



DRAFT FOR COMMENT

Asia Microfinance Industry Assessment Summary

**Extract from:
'Microfinance in Asia: Trends, Challenges and Opportunities' soon to be published by
the Foundation for Development Cooperation and the Banking with the Poor Network.**

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This chapter provides a summary of microfinance industry assessments undertaken in 2008/09 as a part of the Citi Network Strengthening Program as well as a report on the India Microfinance Sector published in 2007. The CNSP industry assessments considered are: Bangladesh, China, Indonesia, Nepal, Pakistan, the Philippines, Sri Lanka and Vietnam. Each of these assessments was completed by Asian microfinance networks and provides in depth analysis and description of the respective industries.ⁱ The purpose of this section is to provide a snapshot of the industry by comparing and contrasting various aspects of the each report; it is recommended readers access the respective industry assessments for further insights into each microfinance industry considered.

I. Regional Overview

Population and demographics

In 2007, the population of South, East and South East Asia stood at 3298.3 million; just under half of the entire world's population.ⁱⁱ Although 74% of this number resides in China and India, all countries in this report except Sri Lanka, Vietnam and China exceed the average international population growth rates of 1.2%. Nepal (2.1%) and the Philippines (2%) demonstrated the highest growth rates in 2007. Although life expectancy has risen across the board in Asia over the previous decade, poverty rates, especially in South Asia, still remain high. Gains in poverty reduction achieved in many countries have been undermined by food and oil price inflation over the course of 2008, and will only be exacerbated by current global financial conditions.

Of the countries considered in this report, all are net-loss migration countries, with Sri Lanka the highest at just under -0.5% of the population from 2000-2005. Net migration rates for all other countries are between 1 and 3 per 1000 for these years, with India being the lowest.ⁱⁱⁱ Internal migration from rural to urban areas continues to trend upwards, especially in China, however the populations of all countries considered in this report remain predominantly rural.

Tables 1 and 2: Population and Demographic Data

	Population (millions)			Population growth (%)			Life expectancy at birth (years)		Population < \$2 a day (%)	
	2005	2006	2007	2005	2006	2007	1995	2006	Previous	Latest
Bangladesh	137.0	138.8	140.6	1.3	1.3	1.3	58.1	63.7	81.9 (95)	81.7 (05)
China	1307.6	1315	1321	0.6	0.5	0.5	69.4	72.0	64.5 (93)	37.8 (04)
India	1101	1118	1134	1.5	1.5	1.4	61.4	64.5	85.1 (93)	79.6 (04)
Indonesia	219.9	222.1	224.9	1.3	1.0	1.3	64.0	68.2	64.2 (93)	40.0 (04)
Nepal	25.3	25.9	26.4	2.3	2.3	2.1	57.9	63.2	77.4 (95)	64.3 (03)
Pakistan	154.0	156.8	159.6	1.9	1.8	1.8	60.9	65.2	74 (96)	59.6 (04)
Philippines	85.3	87.0	88.6	2.0	2.0	1.8	67.7	71.4	52.7 (94)	45.2 (06)
Sri Lanka	19.7	19.9	20.0	1.1	1.1	0.6	72.5	75.0	45.5 (95)	41.5 (02)
Vietnam	83.1	84.1	85.2	1.3	1.3	1.2	67.1	70.8	73.5 (93)	43.2 (04)

	Literacy rate > 15 yrs (%)		Urban population (%)			Human Development Index		
	1990	2007	1995	2000	2007	2003	2004	2005
Bangladesh	35.3 (91)	53.5	21.5	23.2	25.5 (06)	0.52	0.53	0.55
China	77.8	93.3	29.0	36.2	44.9	0.76	0.77	0.78
India	48.2 (91)	66.0	26.6	27.7	29.2	0.60	0.61	0.62
Indonesia	81.5	91.4	35.9	42.1	43.1	0.70	0.71	0.73
Nepal	33.0 (91)	56.5	10.9	13.4	16.2 (06)	0.53	0.53	0.53
Pakistan	42.7 (98)	54.9	23.7	33.0	34.9	0.53	0.54	0.55
Philippines	93.6	93.4	...	...	...	0.76	0.76	0.77
Sri Lanka	...	91.5	16.4	15.7	15.1 (06)	0.75	0.76	0.74
Vietnam	...	90.3	20.7	24.2	27.4	0.70	0.71	0.73

Source: ADB Key Indicators for Asia and the Pacific 2008.

