THE CHALLENGES OF MICROFINANCING IN SOUTHEAST ASIA

By John D Conroy
Special Consultant
The Foundation for Development Cooperation

For publication in

"Financing Southeast Asia's Economic Development"
Singapore: Institute of Southeast Asian Studies, 2003.

THE FOUNDATION FOR DEVELOPMENT COOPERATION
Level 2, 283 Elizabeth Street (PO Box 10445 Adelaide Street) Brisbane Qld 4000 Australia
Tel: 61 7 3236 4633 Fax: 61 7 3236 4696 info@fdc.org.au www.fdc.org.au

ACRONYMS

ACLEDA	Association of Cambodian Local Economic Development Agencies
ADB	Asian Development Bank
AIM	Amanah Ikhtiar Malaysia
APB	Agricultural Promotion Bank (Laos)
BAAC	Bank for Agriculture and Agricultural Cooperatives
BI	Bank Indonesia
BKK	Category of NBFI (Indonesia)
BKKBN	National Family Planning Coordinating Board (Indonesia)
BMT	Islamic Savings and Credit Group (Indonesia)
BPD	Regional Development Bank (Indonesia)
BPR	People's Credit Bank (Indonesia)
BRI	Bank Rakyat Indonesia
CDD	Community Development Department (Thailand)
CGAP	Consultative Group to Assist the Poorest
CGC	Credit Guarantee Corporation (Malaysia)
GOI	Government of Indonesia
CU	Credit Union
GSB	Government Savings Bank (Thailand)
GTZ	German Development Assistance Agency
IDT	Presidential Program for Backward Villages (Indonesia)
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IMF	International Monetary Fund
INGO	International NGO
KSP	Savings and Credit Group (Indonesia)
KUD	Village Cooperative Unit (Indonesia)
KUPEDES	BRI Microfinance Lending Program (Indonesia)
LDKP	NBFI Savings and Credit Institutions (Indonesia)
LVCA	Lao Village Credit Association
LWU	Lao Women's Union
MFI	Microfinance Institution
NBC	National Bank of Cambodia
NCC	National Credit Council (Philippines)
NEP	New Economic Policy (Malaysia)
NBFI	Non-Bank Financial Institution
NGO	Non Government Organisation
PAR	Portfolio at Risk
PCF	People's Credit Fund (Vietnam)
PCFC	People's Credit and Finance Program (Philippines)
PHBK	Program Linking Banks with SHGs (Indonesia)
Pro-Fi	Promotion of Small Financial Institutions project (Indonesia)
PRSP	Poverty Reduction Strategy Paper
P4K	Agriculture Ministry Microfinance Program (Indonesia)
RDB	Rural Development Bank (Cambodia)
ROSCA	Rotating Savings and Credit Association
SBV	State Bank of Vietnam
SHG	Self Help Group
SIMPEDES	BRI Microfinance Savings Program (Indonesia)
SME	Small and Medium Enterprise
SPIN	Credit Program for Fishermen (Malaysia)

SP-IT	Credit Program for Female Household Heads (Malaysia)
UCDO	Urban Community Development Office
UEDSP	Village Economic Activities and Finance Project (Indonesia)
USAID	US Agency for International Development
USP	Credit and Savings Unit (Indonesia)
VBARD	Vietnam Bank for Agriculture and Rural Development
VBP	Vietnam Bank for the Poor
VWU	Vietnam Women's Union
YPEIM	Foundation for the Development of the Malaysian Islamic Economy

THE CHALLENGES OF MICROFINANCING IN SOUTHEAST ASIA

1. Introduction

This paper examines the circumstances of seven ASEAN countries in which institutional microfinance has developed to some significant degree[1]. The treatment is broad-brushed, since it is written as a contribution to a wide-ranging discussion of the capacity of financial systems in Southeast Asia to finance the recovery of regional economies from financial crisis, rather than an attempt to update existing studies which describe microfinance comprehensively in the countries concerned[2].

The paper aims to paint some details into the big picture with which the 2001 ASEAN Roundtable is concerned. They are minor details, and might be regarded as trivial in financial terms, in the sense that the transactions described would scarcely register in the consolidated balance sheets of the financial sectors of any country in the region. However these transactions are significant in the lives of millions of poor people who are not served by formal financial institutions. And while accepting that growth is essential for poverty alleviation, this paper asserts that the participation of the poor in economic recovery and growth will be facilitated by their access to microfinancial services. The crude 'trickle-down' analogy for the diffusion of the benefits of growth may be discredited. But if, for heuristic purposes, we were to adopt that analogy and pursue its implications, microfinancing could be described as a process by which capillary systems are opened to enable the benefits of growth to flow to the poor, and to facilitate their participation in it.

The financial service needs of the poor are simple but their satisfaction can be life-enhancing. The poor need access to convenient, liquid and safe deposit services which are protected against inflation by positive real rates of interest. With savings in reserve the poor are able to smooth their consumption expenditures in the face of uncertain income streams. Savings provide a shield against catastrophic events which, by forcing the vulnerable to divest productive assets, would otherwise tip them over the dividing line between meagre sufficiency and poverty. "Micro"-insurance is a related financial product with potentially profound welfare benefits. Similarly, the poor who make their living in a myriad of activities in the informal sectors of the region, many of them either landless or with insufficient agricultural land, need access to credit to increase the productivity of their labour or to free them from exploitative financial relationships.

---

[1] I am grateful to my colleague Paul McGuire for his comments on an earlier draft, and also to Dr Leeber Leebouapao for his comments on the Laotian material. Dr Sukor Kasim was most generous in making available material which underpins the section on Malaysia. Ms Nina Nayar was most helpful in regard to Cambodia while Ms Michiko Katagami and Dr Nimal Fernando assisted me with materials on that country. None of these people should be held responsible for my final interpretations. Also, I thank Dr Nick Freeman of ISEAS for his patience and good humour.

[2] Relatively few studies of countries in the region deal with microfinance in a national perspective, as distinct from case studies of particular institutions or subregions. McGuire, Conroy and Thapa (1998) contains relevant studies of Indonesia, Malaysia, the Philippines and Thailand, while Asian Development Bank (2000b) includes studies of Indonesia, the Philipines and Vietnam. Indonesia is the best-documented country, with recent material including Robinson (2001), Steinwand (2001),and Holloh (1998), although each of these has its own institutional focus. Meyer and Nagarajan (2000) is primarily a study of rural finance but deals with microfinance in Indonesia and Thailand incidentally. There is a dearth of material dealing with the transition economies.

Defining Microfinance

Having established the significance of the subject, we proceed to definition. "Microfinancing" is the provision of financial services to poor and low income households without access to formal financial institutions. In most of the countries to be considered in this paper, such households form a clear majority. Given the Roundtable's concern with Southeast Asia, it is appropriate to adopt the definition of microfinance used in the ADB microfinance development strategy for the Asia-Pacific region (ADB 2000a, 1):

> *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 micro-enterprises.*

There is a good reason for employing this definition in a gathering of financial sector experts, most of whom probably do not follow the literature and controversies in microfinance. Suffice to say the ADB's definition is a good deal more inclusive than those adopted by many practitioners[3], who would apply strict criteria for loan size and targeting of clients, excluding from consideration the supply of services to 'low-income' people. Many would take such a stand even in a situation where (say) 75 percent of a population are beyond the reach of regulated financial institutions and where the population below the poverty line is (again, say) only 25 per cent. I do not expect such a definition to make much sense to a gathering of financial sector analysts, who would probably see the supply of financial services to the bottom half of the income distribution as a sufficient challenge in itself. A more restrictive definition, while useful for some purposes, would prevent me from discussing here several significant regulated financial institutions which are international leaders in their fields and whose methods of operation have much to teach microfinance practitioners.

Having said that, it is nonetheless important to remember that there is a clear distinction between the economic activities and financial service needs of the SME (small and medium enterprise) sector and those of the clients of microfinance institutions. The latter operate on a much smaller scale and exclusively in the informal sector of the economy. While there may be some overlap between the bottom end of the SME sector and the poor and lower-income people who form the constituency of microfinance, it is the needs of the latter to which this paper is directed.

'Microfinance' encompasses access to savings and other financial services, as well as credit. The term has come into greater currency since the early 1990s and has largely (but not entirely) supplanted the term 'microcredit' in the professional literature. The latter term is now recognised as unfortunate because its use has focussed attention on a single aspect of microfinancial services, lending to the poor, and diverted attention from the need to develop systems of financial intermediation to which the poor have access. Savings is often described, in a memorable phrase, as 'the forgotten half of rural finance' (Vogel 1984). Using the term microcredit perpetuates this amnesia.

Microfinance Institutions (MFIs) are developing forms of 'microinsurance' to protect the vulnerable from misfortunes, such as ill-health, which can tip them over the edge into poverty. Estimating the potential demand for insurance services by the poor as quite substantial, Kunkel and Seibel (1997) refer to microinsurance as 'the forgotten third of microfinance'. In addition, Microfinance practitioners are working to introduce newer

[3] In this the ADB is supported by Marguerite Robinson in *The Microfinance Revolution* (Washington DC: World Bank and Open Society Institute, 2001).

services, such as money transfers (given the high degree of spatial mobility of the working poor and the difficulties and expense they may experience in remitting funds to their families).

The Outreach of Microfinance

The Microcredit Summit, a US-based movement which supports the growth of MFIs targeting the poor, collates data submitted by MFIs concerning the outreach of their programs. Self-reporting is a dubious basis for recording the achievements of grant-seeking organisations, many of which are not subject to audit in their own countries. The Summit attempts to have independent monitors assess the claims of the organisations concerned. On that basis, the Microcredit Summit (www.microcreditsummit.org/SOCreport2001.htm) reports a worldwide increase in the outreach of microcredit programs responding to its surveys as follows:

Table 1: World Outreach of Microcredit

Date	Programs (number)	Clients (number)	'Poorest' Clients (number)
End 1997	618 programs	13.5 million clients	7.6 million 'poorest clients'
End 2000	1,567 programs	30.7 million clients	19.3 million 'poorest' clients

On a regional basis, the Summit Secretariat notes that Asian programs reported 23.6 million clients at end-2000, of whom 10.5 million were classified as 'poorest'. From this it appears the centre of gravity of the world microfinance movement is located in Asia. Looking at the country data, we see that Bangladesh houses a number of 'mega-institutions', of which the Grameen Bank with 2.4 million clients in the 'poorest' category at end-2000 is the leader. Other major institutions in Bangladesh include BRAC, with 1.6 million 'poorest' clients, ASA with 1.01 million and PROSHIKA with 0.89 million. In the case of Bangladesh, it can be said that the level of donor interest and monitoring is such that the reported figures for these major institutions carry some credibility.

Institutions in Southeast Asia do not feature prominently in the tables. From Indonesia, the BRI Units (discussed at some length below) are shown as having 2.7 million clients, of whom 0.125 million are among the 'poorest'. The table does not acknowledge the achievement of BRI in having some 25 million deposit accounts, of which more than 16 million are savings accounts with balances averaging $85. This may not be 'microcredit' but it is certainly microfinance.

The high profile achieved by microfinance in international development circles in the last ten or twelve years is due, more than any other factor, to publicity accorded the successes of the Grameen Bank of Bangladesh and the other Bangladeshi NGOs mentioned above, some of which are also multifaceted social and economic institutions. Broadly speaking, these have in common a basic organisational principle, the use of groups of women borrowers to overcome the problem of their lack of collateral. A short description of this and some other major models of microfinance service provision is given below.

The donor community recognised the potential of microfinance as a tool for poverty alleviation with the formation of an international consultative group, CGAP (the

Consultative Group to Assist the Poorest) in 1995, to which all major multilateral and bilateral donors have subscribed. The World Bank and certain bilateral agencies, notably USAID and GTZ, have a track record in the field dating back at least to the 1980s, or even further if one includes efforts to improve rural financial systems. CGAP identifies and disseminates standards for the measurement and analysis of MFI operations, 'best practice' modes of operation, and other information for microfinance practitioners and donors. Certain major donors, such as the Asian Development Bank in our region, have drafted microfinance strategies to guide their own efforts and those of member governments and MFIs (ADB 2000, www.adb.org/documents/policies/microfinance). This has occurred in response both to CGAP's influence and the broader trend to explicit incorporation of poverty alleviation into program criteria (notably in the PRSP, the 'Poverty Reduction Strategy Paper' process which the World Bank and the IMF now enjoin upon recipient governments).

Models of Microfinance

Among the proliferation of microfinance institutions (MFIs) in developing and even some industrial countries, a number of distinguishable models have emerged. The **Grameen Bank** model, referred to above, has been applied in many countries in a wide variety of settings. The Grameen model requires careful targeting of the poor through means tests, usually with a focus on women and intensive fieldwork by staff to motivate and supervise the borrower groups. Groups normally consist of five members, who guarantee each other's loans. Some compulsory saving requirements are imposed, but in general quite limited voluntary saving occurs. Sustainability is achieved by increasing the scale of operations, and by decentralising control and carefully managing costs. While some other models have as their goal the creation of autonomous institutions, this is not expected of the individual borrower groups. In Bangladesh, where the greatest numbers of Grameen-inspired institutions exist, considerable innovation is occurring; only the basic model is described here

The **Village Bank** is a widely replicated model, found mainly in Latin America and Africa, but with substantially less total outreach than the many Grameen Bank replications. Typically, an implementing agency establishes individual village banks with between 30 and 50 members and provides capital (called the 'external account') for on-lending to individual members Individual loans are repaid at weekly intervals over 16 weeks, at which time the village bank returns the principal with interest to the implementing agency. A bank repaying in full is eligible for subsequent loans, with loan sizes linked to the performance of village bank members in accumulating savings. Peer pressure operates to maintain full repayment, thus assuring further injections of loan capital, and also encourages savings. Savings accumulated in a village bank can be loaned out to members (the 'internal' account). The standard business plan calls for a village bank to accumulate sufficient capital in its internal account to enable 'graduation' after three years, by which time loan capital has been accumulated entirely from internal sources. Hence village banks are intended to become autonomous institutions.

Somewhat less structured than village banks (and a good deal less so than Grameen banks) are **Credit Unions** (CUs). These are democratic, non-profit financial cooperatives owned and controlled by their members. CUs mobilise savings, provide loans for productive and provident purposes and have memberships which are generally based on some common bond. The memberships of CUs is likely to be more heterogeneous than that of Grameen banks, although various CUs differ in the extent to which they include poorer and low-income households. CUs generally relate to an apex body that promotes primary credit

unions and provides training while monitoring their financial performance. In Asia, rural credit unions have been successful in some countries, both in terms of sustainability and of reaching out to the poor (notably Sri Lanka). But they have been less successful in most other countries of the region.

