steadily increased since that time. In recent years the microenterprise sector has constituted a significant growth area for IADB. Between 1990 and 1996, IADB approved 471 microenterprise operations totaling $452.0 million.[2] IADB estimates that its microenterprise programs have reached over 600,000 microentrepreneurs, and have created and strengthened over 1.8 million employment opportunities.

To respond more effectively to the changes in the microenterprise sector, IADB prepared a microenterprise development strategy in 1997. The strategy focuses on promoting the conditions necessary for the growth and development of microenterprises in Latin America and the Caribbean. IADB launched a five-year program, MICRO 2001, to implement the strategy. This program is expected to promote policy and regulatory reform to create an enabling environment for microenterprise development on a sustainable basis. During the five years of implementation, IADB expects to increase its investments in microenterprise development to about $500 million.[3] IADB will also

2 IADB. 1987. *Microenterprise Development Strategy*, IADB: Washington DC. p. 2.

3 This amount includes equity investments, loans, and TA from the Multilateral Investment Fund (a special fund established in 1992 to support new programs, innovations, and activities with demonstration value throughout Latin America and the Caribbean). The fund gives special attention to the development of small enterprises in the region.

make a concerted effort to catalyze private and other resources to microenterprise development in the region. The Microenterprise Unit in IADB's Department of Social Programs and Sustainable Development is responsible for coordinating and monitoring the MICRO 2001 program.

In 1998, IADB, with grant assistance from the Government of Norway, established the Norwegian Fund for Microenterprise Development. The purpose of this fund is to support IADB in strengthening the implementation of the microenterprise development strategy. The resources in the fund may be used, among other things, to (i) meet cost of workshops, publications, and related activities; (ii) provide technical assistance to local organizations for development of microenterprise development projects; (iii) finance activities that directly or indirectly support institutional strengthening of local organizations involved in microenterprise development; and (iv) finance applied research and information gathering and dissemination, especially best practices, that will benefit local organizations working on microenterprise development.

The African Development Bank

The African Development Bank (AfDB) has recognized the importance of microfinance for poverty reduction in recent years. To address the problems posed by the lack of access to financial services by microentrepreneurs, especially women, AfDB established a pilot program, the African Development Fund Microfinance Initiative for Africa (AMINA), in 1997. AMINA assists a wide range of MFIs including national and international nongovernment organizations to build the capacity needed to manage a growing financial services program oriented to the poor, help them acquire needed equipment, and obtain funds for on-lending to support the expanding portfolio that their additional organizational and technical capacity will make possible. AMINA focuses on capacity building because the strengthening of MFIs is crucial to their ability to expand the outreach and to limit the risks involved in their lending. AMINA provides funds for on-lending by MFIs that have demonstrated their ability to manage on-lending operations.