Regional Macroeconomic Overview

Up until 2007, Asia experienced significant growth, primarily due to the strong performance of the China and India. However, the impact of the global financial crisis in 2008/09 has resulted in a deceleration in regional growth from a high of 9.5 percent in 2007 growth reduced to 6.3 percent in 2008. ^{iv} In terms of the two largest economies, India slowed to 5.3 percent in the last quarter of 2008 (down from an annual 9 percent for 2005 - 07), while growth in China slowed from 13 percent in 2007 to 9.0 percent in 2008 with forecasts indicating further slowdowns in 2009.^v

Tables 3 and 4: Economic and Labour Force Data

	Labour force (%)			Unemployment rate (%)			Employment in Agriculture (%)			Employment in Industry (%)			Employment in Services (%)		
	2005	2006	2007	2005	2006	2007	2003	2004	2005	2003	2004	2005	2003	2004	2005
Bangladesh	...	58.5	...	...	4.2	...	51.7	...	...	13.7	...	...	34.6	...	...
China	75.7	75.4	...	4.2	4.1	4.0	...	...	...	...	...	...	...	...	...
India	39.2	...	...	3.1	...	...	...	...	56.1	...	...	18.8	...	...	25.1
Indonesia	66.8	66.2	66.6	11.2	10.3	9.8	46.3	43.3	44.0	17.5	18.0	18.0	36.2	38.7	38.0
Nepal	63.6	63.7	...	...	...	...	...	...	...	...	...	...	...	...	...
Pakistan	43.7	46.0	45.2	7.7	6.2	5.3	42.1	43.0	43.0	20.8	20.3	20.3	37.1	36.6	36.6
Philippines	64.5	64.5	63.2	7.8	7.9	6.3	37.2	37.1	37.0	15.7	15.4	14.9	47.1	47.5	48.1
Sri Lanka	48.3	51.2	49.8	7.7	6.5	6.0	34.0	33.3	30.7	23.0	24.1	25.6	43.0	42.4	43.7
Vietnam	52.5	51.1	51.2	2.5	2.3	2.0	59.7	57.9	...	16.4	17.4	...	23.9	24.7	...

	GDP per capita at PPP (current international \$)			Gross Domestic Saving (% of GDP)			Growth rates of real GDP (%)		
	2004	2005	2006	2005	2006	2007	2005	2006	2007
Bangladesh	1109	1195	1298	20.0	20.2	20.5	6.0	6.6	6.5
China	3607	4079	4658	47.3	47.8	48.6	10.4	11.1	11.9
India	2006	2217	2463	34.3	34.8	...	9.4	9.6	8.7
Indonesia	2995	3207	3471	27.5	28.7	28.2	5.7	5.5	6.3
Nepal	990	1029	1079	11.6	9.0	9.7	3.1	3.1	3.2
Pakistan	2030	2210	2395	15.2	13.7	14.7	9.0	6.6	7.0
Philippines	2769	2935	3127	21.0	20.1	20.9	5.0	5.4	7.2
Sri Lanka	3260	3546	3930	17.2	16.4	16.9	6.2	7.7	6.8
Vietnam	1943	2143	2363	30.3	30.6	29.1	8.4	8.2	8.5

Source: ADB Key Indicators for Asia and the Pacific 2008.