A fourth model, based on **'self-help' groups** (SHGs) is somewhat similar to the village bank concept, although less structured. Most prominent in India, SHGs have around 20 members who should be relatively homogeneous in terms of income. Their primary principle is the lending of members' savings but SHGs also seek external funding to supplement internal resources. The terms and conditions of loans differ among SHGs, depending on the democratic decisions of members. Typical SHGs are promoted and supported by NGOs, but the objective (as with village banks) is for them to become freestanding institutions. Some NGOs act as financial intermediaries for SHGs, while others act solely as 'social' intermediaries seeking to facilitate linkages of SHGs with either licensed financial institutions or other funding agencies. The SHG model is a good platform for combining microfinance with other sectoral activities and their implementing agencies (maternal and child health and adult literacy, among others). However the relatively loose structure of groups makes rapid expansion of outreach and tight monitoring of performance more difficult than, say, with the Grameen Bank model.

In a quite different category from the four models discussed above, each of which has strong voluntary elements involving the action of NGOs or community-based entities, is what might be called a **'rural financial systems approach'**. As practiced in Indonesia, this model exhibits a diversity of regulated financial institutions providing rural financial services. These range from a national-level institution with substantial outreach and extensive networks to small, local institutions occupying particular market niches. Also, depending on the regulatory environment in a particular country it may be possible for an NGO to transform a successful MFI into a regulated financial institution. The rural financial systems approach to microfinancing will be discussed below, with particular reference to Indonesia. The "transformation" process in which NGOs evolve to become regulated financial institutions will be also be described, in the context of Cambodia and the Philippines.

2. Microfinance within the Region: Light and Shade

Within Southeast Asia there is considerable diversity between countries in the degree to which systems of microfinancing have emerged and in the institutional forms developed or adapted for them. Before proceeding to a country-by-country discussion it may be useful to suggest in broad terms the scope of this diversity. For the purposes of this paper, it is convenient to categorise countries in Southeast Asia as either 'market' economies, differing in the degree to which they have modernised their financial sectors, or 'transitional' economies, differing in the extent to which they have accepted the challenge of adopting market principles[4].

[4] Among ASEAN members, Singapore, Brunei and Myanmar will not be discussed here. The first two are wealthy countries. This does not mean there is not scope for forms of alternative financial service delivery to benefit disadvantaged groups in their populations. However discussion of these is outside the scope of this paper. In the case of Myanmar circumstances, including limited information, the closed nature of its economic system, limited donor activity and limited opportunity for NGO initiatives, all suggest that Myanmar might best be treated in a separate country study.

Among the 'market' economies of ASEAN, there are considerable differences, both in the incidence of poverty, which might stimulate microfinance initiatives as a response to disadvantage, and in the balance between private and public involvement in the process. For example, Malaysia and Thailand have considerably higher levels of per capita income than either Indonesia or the Philippines. In Malaysia in particular, absolute poverty was (at least until the financial crisis from 1997) regarded as a residual and diminishing problem which could be eliminated early in this current century. The official Malaysian approach to eliminating poverty, and to the provision of microfinancing services as an element in that process, has been essentially 'social-welfarist'. Microfinance services for people without access to conventional financial institutions have been seen within the framework of a redistributive social policy involving substantial subsidies.

In the case of Thailand, elements of subsidy (and implicit redistribution) have also been present in financial policy for lower income rural people. However, for reasons which will be discussed below, there are marked differences between Malaysia and Thailand in microfinance policy and practice. One such is that whereas the voluntary or NGO sector of financial service provision is relatively undeveloped in Thailand, an NGO with strong political backing is the major actor in Malaysia. And in Thailand, a government financial institution has primary responsibility for microfinancing, and has become both an international leader in its field and an integral part of the Thai financial system.

Indonesia and the Philippines also provide some marked contrasts, both with one another and with Malaysia and Thailand. Indonesia has adopted a model of microfinance service provision based very largely on the operations of regulated financial institutions, whereas NGOs are of relatively limited significance. The emergence of sustainable and effective models of microfinancing within the formal financial system, many of them privately owned and operated, has been more a by-product of Indonesia's efforts at financial sector development than of any conscious policy to stimulate microfinance, *per se*. And by contrast, Indonesia also provides some examples of mass 'microcredit' programs involving NGOs and other community organisations (especially in the late Soeharto era) which were politically-driven and not at all concerned with sustainability.

Microfinancing in the Philippines has followed a more conventional course, based primarily on the energies of a burgeoning NGO community. The influence of Grameen Bank methods of service delivery has been very strong in that NGO community, and the Philippines also has a regulatory environment favorable to the operation of small regulated banks suitable for microfinance. The Philippine Government has explicitly incorporated microfinance into its poverty alleviation strategies, has encouraged NGOs to develop sustainable microfinance programs, and is beginning to promote the transformation of successful microfinance NGOs into regulated financial institutions.

In the 'transition' economies there is a range of experiences and some marked contrasts. In terms of overall economic and financial sector development, Laos has made least progress and its economic activities retain a substantial non-monetised component. In terms of developing a microfinance sector, it lacks important institutional and policy prerequisites.

The cases of the other transitional countries discussed here, Cambodia and Vietnam, provide some instructive contrasts. In many senses, Vietnam is experiencing a more difficult transition to financial liberalisation, given the continuity provided by a militarily undefeated socialist institutional and governmental structure and the resistances to change within it. Also an autonomous NGO movement, as distinct from mass organisations set up

by the State, is still substantially lacking (though this could be seen as simply more evidence of continuity in the political culture of Vietnam).

In Cambodia, however, the history has been one of abrupt discontinuity; the period of turmoil and uncertainty from the time of withdrawal of Soviet influence in 1989 appears to have left less entrenched resistance to change. Simultaneously, a governmental vacuum opened opportunities for the 'INGOs', the international NGO movement (which was the vehicle for much bilateral development assistance in the early period). Among many innovations introduced as part of an INGO-led reconstruction effort in the early '90s were 'microcredit' projects. Some of these have flourished as indigenous NGOs and have embraced financial intermediation functions. These successful institutions are now being incorporated into an explicit legal and regulatory framework for microfinance, the "transformation" process described above.

3. Country Case Studies

i) Malaysia

Malaysia has a modern financial system with a diverse range of institutions, both private and public, including Islamic banks. Public institutions include development financing institutions - a development bank and an agriculture bank (*Bank Pertanian*), as well as the Credit Guarantee Corporation (CGC) which provides guarantees on lending by other financial institutions to small and medium enterprises (SMEs). At the lower end CGC has a credit guarantee scheme for "hawkers and petty traders", but loan sizes for this scheme suggest it is operating at a level somewhat above conventional microfinance. The smaller loans guaranteed by CGC would however qualify in terms of the ADB definition with which this paper commences. There are also urban credit cooperatives, but these serve a salaried clientele, while rural credit cooperatives have minuscule outreach and the cooperative movement as a whole is in a weak condition with Government now attempting to revitalise it. Essentially the only institutions engaging in microfinance are drawn from the NGO community, where there is one dominant MFI and a handful of minor operators.

Among other factors, interest rate controls may have played some part in keeping commercial banks out of microfinance. McGuire, Conroy and Thapa (1998, 185) noted that *Bank Negara,* the central bank, restricted the spread between base and maximum lending rates in the commercial banking system to 4 percent, less than would be required to cover the extra costs associated with microfinance lending. In the case of some loans guaranteed by CGC the permissible spread was only 2 per cent, reinforcing this effect. There has been some engagement by regulated financial institutions with microfinance in other ways, however, and this is described below.

Malaysia is the wealthiest country discussed in this paper, and the only one classified as an upper middle income country by the World Bank. This is an important factor in the approach taken to poverty alleviation through microfinance in Malaysia, an approach deriving from the New Economic Policy (NEP) which operated from 1971 to 1990. The NEP was directed to reducing poverty and income disparities between ethnic groups, and particularly to improving the position of the *Bumiputera*, the indigenous peoples of Malaysia.

Amanah Ikhtiar Malaysia: the dominant institution

Malaysia's dominant MFI, *Amanah Ikhtiar Malaysia* (AIM), was established in 1987. Up to 1998 it made some 103,000 loans and disbursed a total of RM 328 million ($86 million at the current exchange rate, considerably more if contemporary exchange rates are applied). Some 80 per cent or more of all funds loaned were for economic purposes, the remainder for 'social' purposes (Sukor Kasim 2000). AIM's activities have been directed almost entirely to the alleviation of poverty among poor Malays[5]. It was set up with a charter "to disburse small loans on reasonable terms exclusively to the very poor households to finance additional income-generating activities" (Gibbons and Sukor Kasim 1990) but for all practical purposes has confined its attention to the *Bumiputera*. This is evident from its outreach data rather than from its charter.

Believing that while the NEP had successfully reduced the number of households in poverty, the persistence of hardcore povery required a new approach, AIM adopted the Grameen Bank model, with some modifications to suit the Malaysian context. An official survey in 1989 indicated that some 94,600 households, or 2.2 percent of the total population, were classified as 'hard core poor', with incomes below half the level of the official poverty line. The indigenous Malay community was disproportionately represented among these poor households. AIM, intent on targeting the poorest among the poor, used the official periodic Household Income Survey as a guide and developed its own means test to identify the hardcore category. By August 1994, AIM had some 6,100 Grameen groups in operation with a total membership approaching 30,000 borrowers. Assuming that its procedures to identify the poor were both effective and consistently applied, this is quite impressive coverage of the target population, achieved in seven years. As discussed below, outreach might have been higher, but for political interference. Total loans disbursed to that time amounted to RM37.9 million ($14.8 million) and, reflecting the relative priorities accorded savings and credit, total savings were $1.8 million. Some 28 per cent of lending was for agriculture, 46 per cent for trade, 15 per cent for animal husbandry and 10 per cent for other activities (Conroy, Taylor and Thapa, 1995, 20).

In Malaysia, because of the sensitivities of its Muslim clients and sponsors, AIM levied 'service charges' on loans rather than interest expressed in percentage terms. If calculated as interest on the principal involved, however, these charges were well below rates in the Malaysian commercial banking sector. For example, the average loan size for borrowers taking a third loan in 1994 was RM1,044 ($427) for which the service charge equated to around 4.7 percent flat over the usual one year loan term. Service charges on larger loans were somewhat higher in percentage terms, but these were only a small proportion of total advances; for all classes of loans service charges covered only a portion of AIM's lending costs (Conroy, Taylor and Thapa, 1995, 21).

Some 60 per cent of AIM's operational costs between 1989 and 1995 were covered by a Malaysian Government grant, while the state governments granted additional support of up to 40 per cent annually. In consequence AIM had limited stimulus to strive for self-sufficiency in its early years (McGuire, Conroy and Thapa 1998, 178-179). Loan capital was provided by central government grants, supplemented by soft loans from CGC and some commercial banks, especially those with majority government shareholding. However from 1992 a constraint on expansion of outreach operated, due to a government decision to channel a grant of $7.3 million intended for loan capital over the period 1991 to 1995

[5] For discussion of the emergence of AIM in the context of the New Economic Policy, see McGuire, Conroy and Thapa (1998), 175-178.

through YPEIM, an Islamic foundation. YPEIM however decided to program the disbursement over a much longer period, a decision which according to a recent evaluation of AIM's program caused a serious cash flow problem and undermined AIM's plans for expansion and the achievement of viability (Sukor Kasim 2000).

A Loss of Direction

Soft loan financing from regulated financial institutions, mentioned in the previous paragraph, tided AIM over cashflow difficulties from 1992, and indeed permitted an increase in loan ceilings from 1994, after the departure of the founding management. According to the recent evaluation, the average loan size jumped by 400 percent between 1994 and 1998, and this was accompanied by an increase in portfolio at risk. (Sukor Kasim 2000, 307). AIM's expansion from 1994, at which time it had reached some 50 per cent of its target group in Peninsular Malaysia (Sukor Kasim 2000, xii) appears to have been more in terms of value of loans outstanding than increased outreach to the hardcore poor. The evaluation notes that the restoration by central government of loan capital funding in 1997 sparked a further upward revision of loan ceilings, coinciding with a blowout in operational costs. An increase in numbers of 'dropouts' from the program, especially among poorer members, was noted from 1994 as loan sizes increased, a trend which accelerated from 1997.

Citing "blatant disregard of the fundamental Grameen principles", Sukor drew attention to "leakage [of loans] to the 'not so poor' and the 'non poor'". "It is vital for [AIM] to relay the message that their outreach is women who are at the bottom two-third of the poverty household level as the author uncovered that due to relaxation on means testing, the less poor and the non-poor are motivated to become [AIM's] members" (Sukor Kasim 2000, 324). He is particularly critical of two loan programs introduced after 1997. The first was given the name 'SPIN'. The SPIN was directed to men in the fishing industry. The second was titled SP-IT, for 'Single Mothers' (female heads of households). Participants were offered an unprecedentedly high first loan of RM10,000 ($2,650). With the diversion of AIM's attention to larger loans and better-off borrowers, the evaluator was also concerned about the implications of this development for credit discipline and portfolio quality.

Whether the inclusion of larger borrowers is a problem, *per se*, is largely a matter of perception. Other MFIs might do so to diversify risk and improve overall sustainability, but the evaluator takes the view that, in terms of AIM's charter, larger loans amount to "mission drift". And there may be particular political circumstances affecting the choices made for AIM. In the event, the admission of people to the program who are out of sympathy with its objectives has had a corrosive effect on sustainability.

By the end of 1998, portfolio at risk (PAR) had risen to 3 per cent (Sukor Kasim 2000, xviii), not too serious as an end-point but certainly a warning as a trend indicator. But by the end of 2000, the PAR of the whole AIM program with RM100 million outstanding had increased to 10 per cent, with SPIN at 60 per cent PAR and SP-IT at 36 per cent (Sukor Kasim, pers comm 10/01). These are levels which indicate grave problems for the AIM program.

In 1997 AIM decided to break with its early practice by raising the interest rate on loans to a uniform 19 per cent. Not only was this a substantial increase, it also expressed borrowing cost as a percentage of principle for the first time. The evaluation suggests this accelerated the loss of poorer clients from the program, not just because an increase in costs would depress demand but because many of the poorest are devout and would find the interest charge unacceptable.

While management's decision to increase charges is understandable, as being consistent with movement away from subsidies and progress towards financial sustainability for AIM, it does raise an important issue in the particular circumstances of Malaysia. An earlier discussion of funding policy, set in a comparative context (McGuire, Conroy and Thapa 1998, 186) made the judgment that the then official policy of subsidising microfinance was appropriate in the circumstances of Malaysia. It would still be appropriate to do so now, given the relatively small numbers of the hardcore poor and the relative prosperity of Malaysia, provided that AIM settles on an objective set of targeting principles without hint of political considerations and concentrates on running a lean and cost-effective operation. At the end of 1998 AIM had 40 branches and 6 Area offices serving some 39,000 borrowers and almost 56,000 members. The evaluation refers to the need for "a major and expensive rehabilitation exercise". The more recent trends in portfolio at risk appear to underline the correctness of this judgement.

ii) Thailand

Several studies (McGuire et al 1998, Meyer and Nagarajan 2000) have noted that specialised microfinance services are not important in Thailand. Meyer and Nagarajan explain this in terms of a relatively prosperous economy and comparatively minor poverty problems. On the eve of the financial crisis in 1997, official estimates of the incidence of poverty in Thailand were between 10 and 15 per cent, depending on the measure used, and the poor were concentrated in the provinces of the north and northeast (McGuire, Conroy and Thapa 1998, 287). Meyer and Nagarajan also credit the large outreach achieved by BAAC (the State agricultural bank, discussed below) with having reduced the need for specialised MFIs. They note the geographic concentration of Thai poverty, and that cash and in-kind transfer payments support the poor in affected regions, and that they also benefit from government credit schemes.

Perhaps for the reasons suggested by Meyer and Nagarajan, NGO involvement in provision of microfinance services is extremely limited. McGuire et al (1998) could find only one, relatively small, organisation that was exclusively engaged in microfinance, as well as some multi-purpose NGOs which also operated microfinance programs as an adjunct to their main activities. The lack of involvement of NGOs, as creators and operators of MFIs (as seen for example in the Philippines and even Indonesia, and most particularly in South Asia) is striking.

Among government-inspired schemes, as mentioned by Meyer and Nagarajan, which provide some financial services to the poor, there is a mixture of government and non-government activity. Government agencies operate three main programs, those of the Community Development Department (CDD), the Government Savings Bank (GSB) and the Urban Community Development Office (UCDO). McGuire et al (1998, 302) describe the CDD program as "very much government driven, with a government department establishing revolving funds at the village level to be managed by local government authorities". The programs of GSB and UCDO are described as "managed by independent boards, [which] operate by extending loans to cooperatives and community organisations, which are mainly non-government bodies owned by their members". Erhardt (1999, 11) gives a figure of some 1,200 thrift and credit cooperatives in Thailand in 1997, with almost 2 million members, but notes that they experience severe payment problems.

For the rural sector as a whole, Meyer and Nagarajan (200, 319) report a pattern of market segmentation which is somewhat stylised because of the lack of national survey data on rural financial services. They posit a scenario in which:

> *Commercial banks serve large farms and agroindustries; BAAC largely serves small and medium farms, cooperatives, and associations; the poor and landless are served mainly by informal finance and a few government programs and NGOs. Agricultural cooperatives and village-level credit unions may also reach poorer segments of the rural population.*

A study of financial services available to poor and low-income entrepreneurs in Chiang Mai Province, Northern Thailand (Erhardt 1999) describes the modes of financing available in terms of a continuum, with formal, regulated institutions at the 'high', or formal end. Most formal in this sense are the commercial banks, which, while they dominate the financial sector overall, have great difficulty dealing with micro- or small entrepreneurs with limited or no collateral, who have no reliable records and whose requested loan size is below bank thresholds. Further along the continuum are the branches of BAAC, the agricultural bank, which is closer to the rural areas in terms of its branch network, and closer still in terms of its adoption of joint-liabillity lending for small loans to groups of small farmers. Less formal are the cooperatives, which include both agricultural cooperatives and thrift and credit cooperatives, and which occupy the next position on the continuum. Further along still are licensed pawnshops, at the margin of the regulated, formal financial sector. After this we cross over into an informal financial zone occupied by traders who extend credit, by means including hire purchase, then moneylenders, ROSCAs, and finally (at the informal end of the continuum) a host of personal arrangements involving family and friends. It is worth noting that this account of financing options available in sample locations in Chiang Mai Province makes no mention either of NGOs or of the various government-sponsored schemes mentioned above.

BAAC: The Bank for Agriculture and Agricultural Cooperatives

The principal formal financial institution of relevance to low-income rural people in Thailand, referred to by Meyer and Nagarajan, is the Bank for Agriculture and Agricultural Cooperatives (BAAC) established in 1966. It has been the subject of a number of detailed studies (including Sacay, Randhawa and Agabin 1996, Muraki, Webster and Yaron 1998, Meyer and Nagarajan 2000). My account of the operations of BAAC relies primarily on the most recent of these studies, together with the conclusions of an earlier exploration by the Foundation for Development Cooperation (McGuire, Conroy and Thapa 1998).

The most remarkable thing about BAAC is the degree of its market penetration. As Meyer and Nagarajan (200, 321- 323) report:

> *The penetration of BAAC in rural areas is more significant than any other single rural financial institution in Asia. Some 4.7 million of the country's five million plus farm households are registered for its services, although in any one year not all have loans. In 1996, 3.4 million households (72 percent) were registered as individual branch clients, while the remaining 28 percent were registered as members of 877 agricultural cooperatives and 295 farmers' associations that borrowed from BAAC. Therefore, directly or indirectly, it reached about 90 percent of the country's farmers.*

In terms of depth of outreach, the reach to the lower income groups, Meyer and Nagarajan (p. 324) infer from the incidence of relatively small loans that:

> *BAAC must be reaching fairly poor clients, if not the poorest of the poor. Moreover, the cooperatives and associations that on-lend BAAC funds possibly reach members who may be even poorer*[6]*.*

A somewhat sterner, if still tentative, conclusion was reached by McGuire et al (1998, 290-291), who decided that:

> *…BAAC does not specifically target the poor, and some commentators suggested that it may not reach the poorest farm families. Moreover, the poorest people are often without land and therefore are not farmers. These people are not eligible to receive loans from BAAC, by virtue of its mandate as stipulated in its charter…Therefore, while BAAC has huge outreach in the rural areas, it may not reach the poorest households.*

McGuire et al pointed out that the original BAAC charter restricted it to providing loans to farmers for on-farm activities This was amended in 1992 to allow limited lending to farmers for agriculture-related activities. Further amending the charter to allow lending for non-agricultural activities in rural areas has often been debated, and some progress occurred in 1999, discussed below. However, McGuire et al speculated that even if this were to occur

> *…it is unlikely the bank will increase its poverty lending. While there is some pressure for it to do so, its cost structure and interest rate structure mean that it is unlikely that it could engage in poverty lending on a commercial basis.*

Background data supporting this judgement are documented by Meyer and Nagarajan (2000, 333). Despite efficient internal operations, BAAC has maintained spreads between deposit and lending rates which are rather low. It also cross-subsidised smaller borrowers at the expense of larger, has been subject to political direction on interest rates, and has discounted its wholesale loans to cooperatives and associations rather generously by comparison with the rates charged for individual loans.

The other side of this coin is the bank's degree of subsidy dependence. BAAC receives subsidies in several ways. These include soft loans from donors, preferential rediscount facilities granted by the central bank, and exemptions the central bank has granted from reserve requirements on deposits, among others. A calculation for BAAC in 1995 of a 'Subsidy Dependence Index' associated with Jacob Yaron suggested that the bank could have managed without these subsidies by raising its average yield on portfolio from 11.0 per cent to 14.89 per cent (Muraki, Webster and Yaron 1998). This is a highly creditable performance by comparison with most agricultural development banks in the developing world.

Apart from these subsidies, BAAC received a very helpful free kick from the government from 1975, when a direction was given to commercial banks to lend in the agricultural sector. This obligation could be satisfied by the banks' depositing any shortfall in their lending quotas with BAAC, where they earned a relatively low return on the funds. To a large extent this relieved the agricultural bank of the more expensive course of mobilising savings in its rural constituency. Commercial bank deposits represented more than 70 per cent of BAAC'S deposits in the 1980s. This proportion (and the absolute amount involved) declined substantially in the '90s, while BAAC's savings mobilisation performance improved considerably. In 1995, some 3.4 million of its savings accounts (of a total of 4.1 million) held balances below $201, which Meyer and Nagarajan suggest shows that poor people must have held some of these small accounts. They note also that the bank's deposit accounts in 1997 outnumbered its loan accounts by about a million. This is encouraging, but should be

[6] However, "possibly" and "may" are qualifiers which may, just possibly, indicate a certain lack of confidence in this judgement.

compared with the even better performance of Bank Rakyat Indonesia (BRI), discussed below in the section on Indonesia. Indeed the achievements of BRI may provide a benchmark for BAAC in its efforts to rebuild after losses suffered during the crisis from mid-1997.

Meyer and Nagarajan (2000, 347) sum up the weaknesses. Those of particular relevance to BAAC's capacity to engage in microfinance include the fact that rural savings mobilisation is still not a high priority, that BAAC is still subsidy dependent and that its low interest policy "is a disincentive for searching more aggressively for ways to make smaller loans efficiently". Finally, its policies and charter constrain BAAC from serving the rural non-farm sector fully (although legislation in 1999 did authorise it to offer a wider range of financial services in rural areas).

In October 1998 BAAC came under the banking supervision of the central bank. Maurer et al (2000, 5) note that with this change, "the bank has become subject to prudential regulation, such as capital adequacy and loan loss provisioning". In a decidedly upbeat forecast, they suggest that "[m]ore stringent rules and performance standards may be painful in the short term but they will help BAAC in its struggle for financial viability and self-sustainability in the long run". They further suggest that, shielded by its obligations to the central bank, BAAC will be better able to resist political interference in its lending and loan-recovery operations in future. In addition, recent changes permitting BAAC to open a "non-farm window" will revitalise the bank's operations and foster its transition from the status of "specialised agricultural lending institution" to "universal rural bank" in coming years.

Another view of the role of BAAC, which is surprisingly tolerant of its redistributive functions, comes from the IMF[7]. Robert Townsend, working on rural survey data from Thailand, has put forward the hypothesis that BAAC may be operating a "risk contingency system" for farmers. In times of crisis this system yields welfare gains for which the state pays by means of fiscal transfers to the bank. This is in many ways a troubling proposition; it surely cannot mean that the flow of fiscal resources to an agricultural bank should be taken as *prima facie* evidence that it is indeed performing the risk contingency function. If that were the case we could rewrite the history of every politicised agricultural development bank in the world. The judgement that a bank is performing risk contingency functions sufficient to justify subsidies and the occasional recapitalisation would have to be made on careful case-by-case analysis, if at all. It will be interesting to see whether Mr Townsend feels able to make that case for BAAC after further study.

Mr Townsend is more concerned about other measures currently being applied in Thailand. He refers (IMF 2001c) to:

> *…social safety net programs put in place to help the poor in the crisis…village funds and village banks are being promoted throughout the countryside and funded by government expenditure without hardnosed evaluation of the role of these institutions that are supposed to help the poor…[while] the government sets up a small business credit guarantee fund, which I fear…has close to 100 percent guarantee of small business loans…*

The Thaksin Government, elected in January 2001, has "prioritized fiscal measures to boost rural incomes, including suspending farmers' debts and creating village revolving funds" in response to an increase in the numbers of the poor by 3 million during the crisis (ADB 2001, www.adb.org/documents/CSPs/THA/2001/csp0100.asp). Debt forgiveness measures often have corrosive effects, both on the balance sheets of financial institutions

[7] More accurately, from a scholar participating in an IMF panel discussion of IMF-supported research.

and on the credit culture in which they operate. And the creation of revolving funds simply as conduits for government money is seldom the most effective way to build rural financial institutions serving the poor. These measures suggest a more populist approach which may employ the rhetoric of microfinance without absorbing the lessons of its experience.

iii) Indonesia

The pattern of microfinance service provision in Indonesia differs from that observed in almost all other countries in which the sector has achieved any significant outreach[8]. There are two major differences. The first is that certain regulated financial institutions in Indonesia, both public and private, have been able to extend sustainable financial services deep into the countryside, reaching many of the poor. The second, closely related, difference concerns the role and status of NGOs, which in other countries underpin much microfinance activity. In Indonesia, prior to the fall of the New Order government in 1998, the Department of Home Affairs and line agencies operated a comprehensive system of local administration. This gave the central government considerable capacity to implement its policies and programs in the provinces. Coupled with the suspicions harboured by officials at all levels about NGOs, this meant that there was less scope in Indonesia for the spontaneous emergence of private NGO initiatives than in, say, the Philippines.

The position of NGOs changed substantially in 1998, when in the wake of the financial crisis the Habibie Government and the international community gave responsibility for relief and reconstruction under the "Social Safety Net" program to the Indonesian NGO community. NGOs continue to enjoy a more positive status although the Indonesian NGO movement is still a minor player in the provision of microfinance services.

Methods of delivering microfinance services found in Indonesia cover a wide range. Solidarity group-based lending approaches are commonly used by NGOs. However most microfinance services are delivered on an individual basis, due to the dominance of the sector by regulated financial institutions, following normal banking practice. The poor also manage their own financial service provision using *arisan*, traditional ROSCAs which are very common in Indonesia. Cooperatives also provide financial services to their members, traders provide credit for the poor as an element in transactions, and the State operates pawnshops. Patron/client financing relationships are widespread and tenacious outside the formal sector.

Bank Indonesia: the Central Bank

Bank Indonesia (BI) has regulatory oversight of most of the major institutions engaged in microfinance and has participated actively in shaping them. In this it is unlike its counterparts in other countries with strong microfinance sectors, such as Bangladesh for example, where the central bank has been largely irrelevant to microfinance. Following the emergence of the New Order government, a new central bank law was enacted in 1968. This law gave Bank Indonesia a strong "developmental" mandate. However, in 1983 a process of financial sector deregulation and liberalisation commenced. A longer-term consequence of these reforms was the successful turnaround of the village-level financial operations of Bank Rakyat Indonesia (BRI), the state bank whose primary focus was the agricultural sector. The

[8] This section draws extensively on Conroy (2000) and McGuire, Conroy and Thapa (1998). The writer also benefited from participating in an AusAID review of the Indonesian microfinance sector in January 2001, in company with Dr Kieran Donaghue and Dr Sumantoro Martowijoyo. Mr Dominique Gallman of the GTZ/Bank Indonesia Pro-Fi project has been a most helpful correspondent.

Pakto financial deregulation "package" in 1988 continued the liberalisation process. Among other measures, it freed-up entry of new banks to the so-called "rural bank", or BPR, sector.

A new central banking law was enacted in 1999 by the Habibie government (Law No. 23 of 1999 on Bank Indonesia) at the urging of the IMF. Among other measures, BI's previous role as an "agent of development," responsible for channelling credit to priority sectors and groups, was abolished. These credit functions were to be transferred to other entities, the continuation of credit subsidies thus transferred was to be time-bound, and the costs of continuing credit subsidies were to be approved as part of the government budgetary process, rather than being funded by BI.