There has been a reduction in growth across the board due to the global financial crisis. Declining private investment, a slump in exports and rising inflation due to the surge in global oil and food crisis all negatively affected Asian economies to varying degrees. Although countries such as Indonesia and the Philippines are structurally more robust than during the Asian Financial Crisis of 1997, the current global financial crisis is of another order and the effects will remain somewhat unpredictable in the short and medium term. Countries with less exposure to the global financial sector (such as Vietnam) and those less dependent on exports (such as India and Sri Lanka) have not been as severely affected.

The effects on development have not been fully realised but forecasts are gloomy in terms of the effects on the poor as exports continue to fall, unemployment increases and the flow of remittances decreases, especially to high remittance receiving countries such as Sri Lanka, the Philippines and Bangladesh. This will greatly undermine poverty reduction efforts in the region

Political instability and conflict remains an issue in several Asian countries such as Pakistan, Nepal and Sri Lanka and, as was seen in 2008, natural disaster such as those in Bangladesh and China continue to undermine economic growth in particular regions.

The Asia Development Bank suggests that because of structural reforms made following the Asian Financial Crisis the banking sector is the one positive on the Asian landscape. However suggestions of an increasingly risk averse banking sector and subsequent 'flight to quality' have implications for the microfinance industry in the medium to short term.

Recovery prospects for Asia will depend greatly on each country's ability to manage their own domestic challenges within the context of highly unfavourable economic circumstances. Regionally, this will depend on whether or not monetary conditions remain favourable, food supply levels are maintained, global oil prices remain relatively stable and the speed and depth of recovery rates of the industrial economies in 2010.

Microfinance Data

Data from the 313 MFIs included in the recent MIX/Intelicap Asia Microfinance Analysis and Benchmarking Report 2008 are reaching almost 47 million borrowers, managing over USD 10.2 billion in loans and have deposits totalling more than USD 7 billion.¹

¹ The Mix Market is the microfinance industries leading platform for microfinance data collection. Although the data collected by the Mix Market and published by the Mix does not reflect all microfinance institutions in Asia, its rigour in ensuring transparency and statistical accuracy ensure data included here is reflective of regional trends amongst 'best practice' institutions.

Table 5: Overview of Asian MFIs reporting to the Mix Market

Country	MFIs	Borrowers (Thousands)	Gross Loan Portfolio (USD millions)	Deposits (USD Millions)
Afghanistan	14	358	106	5
Bangladesh	28	21,699	1,680	374
Cambodia	15	802	469	348
China	6	32	13	-
East Timor	2	14	5	2
India	80	9,910	1,359	31
Indonesia	33	3,712	3,558	5,728
Laos	1	<1	<1	-
Nepal	34	478	81	16
Pakistan	15	1,248	143	32
Philippines	55	1,921	365	222
Sri Lanka	14	943	263	189
Thailand	2	5	1	-
Vietnam	12	5,788	2,203	126
Total	311	46,910	10,245	7,073

Source: MIX and Intelicap: Asia Microfinance Analysis benchmarking Report 2008

Asia's relatively high outreach internationally is predominantly bound up in the portfolios of a small number of MFIs in countries with high population densities such as Bangladesh and India. Nevertheless, recent growth rates have been spectacular in parts of Asia but have been inconsistent across countries. In terms of MFIs reporting to the Mix market, in 2007 India and Vietnam had rates of growth 50 percent higher than the regional average of just over 60 percent. On the flip-side, while Nepal grew at only half the regional rate, Bangladesh (24%) and Indonesia (16%) grew at rates of 40 and 25 percent of the rest of the region.

Table 6: Growth Rate for Active Borrowers for Selected Countries and by region (2006 - 2007)

Country	%	Number of Borrowers
Nepal	13%	28,598
Bangladesh	20%	3,318,282
Vietnam	20%	965,045
Sri Lanka	22%	55,202
Afghanistan	32%	80,417
Cambodia	32%	193,408
Philippines	36%	438,417
Indonesia	36%	45,277
India	44%	2,895,159
Pakistan	57%	277,502
Regionally		
East Asia Pacific	24%	1,656,631
Asia	26%	8,311,791
South Asia	27%	6,655,160

Source: MIX and Intelicap: Asia Microfinance Analysis benchmarking Report 2008

II. Financial Sector

As developing countries go, the Asian economies have ridden the financial boom of the last decade and now have well-developed and sophisticated financial, money and capital market systems. In every country commercial banks, both private and public, dominate the formal financial sector and operate under the direct supervision of the central bank, Securities and Exchange Commission/Board, Monetary Board, the treasury and other such financial regulatory bodies.