During the short Presidency of Abdurrahman Wahid political opposition to the new law began to swell. There was some support for reviving the role of BI as an "agent of development", together with calls for the restoration of liquidity financing by the Bank. Under IMF pressure, in 2001 the matter was referred by the new Government of President Megawati to an independent expert panel for advice. A 'Letter of Intent' transmitted by the Government to the IMF in August 2001 (IMF 2001) committed the GOI to maintaining a 'strong, independent and accountable central bank'.

The Banking System

The banking institutions regulated by BI are the commercial banks and the BPRs, or 'rural banks'. Among commercial banks we give particular attention to Bank Rakyat Indonesia and its Units and also consider the Regional Development Banks (BPDs). This account also considers the several categories of BPRs (Bank Perkreditan Rakyat, literally, people's credit banks. The BPRs are generally very much smaller than commercial banks and offer a more restricted range of services.

As is well known, the Indonesian commercial banking system was devastated by the financial crisis. With few exceptions, commercial banks were little involved in microfinancing prior to the crisis. They are even less inclined to become so under current circumstances. However, under the New Order government, a number of commercial banks were involved as channelling agencies in official credit schemes implemented by Bank Indonesia. To some extent the rhetoric of these official schemes included microfinance but their performance in outreach to the poor did not match the rhetoric. A number of commercial banks have been involved in another government microfinance program, the PHBK (Program linking Banks with Self-Help Groups).

Prior to the crisis some larger commercial banks had begun to explore the market potential of lower-end financial services, by means including the acquisition of small banks (BPRs) and setting up their own microbanking divisions. The financial crisis put an end to this tentative expansion of financial services to low-income people. However, several small commercial banks had developed niche activities in microfinance which have continued unabated. They have strong microfinance customer bases, although their outreach is small.

TABLE 2: Indonesia: Regulated Financial Institutions and Microfinance, 2000

Institution	Loan Accounts: Numbers. (million)	Mean Balance Outstanding per Account (Rp. Mn/$US)	Deposit Accounts: Numbers (million)	Mean Balance Per Account (Rp. Mn/$US)
BRI Units	2.60	Rp2.55m/$340	16.7	Rp0.65m/$85
BPRs	1.68	Rp1.94m/$260	4.6	Rp0.25m/$33
BKDs	0.70	Rp0.22m/$29	0.6	Rp0.05m/$7
LDKPs	1.30	Rp0.28m/$35	n.a	n.a

Notes: Data for BRI relate to the Kupedes (loan) and Simpedes (deposit) accounts. Term deposits are excluded. Various dates during 2000. Sources: BI and BRI.

Bank Rakyat Indonesia (BRI)

At the other end of the scale, Bank Rakyat Indonesia (BRI) is one of the largest commercial banks. Here we are concerned specifically with BRI's Unit division which operates at a retail level in rural areas and has successfully encompassed elements of microfinance. Units offer a restricted range of services tailored to the needs of small rural customers, including the Simpedes savings account and the Kupedes loan.

BRI's Unit (formerly Unit Desa) system, operating at village or sub-district level in rural areas, performed strongly throughout the crisis, with its Kupedes borrowers continuing to make over 97 percent of the instalments that fell due in the period from mid-1997 to mid-1999. Savings mobilised through the Units grew dramatically over this period, doubling from Rp 8.3 trillion at the end of October 1997 to Rp.17.7 trillion at the end of June 1999.

The BRI Unit Division's performance in the face of the crisis put the seal on its reputation as one of the most efficient rural financial institutions in the developing world. Its strong repayment performance occurred at a time when the commercial banking system as a whole had non-performing loans estimated at 60 per cent of portfolio. BRI's deposit-taking operations, serving small and micro clients through the unit network, provided the lifeblood of liquidity for the bank as a whole throughout the crisis. This helped to prop up BRI in the face of heavy losses incurred by its corporate lending division.

In mid-2000, some 3,600 BRI Units had about 2.6 million Kupedes loans outstanding (table 2), with an unpaid balance of Rp6.7 trillion ($0.89 billion)[9]. The average outstanding loan balance was Rp2.55 million ($340) and the 12 month loss rate on the loan portfolio was at the extremely low level of 1.37 per cent. Studies of the size distribution of loans and the characteristics of borrowers indicate that at the lower end of the lending range the BRI Units do indeed reach the ranks of the poor. However, the outreach of the BRI units to low-income and poor people appears quite variable from place to place. Moreover, Kupedes loans are secured by collateral, most commonly some certification of land ownership, and are made in respect of established economic enterprises, not start-ups. These requirements constrain the capacity of Units to lend to the very poor, although less stringent requirements for loans belowRp1 million ($130) are being trialed.

On the other side of the balance sheet, the Units had 24.9 million savings accounts. These included 16.7 million Simpedes savings accounts (see Table 2) with a mean balance of around Rp650,000 ($85). Again this suggests that many depositors are likely to be poor. Clearly lack of liquidity is not a constraint on the lending of the BRI Units. With a loss rate close to 1 per cent the Units could be considered too conservative in lending.

Regional development banks (BPDs)

Another category of Indonesian commercial bank is of particular significance to microfinance. They are the BPDs (Regional Development Banks), one in each province, owned by the respective provincial governments. While they have a mandate to act as bankers to their governments, they also perform some functions analogous to those of so-called "Second Tier Institutions" operating in microfinance in some other Asian countries (For example, PCFC in the Philippines). Some BPDs (7 out of 26) have responsibility for supervision of certain small formal financial institutions operating within the provinces. Their regulatory and supervisory responsibilities appear likely to increase as governmental devolution takes place in Indonesia.

The BPRs (Rural Banks or BPR non-BKD)

The term "BPR" (people's credit bank, but often translated simply as rural bank) is used in the Banking Act of 1992 and elsewhere to describe two categories of small regulated financial institution. The first is the "BPR non-BKD", most commonly called simply "BPR". There were around 2,400 of these small banks in mid-2000. Recently a number of BPRs practising banking under Islamic (Syariah) principles have emerged.

The second category is called, formally, BPR-BKD, or simply, "BKD' (Village Credit Body). There were 5345 BKDs in mid-2000. They date back to the late nineteenth century and were formed under Dutch rule on Java and Madura islands as pioneer microcredit institutions. For simplicity, in this paper the two categories of institutions will be called simply BPRs and BKDs. The BKDs are very much smaller institutions than the BPRs. Both are subject to the Banking Act, and are in principle regulated and supervised by Bank Indonesia.

Under the 1992 Banking Act, the BPRs may accept time and savings deposits, and provide credit. Most are limited liability companies in private ownership, operated for profit. Some are in chains associated with commercial banks or NGOs. Some are registered as

[9] A rate of Rp 7,500 is used for many currency conversions in this paper and where other rates are used this is evident from the text. In a situation of extreme exchange rate instability such as in Indonesia since mid-1997, it is often misleading to convert to other currencies when discussing changes in rupiah values.

cooperatives, others are organized on Islamic principles (BPR Syariah). In mid-2000, BPRs had 1.677 million accounts (table 2) with outstanding loans of Rp3.256 trillion ($430 million) and a mean outstanding balance of around Rp1.94 million ($260) per account. The comparable figure for the BRI *Kupedes*, as noted above, was $340. There were almost 4.6 million demand deposit accounts, totalling some $230 million, with a mean balance of around Rp250,000 or $33 (compared with the BRI *Simpedes* average of $85) as well as fixed deposits totalling Rp1.675 trillion ($220 million). Loan-to-deposit ratios were typically around 80 percent, and the average BPR had assets of perhaps Rp1,800 million ($240,000). The mean loan and deposit balances of the BPRs suggest they are, in general, serving a lower income stratum of the population than the BRI Units.

In May 1999, BPRs accounted for 0.65 percent of credit outstanding in the banking system and their deposits were some 0.25 percent of all deposits. While this is almost trivial if the chosen numeraire is a financial one, the number of clients who benefit from access to BPRs (almost 1.7 million borrowers) is far from trivial. Typical loans offered by a BPR are short-term microloans for petty traders ranging from Rp100,000 to Rp3 million, with 3-6 month maturities, daily instalments, and flat rates of interest in the range 2-4 per cent per month. The BPR system withstood the crisis, in general, much better than the commercial banks. BI strengthened prudential supervision in 1999 and liquidated 72 BPRs, while the overall level of non-performing loans rose to 37 percent[10]. Bank Indonesia and GTZ have begun a project (ProFI or Promotion of Small Financial Institutions) to address the weaknesses of the BPR system.

The BKDs (Village Credit Bodies, or BPR BKD)

The BKDs commenced operations more than a century ago and their status as banking institutions was affirmed by legislation in the colonial parliament in 1929. They were never subject to Bank Indonesia interest rate restrictions, which enabled them to set interest rates at sustainable levels well before the financial sector reforms of the 1980s. The 1992 Banking Act brought them under the supervisory jurisdiction of BI. They are supervised by BRI on behalf of BI. Some 5,400 of these small locally-based institutions served more than 700,000 borrowers in mid-2000. They are found primarily in the provinces of East and Central Java. As mentioned they do not offer the levels of service of the BPRs, and are normally open only one day a week, in association with local market days. In mid-2000, BKDs had loans outstanding of Rp152 billion ($20 million) (Table 2) at an average loan size of Rp217,000 ($29). The BKDs focus almost exclusively on credit provision, although a portion of each loan is held in a mandatory deposit. These mandatory balances totalled Rp32 billion in mid-2000, with more than 600,000 accounts and an average balance of around Rp50,000 or $7. These savings and loans figures suggest genuine microfinance.

Most BKD loans have a 12 week term with weekly instalments and an effective annual interest rate of 43 per cent. Management of each BKD is in the hands of a committee drawn from the village government. Loans are approved primarily on the basis of character and bankability. An itinerant bookkeeper employed by the district government and paid for by the BKDs serves 5 or 6 BKDs, each of which opens on a rota determined by village market days. All record-keeping is manual.

[10] By comparison, at the height of the crisis the non-performing loans of the commercial banking sector were calculated at some 60 per cent. Data for the BPR sector in mid-1999, based on CAMEL ratings, showed 42.5 per cent of BPRs as "sound", with 14.7 per cent "fairly sound", and 28.1 per cent "unsound".

Non-Bank Financial Institutions

The NBFIs are a heterogeneous group, having in common (besides their activity in microfinance) that they are not subject to BI regulation. For the purposes of microfinance in Indonesia, they include small community-based institutions (LDKPs), pawnshops and the savings and credit cooperatives.

The LDKPs: Community-based Non-Bank Financial Institutions

The acronym "LDKP" is applied generically to a range of small savings and credit institutions which exist, with variations, in a number of provinces. A total of 2,272 LDKPs (table 2) were operating in mid-2000 serving more than 1.3 million borrowers with loans outstanding of some Rp360 billion ($48 million), with a mean balance outstanding of Rp275,000 ($35). The level of savings mobilised by the LDKP (Rp334 billion) was almost as great as the loans outstanding. As with the BKDs, this also suggests genuine microfinance. A mean loan size (balance outstanding) of $55 for LDKPs puts them on roughly the same social level as the BKDs ($43) and on a very much lower level than the BPRs ($390) and the BRI Units ($510).

The lending procedures of one type of institution within the LDKP category, the BKKs of Central Java, give a sense of the nature of these small village-based institutions:

> BKKs apply the now typical instruments of microcredit: loans are unsecured and character-based, relied on references from local officials rather than based on feasibility studies … Initial loans are small and gradually increased, based on repayment performance. This mechanism functions as the primary repayment incentive. Loans are paid in equal instalments, carrying maturities from 22 days to 12 months, according to six different repayment plans with monthly effective interest rates ranging from 2.2 per cent to 10.8 per cent. Savings are mandatory for every loan and are treated as cash collateral, becoming accessible only after full loan repayment (BI and GTZ 1999).

Savings and Credit Cooperatives

Cooperatives were a primary instrument of state policy under Suharto and independent initiatives were discouraged. Essentially the only cooperatives in rural areas were those within the official KUD (Village Cooperative Unit) system. A new cooperative law in 1992 attempted to entrench the official cooperatives in certain areas of the economy. However since 1998, independent entities are now free to obtain licenses under the Act of 1992 to set up KSP (Savings and Credit Cooperatives). Some NGOs have taken advantage of the new situation to set up financial services cooperatives. Islamic self-help savings and loan groups (the BMT) are in many cases adopting the cooperative legal form, while a long-running government microfinance program (P4K) is working towards having its self-help groups adopt cooperative status. There is also a proliferation of unregistered cooperatives, and some moneylenders have adopted these (referred to as Kosipa) as a front for their high-cost lending. Many USPs which originated within the KUD movement continue actively, although less tightly linked into the official system than before.

Some 36,000 cooperative savings and loan entities were registered in Indonesia in October 2000. These comprised around 1,200 KSPs and some 5,200 USPs (the latter rural, and associated with the KUD cooperative system). In addition there were some 29,600 urban USPs, mostly associated with workplace arrangements. The KSPs had perhaps 0.7 million members and the rural and urban USPs around 3 million and 7 million, respectively. A Bank

Indonesia/GTZ assessment of the credit union activities of the USP units of the KUD is that:

> [they] have so far played a minor role as financial intermediaries due to repressive regulation and excessive government interference under the New Order regime of former President Suharto. However, the more than 5,335 government-sponsored KUDS are established throughout the country and would in fact possess a tremendous microfinance potential if properly stimulated and regulated.

Informal Financial Institutions

NGOs conducting microfinance require no permission to extend credit, and there are no reporting requirements or supervisory arrangements for such activities. However, they are forbidden to mobilize the savings of members unless these are deposited directly in a regulated financial institution. In practice, some savings mobilisation appears to be tolerated as long as the amount is small. Some larger NGOs have set up their own BPRs to overcome the problem. Also, the new freedom to set up savings and loan cooperatives under the Act of 1992 offers another solution to this problem. However, for NGOs unable to take either of these paths, the inability to mobilize even compulsory savings in conjunction with lending is a constraint on their activities. NGOs have been involved in mass poverty alleviation programs of the GOI which involve elements of microfinance, especially the IDT (or 'backward villages' program, of 1993-1997). Their function in such schemes has been to act as social intermediaries, preparing "self-help groups" of the poor to participate. Relatively few NGOs in Indonesia are specialist microfinance providers. Most have microfinance as only one among a range of development activities. By contrast, Grameen replications have not been particularly successful in Indonesia and the outreach of this category of NGO is insignificant.

Self-help groups (SHGs) are completely informal organisations. Hundreds of thousands of informal SHGs with savings and credit activities exist in Indonesia. Many are spontaneous groupings, based on traditional forms of association, such as the *arisan*. This is the Indonesian version of the ROSCA. Many other SHGs have been founded by government and community organisations in connection with government programs, or have been created by NGOs, and some are organised on Syariah principles.

An unknown number of SHGs continue in operation on the basis of revolving funds which they have been able to preserve from one or another of the mass programs operated by government from time to time (described below). As many as 400,000 groups were formed during the 1990s in connection with one program or another, involving perhaps 10 million individual members and touching the lives of perhaps another 40 million family members. This is enormous outreach, mostly to the poor and very poor, but financial sustainability has been elusive.

The role of government

Since the advent of the new Order, successive governments, acting through the central bank and a number of line departments, have supported activities now categorised as microfinance. Initiatives have been dedicated either to financial sector development in some broader sense, or to nurturing particular microfinance projects. There has often been significant donor involvement in these activities and the overall record, as exemplified by the performance of BRI, has been good. Initiatives styled specifically as 'microcredit' or 'microfinance' became more important over time during the Suharto period, as the overall incidence of poverty fell and the need was felt for a more targeted approach to eliminating

the residual. To some extent this reflected a realization by the New Order government that, despite the successes of BRI units and small bank and non-bank financial institutions in extending sustainable financial services to lower strata of the population, there remained a core group of the poor untouched by this progress.

Mass poverty alleviation programs

By contrast with the government's achievements in financial sector development for the benefit of lower-income and rural people, there was a parallel development of mass credit schemes, in which neither institutional sustainability nor financial sector development have been objectives. Indeed, these have often operated at odds with the sustainable programs already described. These mass schemes reflected political concern with the problem of the hardcore poor. The first was the IDT (Presidential instruction relating to backward villages) which commenced in 1993. A second, the UEDSP (village economic activities with savings and loans), commenced in 1995, also with the benefit of presidential funding. A third campaign, the Prosperous Family Program, was introduced as an emergency measure in 1996. Donors have avoided entanglement in unsustainable mass schemes of the GOI, although they did support microfinance in the context of "social safety net" programs as a response to the crisis.

Some sense of the character of these mass government programs may be gained by considering the most meteoric scheme of this genre, the "Prosperous Family Program'. In 1996 as an emergency response to political concerns about income inequality, President Suharto launched this program using the National Family Planning Coordinating Board (BKKBN) as the implementing agency. Some 9.8 million Indonesian families received highly subsidized funding under this program in just 12 months. The program was financed by a levy of 2 percent on the incomes of corporations and high income individuals, channelled through a Suharto family foundation. It became one of the "social safety net" programs after the commencement of the crisis in 1997. Cumulative disbursements by the various microcredit programs implemented by the Family Planning Board rose from Rp317 billion in December 1997 to Rp768 billion in December 1998 and Rp900 billion in March 1999. This last figure is equivalent to approximately $100 million at an exchange rate of Rp9000. The Prosperous Family and other programs in this category, such as the UEDSP, were retrogresive in their influence on financial sector development in Indonesia. They often acted to undercut legitimate microfinance institutions attempting to achieve sustainability with realistic interest rates and they were a negative influence on the rural credit culture.

iv) Philippines

In the Philippines there are three categories of MFI, each of which answers to a different regulator. These are rural and thrift banks, NGOs which provide microfinancial services, and credit unions or cooperatives. Of these three institutional types, the rural banks appear to deal with somewhat higher-income clients and to make larger loans than the microfinance NGOs. Many of the NGOs have adopted variants of the Grameen Bank model and in general, group organisation of one sort or another is their most common mode of service delivery. The assets of these three types of MFIs were equivalent to only about four percent of the assets of the commercial banking system in 1996. However, as Llanto (2000a, 252) points out, "the combined number of MFI offices, at 7,855 outlets, is more than twice the number of commercial bank offices".

A characterisation of microfinance NGOs in the Philippines (Llanto 2000a, 254-255) suggests that:

- their capital consists substantially of donated funds
- they have engaged in very limited borrowing from commercial sources
- they have typically mobilised only small amounts of savings from their members, but
- they employ innovative lending techniques

Most microfinance NGOs are financed by foreign donors, or by domestic philanthropists or foundations. As non-stock, non-profit organisations, they have difficulty accessing loan capital from commercial sources. Further, they are not legally permitted to mobilise deposits from the public or even (strictly speaking) from their members. Hence their capacity to fund lending through savings mobilisation is quite limited. As against this, NGOs are quite innovative in their design of loan products and in overcoming their clients' lack of hard collateral. Despite this, Llanto remarks that most credit NGOs in the Philippines are neither viable nor sustainable.

> *While credit NGOs effectively target and reach poor clientele, they are neither effective nor efficient credit intermediaries because of their weak institutional capacity and financial position. These institutions seem capable of delivering financial services to the poor only because of their access to grants and concessional loans* (Llanto 2001a, 255).

The Microfinance Council: an instrument for self-regulation

Leading Philippine NGOs are concerned to improve this situation. Microfinance NGOs have been active in dialogue with the National Credit Council (discussed below) and in self-regulation. The Microfinance Coalition for Standards (now the Microfinance council), set up in 1996 with USAID assistance, is an organisation of MFIs and other microfinance stakeholders (including the central bank) which documents best practice and sets benchmark standards for MFI performance, as well as conducting training activities.

Commercial banks have had limited engagement with microfinance in the Philippines; only government-owned financial institutions have had any substantial involvement. The Development Bank of the Philippines, the LandBank and the People's Credit and Finance Corporation (PCFC) have provided wholesale loans to MFIs for on-lending to microfinance clients. In this way they have financed rural banks, cooperatives and NGOs to serve as conduits for credit. However this involvement has often been on unsustainable terms, with subsidised credit delivered at government direction

Private commercial banks, on the other hand, have been extremely tentative in their approach to microfinance. A study of *The Role of Commercial Banks in Microfinance* (Goodwin-Groen 1998) discusses the quite limited record of commercial bank microfinancing in Asia and the Pacific. While there is a long tradition of government subsidised loans channelled through banking systems, microfinance conducted as a profitable business is comparatively rare. Goodwin-Groen identified BRI and another small private commercial bank in Indonesia, together with one small private commercial bank in each of Sri Lanka and India, as comprising the four commercial banks in the Asia-Pacific region which treat microfinance as a profitable core business.

In the Philippines, Ms Goodwin identified some cases where private commercial banks have made lines of credit available to particular MFIs. However, in one case this occurred at a sub-market rate of interest and in another the bank concerned channelled the money through its charitable foundation to allow for a tax writeoff should the loans fail. Good performance by certain NGOs had encouraged the bank to convert this lending to a fully commercial basis, but the crisis in 1997 cut short this experiment. At that time a single

NGO, TSPI Development Corporation, had eight loans from three leading commercial banks and its financial performance was exemplary. Despite this, interviews suggested that personal relationships between board members of TSPI and senior bank executives were the primary motivation for these arrangements (Goodwin-Groen 1998, 27).

The experience of this and several other well-performing NGOs in the Philippines suggests that there are barriers of culture and perception in the banking community which must crumble before traditional bankers will consider funding even the best-performed of MFIs. This has led some MFI leaders to conclude that the only feasible path to expansion and mobilisation of the funding necessary to meet the demand for microcredit is to transform their organisations into small regulated banks. Several MFIs have followed the 'transformation' strategy so far, including CARD Bank and Opportunity Microfinance Bank.

The Potential of Small banks

Among regulated financial institutions in the Philippines are some smaller banks, including thrift banks, rural banks and cooperative banks. These banks offer a smaller range of services than commercial banks and typically serve a community or a limited geographic area. They have much lower minimum capital requirements than the commercial banks and these are lower depending on the size of the urban centre in which they are located. This is a provision favourable to NGOs, such as CARD and the APPEND group of NGOs, seeking to obtain bank licences for their microfinance business. They are quite widespread throughout the provinces.

Concerning the small local banks, McGuire et al (1998, 237) note that

> *Of all the banks it is the rural banks that are best placed to engage in microfinance. Rural banks are established to meet the credit needs of borrowers who are often outside the catchment areas of commercial banks and/or who may be considered poor risks by other banks........ In addition cooperative banks may be organised to perform banking and credit services for the cooperatives. Most rural and cooperative banks do not have means-tested programs targeted to poor borrowers, and it is understood that most of their clients are people in the rural areas who are slightly better off.*

Despite this there are a number of rural banks actively providing small loans to the poor and several operate microfinance programs employing group methods. The World Bank (1996) identified a particular model of rural bank, the cooperative rural bank, as having the potential to reach the poor without the necessity to set up new specialised institutions for the purpose. Certainly a rural bank license is one option for an MFI looking to scaleup its operations

Cooperatives and credit unions are supervised by the Cooperative Development Authority. McGuire et al note that of some 42,000 cooperatives registered under the Cooperative Code in 1997 half were non-operative. The cooperatives accept fixed deposits from members which cannot be withdrawn unless the member resigns. They also offer savings and time deposits which are withdrawable. Consequently the cooperatives have a larger resource base for lending than the NGOs. Cooperatives have been promoted in the past by government to support 'livelihood' programs under which LandBank employed them as funding conduits. Llanto notes of the cooperative movement that it has demonstrated its potential for mobilising deposits and providing financial services to small savers and borrowers, and that it has been able to finance its lending from share capital and deposits, quite apart from its role as a conduit for government funding. Well-run cooperatives in the Philippines show positive financial performance and are sustainable, although limited financial reporting

required of them by the regulatory authority and the laxness of supervision make it difficult to arrive at firm conclusions on what proportion of institutions performs at a high level.

PCFC

The People's Finance and Credit Corporation was set up in 1995 as a specialised institution for lending to the poor. PCFC is a registered finance company and its Articles provide for it to be privatised. PCFC funds microfinance institutions, defined broadly, and including NGOs, rural banks, cooperatives and other intermediaries as conduits for on-lending to the poor. These intermediary organisations are required to operate in a self-sustaining and operationally viable manner. In 1997 the Congress of the Philippines passed the *Poverty Alleviation Act* which

> *promotes the adoption of a market-based approach in addressing the demands for financial services of the poor. It specifically mentions the promotion of a viable and sustainable financial market and the adoption of market-based interest rates in the provision of credit services to the poor as key elements of the policy and strategy for microfinance in the country* (Llanto 2000a, 260).

PCFC was identified as the primary vehicle for the delivery of financial services to the poor, acting as an apex or second-tier institution. It commenced operations by taking over the capital and loan portfolio of LandBank under an earlier anti-poverty initiative, the National Livelihood Support Fund. It has also received ADB/IFAD funding for on-lending to MFIs, in particular those following the Grameen model. PCFC also has a supervisory role. As lender to a wide range of small MFIs it has a legitimate concern to safeguard its resources by requiring their adherence to appropriate accounting and reporting standards and operational methods. In addition it has a concern for capacity-building among its client organisations. In this sphere it cooperates with the People's Development and Trust Fund which was created specifically for capacity-building of MFIs. PCFC is a member of the Microfinance Council, discussed above, and maintains dialogue with the MFIs and with external agencies such as the Washington-based CGAP, which is influential in defining performance standards for MFIs.

Policies for Microfinance

In 1994 the Government of the Philippines established a National Credit Council (NCC) with the objectives of rationalising government lending programs and developing a national credit delivery system capable of addressing issues of poverty. The Council's focus has been exclusively on small credit and microcredit and one early task was for it to draft and disseminate a set of guidelines, *Policy Guidelines for Credit for the Poor,* for government agencies undertaking lending programs. In 1997 the NCC published a *National Strategy for Microfinance.* This is set a framework emphasising the role of the private sector, including MFIs, and the need for an enabling policy environment. Given the pervasive use of subsidised credit in government programs at that time, it emphasised the need for market interest rates to apply to loans and deposits. It further proposed that government line agencies should withdraw from the implementation of credit and guarantee programs in favour of specialised lending agencies (McGuire et al 1998).

These recommendations were taken up in a law signed in August 1999 which provided for the phaseout of all subsidised credit programs in the agriculture sector over a four year timespan. An Executive Order (No. 138 of 1999) also required government non-financial agencies to terminate all non-agricultural credit programs and transfer their funding to

government financial institutions. An administrative order empowered the NCC to rationalise directed credit programs in all sectors and to formulate policy guidelines. An inventory of 86 such programs implemented by 21 executing agencies was drawn up. The government financial institutions to which these programs were to be transferred were further instructed by Executive Order to make credit decisions in these programs "based on market conditions and the creditworthiness of private credit conduits" (Llanto 2000a, 260). However Llanto (2001) notes that despite the support of the central bank and the Finance Ministry for this policy, in practice government financial institutions have yet to comply fully and credit subsidies persist in some government programs.

More recently, changes to banking legislation embodied in the General Banking Law of 2000 have provided a more conducive regulatory environment for microfinance among regulated banking institutions (Credit for the Poor 2000). Provisioning requirements which had operated to penalise institutions lending to microfinance clients have been modified. Banks may now conduct microfinance lending based on clients' cashflow, rather than on traditional collateral criteria. Repayment schedules may also be tailored to the cashflow patterns of microfinance clients, with daily repayment if necessary. Such lending must now be market-based, in the sense that interest rates must be constructed to recover all the transaction costs associated with such lending. Llanto (2000a) had previously identified some unconscious regulatory bias against microlending, in central bank provisioning and other requirements, and these legislative changes make some improvement in this situation. The changes are thought likely to increase pressure for MFIs to follow the "transformation" path, although a moratorium on the establishment of new banks during 2000 prevented early action on this front.

Microfinance in the Philippines is conducted in a generally supportive policy environment and within a substantially liberalised financial system. Its strengths include regulatory provisions which make possible the establishment of small banks with modest minimum capital requirements and an energetic NGO sector, leading elements of which display awareness of the need to define and employ best practice operating procedures. Many NGOs, however, are still locked into a dependent relationship with donors and have yet to develop the necessary standards of professionalism. In pursuit of high standards and a modality for funding and supervising a diverse range of MFIs, the Philippines has established a second-tier financial institution, PCFC. It has the resources and the mandate to use a 'carrot and stick' approach to improving the financial performance of MFIs.

v) Cambodia

Cambodia has a population of 11.8 million people and GNP per capita of $260, placing it among the 20 poorest nations. It is a post-conflict economy, which suffered enormous loss of human and physical capital during 25 years of turmoil. Some 85 percent of Cambodians live in rural areas and agriculture constitutes half of the country's GDP. The incidence of poverty is estimated at 36 per cent nationally, and 40 percent for the rural areas (World Bank, www.worldbank.org/country briefs/cambodia). Despite the importance of the rural economy, rural financial services are ill-developed. Some 40 per cent of the rural population live in provinces without a commercial bank branch, and in those where branches exist, services are confined to principal towns. Only about 4 per cent of outstanding commercial bank credit is for agriculture-related activities. In the absence of commercial provision, the demand for financial services is met by NGOs and moneylenders, as well as family, friends and agricultural traders (ADB, 2000).