The microfinance sector in contrast has grown organically and in most cases, where the NGO sector dominates, the growth has been outside the legal and regulatory framework that exists for the banking sector, with the exception of Indonesia where the commercial banking sector dominates. The Philippines is unique in that the development of the sector is the direct result of a concerted effort of the government, donors and the private sector. Microfinance has been used by all countries as a tool for poverty reduction and financial inclusion. As such governments play a key role in the provision of microfinance services in each country, with the exception of Bangladesh.

In Bangladesh, with Grameen as the pioneer in micro credit, NGO-MFIs dominate the provision of financial services to the poorer sections of the population, accounting for 86% of the 14.3 million active borrowers, according to a World Bank study conducted in 2005. Grameen Bank alone accounts for about 29% of market share for microfinance, with BRAC, ASA and Proshika making up the rest. Other players are the specialized FIs (Bangladesh Rural Development Board (BRDB) and government divisions and ministries.

In Sri Lanka, Nepal, Pakistan, China and Vietnam government entities or government sponsored programs are the key suppliers of microfinance services.

In Sri Lanka around 65% of micro credit is provided by the government, with the Samurdhi Development Program introduced in 1995, under the purview of the Department of Cooperative Development, being the largest of such initiatives aimed at poverty reduction. The SANASA thrift and credit cooperative societies, also a vast member owned network and the Rural Development Banks, soon to be merged into one Development Bank are the other two major players.

In Nepal, a country with the lowest levels of outreach, the microfinance development banks (MFDBs) are the predominant direct providers of microfinance services. Financial-intermediary NGOs (FINGOs) and the saving and credit cooperatives (SCCs) are the other institutions that make up the sector. There has been a move to privatize the MFDBs, and as of the writing of this report 5 of the 10 MRDBs had moved into private hands. It is hoped that the commercialization of the sector will widen the outreach.

In Pakistan, the microfinance sector has three key categories of microfinance providers (MFPs) – microfinance banks, rural support programs and specialized MFIs, all three service close to a third each of the gross loan portfolio. Not surprisingly the NGO MFIs serve the largest number of active women borrowers.

China is described as a ‘multilayer of rural financial institutions’, with Rural Credit Cooperatives (RCCs) as the major providers of micro credit and groups loans in China and operate with state

funds as providers of policy lending. A range of other institutions, including policy banks, such as the China Development Bank (CDB) and the Agricultural Development Bank of China (ADBC), state-owned commercial banks, such as the Rural Commercial Bank (RCB), and the newly introduced rural financial institutions that include the Village and Town Banks (VTB) and microloan companies, Rural Mutual Credit Cooperatives (RMCCs), all provide microfinance services.

Government departments directly implement subsidised microcredit operations and/or operate specialised institutions as part of the government's poverty alleviation strategy, such as poverty reduction projects operated by Shaanxi, Yunnan, Sichuan and Guangxi provincial governments. The NGO sector, operating in the less-developed provinces of mid- and west -China implement microfinance on small scale as project - based initiatives. It is estimated that up to 300 such projects have been implemented in China by various UN agencies, like UNDP, UNICEF, IFAD, WFP, ILO, UNFPA, the World Bank, and microfinance projects of CFPA.

Three formal providers dominate the Vietnamese microfinance market, the state-owned VBARD, the policy lender VBSP and the 984 People's Credit Funds (PCFs). They all provide small especially rural loans and savings accounts, but with very different approaches. The fourth, the Viet Nam Postal Savings Company (VPSC) has the potential to become an important deposit mobiliser with a convenient outreach and competitive interest rates. VPSC currently cannot provide credit, but is looking to get licensed as a commercial bank.