In Cambodia, as mentioned in the introduction to this paper, the international NGO community played a key role in the introduction of microfinance from the early 1990s. While UNICEF set up the first revolving fund in 1989, international NGOs soon followed, including EMT/GRET, a French NGO, from 1991. A number of foreign agencies set up MFIs which have subsequently become independent Cambodian entities. The largest, ACLEDA, was established in 1993 as the 'Association of Cambodian Local Economic Development Agencies' with UNDP and (later) IFC support. While the commercial banks service only urban areas, by 2000 there were some 70 local and international NGOs operating in microfinance in 24 provinces and municipalities throughout the country. Some 50 of these reported on their activities to the NBC, the central bank. The value of credit outstanding, as reported to the NBC at end 2000, was approximately $29 million. According to one source (Son Koun Thor 2001, 2) this benefited some 370,000 households, or around 21 per cent of the total rural population. The ADB (2000) reported only 11 per cent coverage and $21 million outstanding to 255,000 households at a sightly earlier date but the apparent discrepancy may be due to a combination of rapid growth and improved data collection. For the voluntary sector to achieve outreach of 21 per cent in a decade would be a considerable achievement. As an indicator of the broader significance of the NGO movement for provision of services, it is worth noting that NGOs currently disburse about $75 million annually for a wide range of activities, an amount greater than 20 per cent of the annual Government budget (ADB 2000, 5).

In parallel with the development of an MFI sector, reforms to the Cambodian banking system created separate commercial banks and a central bank (the National Bank of Cambodia, NBC). Private commercial banks commenced operations from 1991 as a legislative framework was put in place. Interest rate liberalisation commenced, with banks free to set their interest rates from 1995. A more comprehensive law on banking and financial institutions was enacted in 1999. Apart from the NBC, which has 20 provincial branches, there are 31 commercial banks and a specialised financial institution, the Rural Development Bank (RDB). Most transactions of the formal financial institutions are still conducted in US dollars. There is a substantial interest rate margin quoted for loans in Riel, the national currency.

A Policy Framework for Microfinance

Cambodia has developed a policy, regulatory and supervisory regime for microfinance which provides a marked contrast with other countries in the region, in the extent to which it assigns a formal status and role to MFIs and has created an institutional framework for their operation. This perhaps reflects the particular circumstances of the parallel development of the microfinance and formal financial sectors in the reconstruction period from 1989, and the relative vigour of the INGOs compared with the halting start of the commercial banking system.

An important step in the evolution of a distinctive Cambodian policy regime was a decree in 1995 setting up the Credit Committee for Rural Development, supported by UNDP and a French agency. The committee was given a mandate to design a legal framework for rural credit in which MFIs would be recognised and facilitated, to formulate a savings mobilisation policy, to facilitate rural access to financial services including money transfer and to deal with donors in support of these objectives.

The next important element in the regulatory and supervisory system for microfinance was the Supervision Office for Specialised Banks and MFIs, set up in the Bank Supervision Department of the NBC in 1997. It receives financial and technical support from the

French agency AFD and is responsible for collecting financial information on the microfinance sector, and for capacity-building and assuring the compliance of MFIs with regulatory, accounting, management, and prudential standards.

The Rural Development Bank

Under the policy framework for microfinance, a key initiative of the Royal Government is to support and strengthen microfinance services in rural areas through the Rural Development Bank, established in 1998. The policy calls for:

> *Support and strengthening of micro finance services in rural areas through the Rural Development Bank and national and international micro finance operators … for provision of credit services in support of agriculture and rural economy based on free market for development, efficiency and sustainability (Son Koun Thor 2001, 1).*

The RDB is under the financial control of the Ministry of Economy and Finance and is supervised by the NBC. Licenced as a commercial bank, RDB engages in rural finance, solely at the wholesale level. RDB functions as a second-tier institution wholesaling loans to licenced financial institutions (LFIs). Its responsibilities include:

- financing and refinancing MFIs and commercial banks in support of the rural economy
- negotiating with donors for funding
- encouraging the mobilisation of deposits by the public
- cooperating with financial institutions in providing agricultural credit
- conducting wholesale banking activities, and
- training staff of MFIs.funded by donors or government.

RDB's charter calls for it to provide capital to licenced MFIs and other microfinance providers, and to local and foreign investors willing to contribute to rural development in Cambodia. The bank has granted loans for onlending to a number of leading Cambodian MFIs at concessional rates (Son Koun Thor 2001).

Following the enactment of a Banking Law in 1999, a regulation *(Prakas)* on the licencing of MFIs was issued by the NBC, the central bank, in January 2000. According to the CEO of the Rural Development Bank this

> *provides opportunity to national and international financial organisations, credit operators to transform themselves into MFIs and to join the formal banking system. Moreover, it also gives them access to financial resources from national and international institutions, especially from the RDB.* (Son Koun Thor 2001, 6).

Requirements under the *Prakas* include

- applicants for an MFI licence must be incorporated as a limited liability company or a cooperative
- licenced MFIs must have minimum registered capital of KR250 million ($65,000)
- MFIs must maintain a minimum capital adequacy ratio of 20 percent between eligible capital and weighted risks and there are liquidity radio and large loan exposure requirements
- all other entities not satisfying the licencing requirements but which provide credit services to individuals or groups must register with the NBC
- All microfinance operators whether licenced or not are excluded from a range of financial sector activities including leasing, derivatives, gold and commodities dealing, and the provision of cheque facilities and swap or forward dealing in foreign currencies.

ACLEDA

The licenced financial institutions (LFIs) eligible for funding which are, or soon will be, eligible for RDB funding include ACLEDA, the major Cambodian NGO which has achieved the status of a specialised rural bank, and a number of licenced MFIs (EMT and HK). A number of other NGOs are in process of achieving licenced MFI status, including CCB, Prasac Credit Association and ANS. As mentioned, the most significant financial institution to emerge from the NGO sector is ACLEDA, which at end 1999 had loans outstanding of KHR52 billion ($13.7 million) to some 58,000 borrowers. This loan portfolio was 65 percent (by value) and 23 percent (by numbers of clients) of the total portfolios of 25 large NGO credit providers reporting to the central bank (ADB 2000, Table A3.1).

ACLEDA was licenced as a specialised rural bank in October 2000 and issued capital in the company is held by ACLEDA (45 percent), ACLEDA staff (6 percent) and four foreign investing entities, including the International Finance Corporation. Its outstanding loan portfolio at end March 2001 was some $19.6 million, with loans averaging $296 to more than 66,000 clients, of whom almost 80 percent are women (www.bellanet.org/partners/mfn/acleda). ACLEDA Bank has more than 50 per cent market share of microcredit in Cambodia and employs some 551 staff in 61 offices in 14 provinces. It is working to expand savings mobilisation and to develop money transfer services.

With regard to savings, the ADB (2000, 4) notes that the domestic savings rate in Cambodia in 1997 was only five percent of GDP, the lowest in Southeast Asia. The ADB believes there would be a strong demand for saving among rural communities if appropriate facilities were available. While most NGOs have emphasised credit before savings, the existence of substantial capacity for savings is shown by the success of a savings mobilisation project conducted in Battambang province by CARE Cambodia. Within less than two years, CARE established 75 'Savings Banks' in 72 villages, serving more than 6,000 active savers, some 4,000 of whom are women. Total savings mobilised amount to US$51,000. Some 2,300 members had loans outstanding from the Savings Banks, amounting to US$87,000. The mean savings and loan balances are $8.50 and $37.00, respectively, and portfolio at risk was only 0.35 percent. An evaluation report (Mehrtens and Cornford 2001) notes that "members are very aware that the money they are borrowing is the money that they and their neighbours have saved". CARE provides continuing subsidies for staff costs and the project has some way to go towards financial sustainability. Nonetheless the experience of the Battambang project in savings mobilisation is encouraging. During the early, pilot, phase of the project the Savings Bank paid three percent per month for voluntary savings, later reduced to two percent per month. From 1 April 2001 this rate has been reduced drastically to eight percent per annum in an effort to cut costs and increase self-sufficiency. It will be interesting to see how this affects the availability of deposits.

Concerning microfinance industry practices, RDB reports (Son Koun Thor 2001) that where MFIs make individual loans, collateral is required. A typical microenterprise loan with a term of less than one year or less may be in the range $100 to $500 (substantially more in the case of ACLEDA). ACLEDA's rate for such loans is four percent per month on a flat basis. Group lending by NGOs for the rural poor does not require collateral because of the joint liability arrangement. Loans are made to the individual in amounts usually from 20 to 100 dollars and interest rates range from three percent to six percent per month depending on the policy of each operator. Higher monthly rates may be calculated on a declining balance. Most programs require compulsory deposits as a condition for obtaining loans.

Interest rates on deposits range from one percent to three percent per month and savings are available for lending to members upon agreement by the group. However, relatively few programs place as much emphasis on savings as the Battambang project described above. Among leading MFIs in Cambodia the most successful in savings mobilisation is the local affiliate of CRS (Catholic Relief Services) which has mobilised savings equivalent to 30 percent of a loan portfolio valued at 1.34 million dollars at end 2000.

EMT is the third largest MFI in Cambodia in terms of loans outstanding. At end 2000 its portfolio totalled 2.8 million dollars compared with more than 17 million dollars at ACLEDA Bank. However EMT had some 73,000 borrowers compared with ACLEDA's 61,000, giving mean loan sizes of $38 and $280.00, respectively. Besides targeting a poorer clientele, EMT is also innovative in having established an autonomous health insurance project in 1998. EMt reached break-even point in 1998 with its solidarity group lending and decided to test a health insurance system. The experiment has revealed some difficulties and is proceeding (GRET 2000).

Cambodia has adopted what might be called a 'transformation' model of microfinance service provision. This is one where microfinance services originate in the voluntary sector and government's role is seen as providing an appropriate policy and regulatory environment and financial infrastructure (specifically, a second-tier institution, the RDB, to act as a wholesaler for and nurturer of MFIs). Microfinance institutions are then expected to follow a linear path on which they transform themselves from informal revolving funds to NGOs to licensed MFIs and then to specialist microfinance banks. Only ACLEDA has made the transition to bank status, and at present only a couple of institutions are licensed MFIs although more will become so in the next year or two. The ability to incorporate a small specialist bank such as ACLEDA Bank under Cambodian law is an essential part of the supportive regulatory environment. Cambodia is one of a relatively small number of countries in the Asian region (Indonesia and the Philippines being others) where this is possible.

vi) Vietnam

Despite considerable progress in poverty reduction during the 1990s[11], Vietnam remains one of the poorest countries in the world. Among many elements in a poverty reduction strategy, the Government has focussed on the financial service needs of the poor, particularly in rural areas. Government efforts in the field have involved central bank regulation of interest rates and direction of the state banking system to provide subsidised credit to target groups. In addition, international agencies and NGOs have drawn the Government's attention to the potential of microfinance to alleviate poverty, and have supported a number of projects trialing imported models of microfinance service provision[12]. These developments have occurred while Vietnam has been moving to establish the institutional framework for a modern financial system and to introduce elements of liberalisation as possible and appropriate.

[11] The proportion of people under a "total poverty line" dropped from 58 per cent in 1992-93 to 37 per cent in 1997-98, while the proportion under a "food poverty line" fell from 25 to 15 per cent (Vietnam Development Report 2000).

[12] Published materials on microfinance in Vietnam are sparse. Two recent country overviews are available (Llanto 2000 and McCarty 2001) and are the primary sources for this paper.

The movement away from a socialist monobanking system in Vietnam has proceeded since the late 1980s, beginning with the establishment of VBARD, the Vietnam Bank for Agriculture and Rural Development, as a separate entity in 1988. VBARD is a state "policy" bank, responsible for "directed" lending to agricultural and rural sector lending and with a brief to develop lending to individuals and households, by contrast with the earlier pattern of financing state-owned enterprises and communes. For these purposes it enjoys government subsidies and access to central bank credits. More recently, in 1995, another policy bank was established within the corporate structure of VBARD to perform specialised lending to poor households unable to meet VBARD's credit criteria. This is the Vietnam Bank for the Poor (VBP).

A central bank, the State Bank of Vietnam (SBV), has regulatory oversight of formal financial institutions. The formal financial sector now includes, besides the SBV, VBARD and VBP, a number of government-owned commercial banks. There are in addition almost a thousand Peoples' Credit funds (PCFs), a much smaller number of credit cooperatives, around 50 small "shareholder banks" and a number of foreign and joint-venture banks. Of these institutions, VBARD, VBP and the PCFs are relevant to microfinance, while a small number of rural shareholder banks appear to have potential in the field (Llanto 2000b).

There is also a semi-formal sector, not regulated by the SBV, consisting of the microfinance operations of mass organisations (including those for women, veterans, farmers and youth) which are instruments of the State. These organisations are represented at every level from the national to the povincial and down to the commune, and are able to disburse government-funded loans under a range of programs. Within this semi-formal sector also there is a relatively small amount of microfinancing conducted by NGOs. These are still primarily foreign in funding and management, due to the limited development of indigenous NGOs independent of the mass organisations.

Finally, there is an informal sector in which finance is available from family and friends as well as moneylenders, and in which traditional Vietnamese ROSCAs, known as hui or ho, are common. Informal financing mechanisms were until recently the most important sources of credit in rural areas, although the rapid expansion of VBARD's operations, and then more recently the advent of VBP, have wrought substantial structural changes in rural credit markets (McCarty 2001).

Rapid Change in Rural Financial Markets

National household surveys were conducted in 1992-93 and 1997-98, with results indicating that in the former period private moneylenders and individuals provided 73 percent of loan funds in rural areas, and government banks 23 percent. By the latter period, after only five years, government banks had increased their share of rural lending to 40 percent. At the same time, the share of money-lenders had fallen from 33 percent to 10 per cent. This change "reflected the rapid growth of VBARD lending and a 'crowding out' of the informal sector" (McCarty 2001,5).

Aggregate data for 1998 cited by Llanto (2000b, 337) suggest even greater state bank coverage, and are perhaps consistent with a pattern of very rapid growth in outreach. Some 5.9 million rural households (about 49 per cent of the total) had loans from regulated financial institutions, with mean loan sizes of $290 (VBARD) and $110 (VBP). Of this number, 2.7 million loans were made to "low income households", said to be 40 per cent of all such households in the rural sector. This suggests the possibility of at least some continuing unsatisfied demand for credit among the poor.

McCarty (2001,5) judges that "[t]he extension of the formal banking system to rural Vietnam is the most remarkable achievement of microfinance in Vietnam since 1996". Indeed rural households appear more likely to be borrowing from banks than urban households. The household survey data indicate that in 1997-98, 7 percent of rural households reported loans due to the VBP (compared with 4 percent in urban areas), and 26 percent reported loans with VBARD and other government banks (as against 9 percent in urban areas). Such "rural bias" is highly unusual, in the region or indeed anywhere.