VBARD, the AgriBank, with large subsidized credit lines from donors, is the largest bank in the country and provides a full range of services to rural households and SMEs involved in agriculture or off-farm enterprises. VBSP dominates the poverty microfinance market and runs a supply-driven socio-political agenda. PCFs, established in 1993, are community-based financial cooperatives that are owned, operated and governed by shareholding members. PCFs, as the name suggests, is the most demand-oriented of the financial providers however is targeted at the non poor. VPSC targets both poor and non poor client, however, its minimum deposit amount for clients at VND 50.000~ 3 USD provides a significant barrier for the poor to access these services.

India's microfinance sector is dominated by self-help groups (SHG) and microfinance institutions. India is the leading proponent of the SHG methodology and through this model maintains outreach to microfinance clients on a scale not seen elsewhere in the world. The SHG model was begun by the National bank for Agriculture and Rural Development (NABARD); SHGs, which are usually formed by NGOs, governments agencies, and banks, are informal groups of women linked to the formal financial sector. The majority of India MFI providers are NGOs, ranging from for profit, regulated institutions which operate as Non-Banking Financial Companies (NBFCs) to transformed NGOs and traditional developmental NGOs.

Indonesia, one of the first industries to develop commercial microfinance in Asia, has regulated financial institutions providing the bulk of microfinance services. It has numerous subsidized government programs, local and community based financial institutions, cooperatives and NGOs, but these play a very small role in the microfinance sector. The cooperative system, highly politicized under the Suharto regime, continues to suffer from political interference and weak

regulation. It is paradoxical to see examples of populist micro-credit and best practice microfinance operating side-by-side in Indonesia. Of note is the fact that many of the microfinance institutions are owned by one or another of the various levels of government - central, provincial or local. Another significant player in the formal microfinance market is the state-owned pawnbroker, Perum Pegadaian, but this serves a predominantly urban clientele.

In the Philippines, NGOs, rural banks and cooperatives are the major providers of microfinance services. The Philippines National Strategy for Microfinance envisions a viable and sustainable microfinance sector operating in a market-oriented economy where the private sector plays a major role and the government provides the enabling environment.

In-country Regional Focus

Microfinance, more specifically micro credit as a tool of government poverty alleviation policy has historically had a rural focus. With the emergence and subsequent dominance of the Grameen model in the last few decades, the industry currently targets the rural poor, and in most cases primarily women. In Bangladesh, Nepal, Pakistan and Sri Lanka well over 50% of microfinance clientele resides in the rural areas. In Bangladesh the government estimates that the FI-NGOs reach approximately 70% of the poor households and that 90% of microfinance recipients are women.

In Nepal, with just 9% of the population living in urban areas the MFIs operate primarily in the rural areas. Outreach in the hill and mountain regions is sparse because of inhospitable terrain and limited physical infrastructure. The lack of local financial institutions and the unwillingness of large MFIs to operate there only re-enforces the limited outreach.

In Sri Lanka almost 90% of the microfinance outlets are located in rural areas, with less than 10% of outlets located in urban areas and only 1% in the estate sector. Clearly the estates sector is underserved, as is the Northeast and Eastern region.

In India, MFIs have historically operated in rural and semi-rural areas, with some working with peri-urban populations. There has been an upsurge of interest in urban microfinance primarily by three distinct groups - professionals with successful careers in banking and in some cases unrelated fields; microfinance professionals taking on the challenge of uncharted territory of urban microfinance and lastly the well established rural MFIs expanding into neighbouring towns and peri-urban areas. The majority of microfinance providers are located in the Southern states, followed by the Eastern and the Northern region. The Northeast and Central regions are underserved.

Indonesia with the commercial banks dominating, the population served is largely from the urban and peri-urban areas. NGO-MFIs and government cooperatives that serve the rural poor have limited resources and outreach; as a result the rural hinterland is underserved.