Llanto describes VBARD as innovative in its efforts to reach people at the commune or grassroots level, where its representation is thin. It has introduced mobile banking units to increase the outreach of its credit and deposit services and has also developed joint liability groups. These act as intermediary organisations for borrowers unable to offer conventional collateral. It also lends to individuals who are members of "guarantee groups" under the auspices of one or another of the mass organisations, for example for women or farmers. The bank works closely with these mass organisations. Such measures have contributed to rapid growth, in line with VBARD's mandate to reach as many households with subsidised credit as possible. However Llanto (2000b, 337-8) comments that VBARD has limited outreach to poor communes in isolated and mountainous regions, where poverty is found in the highest concentrations. He also points to a contradiction between its role as a source of subsidised credit and its function of providing commercial credit to non-poor entities.

The VBP was, as mentioned above, established to compensate for VBARD's shortcomings as a lender to the poor. It has a specific mandate to provide subsidised credit to poor households, using VBARD's branch network and field staff. It does not mobilise savings and is dependent primarily on government for funding. According to McCarty (2001, 6), by the end of 1999 some 2.3 million poor households had gained VBP loans totalling $276 million at an interest rate of 0.7 per cent per month. The maximum loan term was 36 months, the maximum loan size around $170, and the mean size around $120.

Llanto suggests (2000b, 338) that the long-term viability of VBP is problematic. This is because its lending interest rate, although subsidised, is not high enough to cover costs. Also, it is dependent on external sources for loanable funds (Government) and staff and physical facilities (VBARD). Its joint liability system of loan management seems not to be effective, as evidenced by repayment problems. Finally, its policy of lending only to farm-based households prevents it from financing an expansion of rural non-farm economic activity, which would be a highly appropriate form of microfinancing.

The People's Credit Funds

People's Credit funds (PCFs) are savings and credit cooperatives operating at the commune level and have the most widespread network of any financial institutions in Vietnam. They were created in the early 1990s with foreign NGO assistance, and erected atop the wreckage of an earlier credit cooperative system which collapsed in the late 1980s. They operate under the cooperatives law and lend only to members, although they mobilise savings from members and non-members alike and are permitted by the SBV to set deposit and lending rates above those of VBARD and VBP. In 1998 they served some 0.6 million rural households, perhaps 5 per cent of the total. About half of loans went to "low-income" households, although the mean loan size (at $300) was slightly above that for VBARD's subsidised lending. While the volume of PCFs' lending was less than that of VBP and much below that of VBARD, the PCFs appear to be relatively more successful in deposit mobilisation. This is because of their physical accessibility, their higher interest rates, more

attractive savings products and the security offered by deposit insurance on longer-term deposits (Llanto 2000b, 338-40). This last point is important to a clientele which remembers losing savings in the collapse of the predecessor cooperative system.

Llanto judges the PCFs to have considerable potential as microfinance institutions, although at present they discourage the poorest by their shareholding requirement, and are inexperienced in microcredit methods, including dealing with women and joint liability groups. He also mentions the Rural Shareholders Banks as having some promise as a model of microfinance provision, by virtue of their legal status, despite their small numbers and limited resources. This review of microfinance in Southeast Asia has noted the good performance in several countries, including Indonesia and the Philippines, of small regulated banks with strong links into local communities.

McCarty (2001,3) describes the microfinance market in Vietnam as "segmented", and suggests that "the most useful breakdown is to divide households into those who can access the Vietnam Bank for Agriculture (VBARD) and those who cannot". He comments that the poor are mostly unable to access subsidised credit from VBARD. While some may access VBP credit (perhaps 40 per cent, according to data cited above) it is not clear whether this will prove a sustainable source. Otherwise poor households must turn to relatives or private lenders. He suggests that for the poor, access to credit on a sustainable basis, at interest rates closer to those charged by informal lenders, would be a boon. McCarty describes the NGOs as "trapped in a microfinance-as-charity vision", dependent on subsidies and taking their lead on interest rates from subsidised government institutions rather than moving to compete with high cost providers in the informal sector.

Semi-formal Microfinance: Mass Organisations and NGOs

Outside the formal financial sector, there is the semiformal sphere of microfinance activity, involving various mass organisations and NGOs, often acting as agents of one or another government program. These may be directed to specific objectives, such as job creation, regreening or resettlement, and have in common their reliance on heavily subsidised government funding and low interest rates. Mass organisations also provide their members with facilities for solidarity group microfinance, where resources may be channelled from VBARD or VBP. For example, the Vietnam Women's Union (VWU) has 11 million members and some 80,000 women's savings and credit groups (Llanto 2000b, 341). However McCarty describes as a "myth" the suggestion that much rural microfinance is channeled to women and their organisations. He states that this "is only the case for many of the small NGO schemes, an uncertain percentage of informal lending, and for some VBARD lending. The vast majority of rural loans are, however, made to men" (McCarty 2001, 22).

Microfinancing by NGOs is for the most part conducted as an activity ancillary to some primary objective, in fields such as education, health or livestock rearing. Here microfinance is likely to be viewed more as an entry point to the villages. In practice there is a range of situations, with one or two international NGOs attempting to introduce international best practice, emphasising savings mobilisation and setting interest rates for sustainability, while the others act out the "microfinance-as-charity" role. McCarty's generalisation of NGO behaviour is based on a survey of 76 such microfinance schemes in mid-2000. Only two Vietnamese NGOs could be identified for this survey. Data for a group of nine of the larger international NGOs show total loans outstanding of less than $18 million, minute in relation to the volumes of subsidised credit channelling via the state banks. Lending interest rates charged by these schemes were generally in line with VBARD rates, and savings

mobilisation was "either zero or modest". All these larger schemes integrated microfinance with other activities and objectives McCarty 2001, 15).

Informal sector lending, involving relatives, friends and neighbours, the professional moneylenders, and traditional ROSCAs, continues to be of great importance in rural Vietnam. According to McCarty (2001, 11),

> [t]he main reason for an ongoing strong informal sector is that the formal sector can meet demand for loans at the low interest rate only for the most credit-worthy households. In this sense rural Vietnam is a "repressed financial system" where a significant proportion of households get little or nothing from the formal sector. Formal loan conditions (and maybe informal ones) act as the "rationing mechanisms" that exclude households.

These mechanisms include collateral requirements, prescribing how loans must be used, and setting loan sizes and terms not suitable for the needs of the poor. For example, only about 30 per cent of all rural households can provide the documents required to pledge land against credit. The reference to "informal" criteria being applied may suggest some politicisation or favouritism in official lending. Certainly, Llanto (2000b, 345n) implies that international NGOs active in microfinance are sceptical of the official lists of the poor eligible for credit from official sources.

The neglect of savings mobilisation

Leaving aside issues connected with the provision of credit, there is an even more serious deficiency in Vietnamese microfinance: the neglect of savings mobilisation among poor and lower-income households. This is a weakness of VBARD, set up to be the principal financial services provider in rural areas, and still more of VBP, set up to serve the poor, but which does not collect savings at all. The minimum deposit accepted by VBARD branches is VND 50,000 (say, $3.50) and VND 100,000 in commercial bank branches (McCarty 2001). This is an obstacle to savings accumulation by the poor in a country with per capita income of $400.

The source of VBARD's and other banks' deposits is overwhelmingly urban, and the interest rate structure and limited range of savings products do not encourage rural deposits. However McCarty (2001, 20) notes that VBARD's savings performance is "very erratic", varying greatly across the country. Thus savings, as a percentage of loans, is as high as 92 per cent and as low as 2 per cent across nine provincial branches. While the poorest provinces appear to have the lowest savings ratios, international experience of aggregate savings behaviour provides no evidence to suggest that this should be so. Examining the reasons for such wide variations in performance and, in particular, case studies of successful savings mobilisation by VBARD branches, could prove instructive.

In this regard, the experience of the PCFs might also provide some lessons. Their comparative success in mobilising savings appears to flow from the ability to offer higher deposit rates and to design products better matching the needs of low-income and poor people, as well as their accessibility to the poor. NGOs, on the other hand, appear to take their cue from the government financial institutions, and to share their limited appreciation of the value of savings, either for institutional viability or for the welfare of the poor. Consequently they have pursued a microcredit rather than a microfinance orientation.

The policy and regulatory environment

Gilbert Llanto (2000b, 346), surveying the state of microfinance in Vietnam in 1999, described the major unresolved issues as being

- to find a proper role for the state-owned banks
- to agree an appropriate interest rate policy for the central bank
- to implement a positive approach to savings mobilisation
- to achieve a competitive, market-oriented environment for microfinance and for the financial sector more broadly, and
- to institute appropriate regulation and supervision for MFIs.

As is usually the case in transitional economies, many of the problems constraining the development of sustainable microfinance can only be resolved in the context of broader financial sector reform, including movement towards a commercialised banking system. Short of full interest rate liberalisation, it may be feasible to allow progressively greater latitude in setting interest rates to particular institutions. This is happening with respect to PCFs and other non-bank credit institutions, for instance, along with some loosening of interest rate ceilings and the SBP's move to a "base rate" method of setting rates in 2000. A trend towards positive real interest rates over the last three years, in consequence of price stability, has also been helpful to institutional sustainability and financial sector development.

A number of other reforms and clarifications have occurred in recent years, including greater flexibility now given to commercial banks in deciding loan guarantee requirements. Rights and obligations with regard to borrowing and lending have been clarified in the Civil Code, registration for non-credit institutions conducting banking activities has been introduced in a Law on Credit Institutions, and a cooperatives law which provides a framework for the development of credit cooperatives has been enacted. Also, in 2000, a Politbureau directive called for a review of the PCF system, to achieve its consolidation and improvement, and to provide for supervision (McCarty 2001, 12).

The Asian Development Bank evidently feels the time is ripe to assist the Government to develop a policy and legal framework conducive to the development of microfinance in Vietnam. A loan for technical assistance is to be made in 2002 to assist the SBV with the conceptual framework for a national policy on microfinance, with the possibility of drafting specific legislation for the sector. Particular attention will be given to drafting prudential regulations for MFIs, with a view to legitimating and expanding their savings mobilisation. The Bank also intends to assist in improving the functioning and coverage of the Deposit Insurance Agency to support savings mobilisation. It aims to assist in crafting a regulatory framework within which MFIs can evolve into formal regulated financial institutions. ADB thus appears to have a "transformation" scenario in mind for MFIs, perhaps similar to that in Cambodia, discussed elsewhere in this paper.

vii) Lao PDR

Laos has the least developed microfinance sector of any country considered in this paper, and is classified both as least developed and as an HIPC (heavily indebted poor country). Sparsely populated, it has a pattern of small, dispersed settlements, unfavourable for the delivery of all services, not least microfinance. The continuing importance of non-monetised subsistence activities is another constraint on financial sector development, and there is an apparent absence of significant traditional ROSCA activities and even of a well-developed

system of professional village money-lending (Kunkel and Seibel 1997). By contrast these practices are commonplace in neighbouring countries as well as throughout the region more generally. However sample survey evidence cited by Kunkel and Seibel (from which single source most of my information is drawn) seemed to them to suggest an incipient demand for microfinancial services in the rural economy, especially for savings deposits. This judgement was based on evidence concerning household holdings of cash, gold and silver.

The Lao PDR commenced its transition from central planning in 1986, with a series of reforms under the 'New Economic Mechanism'. From 1990 the Government turned its attention to the financial sector, carving the former state monobank into a central bank and a number of commercial banks. Private sector banks were permitted to operate in urban areas and interest rate liberalisation commenced. Kunkel and Seibel note that in the financial sector "progress has been impeded by the reluctance of administrative and institutional decision makers to fully implement national policy decisions at the local level". By 1996, six state banks served the rural sector and the largest of these, the Agricultural Promotion Bank (APB), had 16 branches and some 90 sub-branches serving a total of 18 provinces and 133 districts. APB was established in 1993 to be the primary agricultural lender and to achieve national outreach. The 5 lesser banks had only 12 branches. Kunkel and Seibel record that perhaps only 15 per cent of households in Laos had access to formal financial services by 1996.

Operating outside the formal financial sector, the Lao Women's Union (LWU), an official mass organisation, had 650,000 members, some 50 percent of the female adult population. With a staff of some 20,000 women and volunteers in virtually all villages, the LWU had the greatest potential for outreach in microfinance of any institution in Laos. Income generation and improved access to credit are among the multiple objectives of the LWU, which between 1990 and 1996 established some 1,650 'Lao Village Credit Associations' (LVCAs) focussing on women and the poor.

Kunkel and Seibel describe the LVCAs as located in target villages selected by local government in association with donors. Among other innovations and reforms likely to support the development of sustainable MFIs in Laos, Kunkel and Seibel saw the need for the LVCAs to be transformed into financial intermediaries. Then they could provide sustainable financial services to their communities, instead of focussing primarily on subsidised credit with little attention to savings.

As they operated at the time Kunkel and Seibel studied them, the LVCAs were not primarily MFIs, but rather groups focussing on some primary concern (such as livestock raising or education and training) with a revolving credit fund attached. Some 13 projects operated by INGOs with the LCVAs and a smaller number funded by multilaterals served perhaps 14 per cent of all villages in the country, disbursing $6 million between 1992 and 1996, with loan sizes typically between $10 and $50. French agencies are active in the field. While interest rates varied, most were at around 10 per cent per annum, around the preferential rate charged by state commercial banks. A Lao economist comments that in a non-monetised economy such as Laos, where the poor have relatively little experience of trading, the livestock loan is a particularly effective form of microcredit. This is because it enables people to build on their existing knowledge, skills and resources, rather than encouraging them to embark on less familiar and riskier enterprises.

Damaging Impact of the Asian Crisis

During the financial crisis from 1997, inflation in Laos peaked at an annualised rate of 167 per cent early in 1999, although this was brought down to 10 per cent by end-2000 (IMF 2001a). Many Lao women must have been glad they had allocated wealth to gold and silver rather than cash or bank deposits. For the financial sector, macroeconomic instability was very damaging. "Negative real interest rates, high inflation, and expectations of devaluations….undermined confidence in the financial sector, keeping savings rates low and limiting monetary depth" (Okonyo-Iweala et al, 1999). The three state commercial banks sustained very high levels of non-performing loans over the period and are still described as "deeply insolvent" (IMF 2001a).

The current Letter of Intent (LOI) from the Lao PDR (IMF 2001a) imposes strict restraints on credit growth for all financial institutions, pending substantial restructuring and reform of the financial system, to include the phase-out of the state commercial banks. Although externally-financed projects (including donor-assisted MFIs) are not affected by this credit stricture, economic conditions during the past four years cannot have been favourable to the further growth and development of MFIs.

In its draft PRSP (Poverty Reduction Strategy Paper) filed with the IMF in April 2001 (IMF 2001b) The Lao Government gives priority to the Agriculture/Forestry, Education, Road Infrastructure and Health sectors for strategic interventions to reduce poverty levels, and singles out Rural Development as an intersectoral priority. Under that latter heading there is specific reference to financial sector reform and to needed improvements in rural financial services, but no reference to microfinance, *per se*. More broadly, donor reservations about Lao government policies for the resettlement of ethnic minorities, which are 70 per cent of the population and a greater proportion of the poor, impede the full commitment of external resources to rural development (Jerve 2001). Given that poverty is concentrated in the rural areas this reticence on the part of donors has significant implications for the full range of anti-poverty interventions, including microfinance.

viii) Impact of the Asian Financial Crisis on Microfinance in Southeast Asia

In 1998 the Foundation for Development Cooperation surveyed MFIs in a number of Asian countries to examine the impact on their operations of the Asian financial crisis, from mid-1997. Countries surveyed included Indonesia, the Philippines, Malaysia and Thailand. The conclusions of this survey included the fact that MFIs in general fared better than the commercial banking systems in most of the countries concerned, that the crisis appeared to have more severe impacts on institutions serving small business clients than on specialist MFIs serving the poor, and that microfinance appeared to have suffered worst in those countries where it was linked most closely into the formal financial system. Microfinance programs, including Grameen Bank replications, which most stringently targeted the poorest were least affected. A summary of the conclusions of this study (McGuire and Conroy, November 1998) is given in the text box.

Impact of the Asian Financial Crisis on Microfinance in Southeast Asia, as at November 1998

Not surprisingly, the crisis has had a much greater impact on microfinance in Indonesia than in any other country. The value of loans outstanding by BRI unit desa and the rural banks have fallen by between one quarter and one half in constant price terms since the onset of the crisis. These institutions are supporting a much reduced level of activity among small entrepreneurs, at the same time as living standards are falling significantly. Moreover, at least in aggregate, the rural banks are running down the real value of their capital stock at an alarming rate. There are also signs of growing fragility in Government schemes such as P4K and PHBK, which call for renewed commitment of resources to assist them to survive the crisis. By comparison, the crisis has had a more moderate effect in other countries. While it has impacted on MFIs in the Philippines, Malaysia and Thailand, in most cases it has served to reduce the rate of growth in their outreach, rather than reduce outreach in absolute terms. There is also increasing evidence that the crisis is having a greater effect on institutions serving small business clients than on specialist MFIs serving the poor. In the Philippines this seems to be a robust conclusion. Evidence from a number of quarters suggests that programs focusing solely on the poor appear to have withstood the crisis better so far, in terms of client numbers and repayment rates, than programs not specifically targeted to the poor. This seems to be the case even where such programs are run by the same institution, such as TSPI. In Malaysia, too, AIM has maintained high repayment rates among poor borrowers while other institutions catering to higher income borrowers have reportedly experienced increased arrears. Another more tentative conclusion is that microfinance appears to have suffered most where it is linked into the formal financial system. This is not surprising as the crisis has been first and foremost a financial one. As noted above the rural banks in Indonesia, which are a major supplier of micro financial services, are facing a very difficult situation. In the Philippines, it appears that thrift banks and possibly rural banks have suffered more than specialist MFIs, with reduced deposits forcing the thrift banks to reduce their loan portfolios. And MFIs in the Philippines and Malaysia have found it very difficult to maintain linkages with commercial banks, because of increased interest rates and more cautious lending policies. On the other hand, MFIs which rely on government and donor agencies rather than the formal financial system for resources appear to have fared better. This does not imply that microfinance should not become more integrated into the formal financial system. Such linkages are critical if microfinance is to reach large numbers of poor people on a sustainable basis. Nevertheless, they may make the microfinance sector more prone to cyclical fluctuations. The findings also suggest that much greater attitudinal change is necessary within the formal financial system about the scope for commercial engagement with microfinance. It is instructive that in the Philippines, individual loan officers at the commercial banks have acknowledged that MFIs are very good clients, but have been obliged to follow bank policy to reduce lending that is perceived as 'risky'. There is a need to further educate senior bank management about the scope for profitable linkages with MFIs, and the need to avoid blanket lending policies which inadvertently work against such linkages (McGuire and Conroy, 1998).

4. CONCLUSION

The 2001 ASEAN Roundtable is concerned with issues of financial sector development, considered in the light of the setback to growth and development from events in the region in the late 1990s. Its terms of reference include consideration of financing for recovery, how further financial deepening may be achieved, and the need to develop new financing mechanisms and vehicles while managing the process of liberalisation better in future. The challenges of corporate and bank restructuring, the appropriate role for development assistance and the public/private balance are other considerations. Further we are asked to consider how the financing needs of SMEs can be met more effectively and whether microfinancing has the capacity to make credit available to a wider spectrum of people.

It is necessary to repeat here a point made in the introductory section of this paper, that there is a clear distinction between the economic activities and financial service needs of the SME sector and those of the clients of microfinance institutions. The latter operate on a much smaller scale. While there may be some overlap between the bottom end of the SME sector and the poor and lower-income people who form the constituency of microfinance, it is the needs of the latter to which this paper has been directed.

It should be clear from the country case studies in this paper that financial liberalisation suppports the development of effective microfinancing mechanisms and institutions. Freedom to set interest rates is essential for sustainable microfinance. Such freedom may be conferred by government fiat (as in Indonesia after 1983) or exist by default, because MFIs are simply able to take matters into their own hands (as in Bangladesh since Independence) because of the weakness of the regulatory authority.

Issues of financial sector deepening give rise to considerations of equity and participation, at least from a microfinance perspective. Extending the outreach of microfinancial services is a contribution to financial deepening, although more important qualitatively than quantitatively. This is because, to repeat a point made several times in this paper, the money value of microfinance assets and liabilities is not likely to become a significant element in the consolidated balance sheets of financial sectors in the region. However, there is a yardstick, other than the monetary one, which has relevance to the issue of financial deepening. That other yardstick should measure the impact financial deepening has on the number of people who are drawn in to participate in the financial system, by virtue of their gaining access to financial services which meet their needs.

The search for new financial instruments and platforms for the provision of financial services has its counterpart in the world of microfinancing. The country studies in this paper have attempted to convey something of the diversity of models and institutions, some of them imported, some of them home-grown, which are being applied in ASEAN countries. A diversity of approaches is appropriate; narrow prescriptions concerning "the" model appropriate to the region or to any single country within it are unlikely to be helpful. It is better to set operational performance standards as benchmarks against which the various models in operation can be measured. The need for financial sustainability is increasingly understood by the voluntary sector agencies which have entered microfinance, while the high standards of certain formal regulated institutions, notably BRI and BAAC, have demonstrated to governments the possibility of sustainable rural sector financing. It is also interesting to note the relative resilience of many MFIs in the face of the Asian crisis.

The challenges confronting microfinance in Southeast Asia, then, include the need to achieve operational and financial sustainability for MFIs, and to achieve this while

integrating the institutions which practice microfinance within the broader financial system, as part of a financial deepening process. They include the need to achieve good governance within MFIs serving constituencies of the poor and to avoid the politicisation of financial service delivery. And they include the need to achieve good governance at the system level, by instituting appropriate policy regimes and forging effective systems of regulation and supervision for microfinance service providers.

In regard to the role of donors, experience noted in the country case studies indicates their best function may be assist with forms of financial sector development which increase the access of poor and low-income people to financial services delivered on a sustainable basis. This suggests the need for intervention at the system level, to assure an appropriate policy and regulatory environment for sustainable microfinance to flourish. At the firm-level, it suggests the desirability of support to assure the creation and trialing of institutional models of MFI which can achieve outreach to unserved or underserved strata of populations in a sustainable fashion and which can function as organic entities within the broader financial system. This formulation implies a role for the private sector in such provision, but does not imply that private investors should be responsible for all the costs of establishing such systems and the institutions within them. Subsidies or external assistance, however, are best directed to establishment and capacity-building costs; financial self-sufficiency in routine operations is a separate and essential goal for all microfinancing institutions.

BIBLIOGRAPHY

Adams, D W, D H Graham, and J D Von Pischke, Eds. 1984. *Undermining Rural Development with Cheap Credit.* Boulder: Westview Press.

ADB. 2000a. *Finance for the Poor: Microfinance Development Strategy.* Manila: Asian Development Bank.

ADB. 2000b. *Report and Recommendation of the President to the Board of Directors on the Proposed Loan to the Kingdom of Cambodia for the Rural Credit and Savings Project.* RRP: CAM 30237. Manila: Asian Development Bank.

ADB. 2000c. *The Role of Central Banks in Microfinance in Asia and the Pacific: Country Studies.* Manila: Asian Development Bank.

ADB. 2001. *Thailand, Country Strategy and Program Update 2002 - 2004.* Manila.

Conroy, J D. 2000. "Indonesia" in ADB, *The role of central banks in microfinance in Asia and the Pacific. Volume 2, Country Studies.* Manila: Asian Development Bank.

Conroy, J D, K W Taylor and G B Thapa. 1995. *Best Practice of Banking with the Poor.* Brisbane: The Foundation for Development Cooperation.

Credit for the Poor. 2000. "Philippines Central Bank encourages NGOs to reinvent themselves as banks". No. 29, December, pp7-8.

Erhardt, Wolfram. 1999. *Credit for Poor and Low-Income Entrepreneurs in Urban and Rural Northern Thailand.* Discussion Paper No. 99/4. Institute of Agricultural Economics and Social Sciences in the Tropics and Sub-Tropics. Stuttgart: University of Hohenheim.

Gibbons, David and Sukor Kasim. 1990. *Banking on the Rural Poor.* Penang: Centre for Policy Research, Universiti Sains Malaysia.

Goodwin-Groen, Ruth. 1998. *The role of commercial banks in microfinance: Asia-Pacific region.* Brisbane: Foundation for Development Cooperation.

GRET. 2000. *Experimenting with a Micro-Health Insurance System in Cambodia: the EMT Example.* CGAP Microfinance Gateway. [www.cgap.org]

Holloh, Detlev. 1998. *Microfinance in Indonesia: Between State, Market and Self-Organisation.* Hamburg: Lit Verlag.

IMF. 2000a. *Lao PDR Letter of Intent and Memorandum on Economic and Financial Policies,* March 2001.

IMF. 2001b. *Interim Poverty Reduction Strategy Paper of the Lao PDR.* [www.imf.org/external/np/prsp/2001/lao]

IMF. 2001c. Panel discussion on Macroeconomic Policies and Poverty Reduction. Washington, DC. <www.imf.org/external/np/tr/2001/010403.htm>

International Finance Corporation. 2001. *Microfinance in Cambodia.* Washington DC: IFC Mekong Project Development Facility. [www.ifc.org]

Jerve, Alf Morten. 2001. "Laos" in Alejandro Grinspun (editor). *Choices for the Poor: lessons from national poverty strategies.* New York: UNDP.

Kunkel, Carmen R and Hans Dieter Seibel. 1997. *Microfinance in Laos, a Woman's Business?* Working Paper No. 1977-1, Development Research Center, University of Cologne.

Llanto, Gilbert M. 2000a. "The Philippines" in ADB. *The Role of Central Banks in Microfinance in Asia and the Pacific.* Volume 2 (Country Studies). Op Cit, pp247-277.

Llanto, Gilbert M. 2000b. "Viet Nam" in ADB. *The Role of Central Banks in Microfinance in Asia and the Pacific.* Volume 2 (Country Studies). Op Cit, pp 334-356.

Llanto, Gilbert M. 2001. "Sustainable Rural Finance: policy and design issues" in *Policy Notes,* No. 4/2001. Manila: Philippine Institute for Development Studies.

Maurer, Klaus, in collaboration with Shyam Khadka and Hans Dieter Seibel. 2000. "Agricultural Development Bank Reform: the case of The Bank for Agriculture and Agricultural Cooperatives, Thailand". *Rural Finance Working Paper,* No. B.6. Rome: IFAD.

McCarty, Adam. 2001. *Microfinance in Vietnam: a Survey of Schemes and Issues.* Hanoi. DFID and State Bank of Vietnam

McGuire, Paul B, John D Conroy and Ganesh B Thapa. 1998. *Getting the Framework Right: Policy and Regulation for Microfinance in Asia.* Brisbane: The Foundation for Development Cooperation.

McGuire, Paul B and John D Conroy. 1998. *Effects on Microfinance of the 1997-1998 Asian Financial Crisis.* Brisbane: The Foundation for Development Cooperation. <www.bwtp.org>

Mehrtens, Grahame and Robyn Cornford. 2001. *CARE Cambodia, Savings Mobilisation Project, Battambang Province: Mid-Term Evaluation Report.* Brisbane: The Foundation for Development Cooperation.

Meyer, Richard L and Geetha Nagarajan. 2000. *Rural Financial Markets in Asia: Policies, Paradigms, and Performance.* A Study of Rural Asia, Volume 3. Manila: Asian Development Bank.

Muraki, Tetsutaro, Leila Webster and Jacob Yaron. 1998. *Thailand, BAAC - The Thai Bank for Agriculture and Agricultural Cooperatives, Case Studies in Microfinance.* Sustainable Banking with the Poor. Washington DC: The World Bank.

Okonyo-Iweala, Ngozi, Victoria Kwakwa , Andrea Beckwith and Zafar Ahmed. 1999. "Impact of Asia's Financial Crisis on Cambodia and the Lao PDR" in *Finance and Development,* Vol. 36, No. 3.

Robinson, Marguerite S. 2001. *The Microfinance Revolution: Sustainable Finance for the Poor, Lessons from Indonesia.* Washington DC: The World Bank and Open Society Institute.

Sacay, O, B. Randahawa, and M Agabin. 1996. *The BAAC Success Story: A Specialised Agriculture Bank Under Government Ownership.* Financial Sector Development Department. Washington DC: The World Bank.

Son Koun Thor. 2001. *The Implementation of the Royal Government Policy Program in Social Development for Poverty Alleviation: Rural Credit in Cambodia.* Phnom Penh: Rural Development Bank of Cambodia and AFD.

Steinwand, Dirk. 2001. *The Alchemy of Microfinance: the Evolution of the Indonesian People's Credit Banks (BPR) from 1895 to 1999 and a Contemporary Analysis.* Berlin: VWF.

Sukor Kasim. 2000. *Impact of Banking on Rural Poor in Peninsular Malaysia: Final Report of External Impact Evaluation Study on AIM Active Borrowers, Non-Borrowing Members, Dropouts and Non-Participating Poor.* Penang: Centre for Policy Research, Universiti Sains Malaysia.

Vietnam Development Report, *Attacking Poverty,* Joint Report of the Government-NGO-Donor Working Group, Consultative Group meeting for Vietnam, 1999.

Vogel, Robert C. 1984. *Savings Mobilisation: the Forgotten Half of Rural Finance,* in Adams, *et al., op. cit.*

World Bank. 1996. *A Strategy to Fight Poverty: the Philippines.* Washington DC: The World Bank.

World Bank. 2000. *The World Bank and Cambodia.* Washington DC. [www.worldbank.org]