In the Philippines NGOs and Rural Banks operate primarily in the rural areas, whereas over 60% of cooperatives engaged in microfinance are located in major urban areas. Women make up 63% of cooperative clientele.

In Viet Nam all three major providers, VBARD, VBSP and PCFs serve the small rural loans and savings market. Women make up well over 50% of the loan portfolio clientele of VBARD, VBSP and other smaller providers.

Since 2001, RCCs have been the major supplier of rural financial services in China building on its large branch outreach and coverage. The RCC began to use bank deposits and funds from the PBC to disburse microcredit loans and group loans to those rural households who could not offer collateral in rural areas. The RCC has operates on a set of policies based on to the pilot microfinance projects of NGOs. It is estimated that while 50 million women has accessed loans by 2008, the overall supply of microfinance products is still low in rural areas.

Access to Microfinance

Access to microfinance by the bottom of the pyramid is keenly scrutinized by the industry in each country. It can be said that those truly at the bottom of the pyramid still find access difficult, if at all they have access. In each country certain geographic areas are clearly underserved and the very non-existence of microfinance providers in these areas is the barrier to access.

In Sri Lanka the Southern province is heavily over-served relative to poverty levels, where as the absence of service providers in the estate sector and in the two central provinces is the most important barrier to access. The estate sector is poorly serviced despite the fact that the poverty headcount is 17% higher than the national average for 2006-07.

In Nepal over 50% of households do not have access to formal financial services which includes both commercial banks and the whole range of micro-finance institutions. Most formal financial institutions are located in urban centres, with 86% of the population living in rural areas it is no surprise that such a large portion of the households are excluded. Location seems to be the one major barrier to access to financial services. In addition, migrant labour and dalits (those at the bottom of the caste structure) are two groups who find it difficult to access credit services.

In Bangladesh the four large entities that dominate the sector have a vast network of branches and an excellent outreach among the rural poor. In the case of the rest of the microfinance providers geographic coverage varies. The less populous and remote North and Southwest districts have relatively few MFIs operating in relation to the rest of the country.

In India, although 9.6 million were covered under the SHG-Bank Linkage program (SBLP) only half of them are estimated to be poor, however strong progress made by the sector bodes well for financial inclusion. However, other factors that indicate that the poor are (maybe) being left behind are increasingly larger loan sizes in the quest for efficiency and profitability and interest rate cap on small loans. Migrant populations in the urban areas in India are another group that has little access to microfinance services.

In Indonesia the commercial bank microfinance entities like the BRI Unit Desa and the BPRs service the middle, lower and near poor groups. NGOs and other semi-formal institutions (cooperatives, credit unions, Villages Credit Boards, rural credit fund institutions) tend to target the poor, but make up a very small segment of the microfinance sector. Therefore there is substantial unmet demand at the BOP. Bank Indonesia defines 'microfinance' as a loan with a

maximum amount of 50 million rupiah (approx. USD 5,000), and it is this upper limit to which a great deal of most of Bank and BRI's lending is directed. However, NGO, cooperatives and credit unions which, which specifically target the BOP, have limited capacity due to the scarcity of funding sources available.

In Viet Nam the policy lending window provides access to ethnic groups, the rural poor, women as target groups. Semi-formal MFIs are the main providers of credit to the BOP together with the vast array of informal players namely, traders, local merchants, money lenders, revolving savings and credit groups. VBSP is the primary lender to ethnic minorities and targets the rural poor and women in particular. Most poor and low-income households (80%) have access to some form of credit and the formal banking system.

Reported access to financial services in China, although relatively high with approximately 31% of all the rural population receiving loans from rural financial institutions, it is also unclear how many of the estimated 13 million people living on less than \$1 a day are considered in the above figures. Statistics provided by the China banking Regulatory Commission suggests that of the estimated demand of 120 million rural households, 75 million (65%) have obtained microcredit and groups loans from rural cooperative financial institutions. However this figure includes all formal rural financial services and does not necessarily indicate how these loans have been targeted. Official concepts of the poor in China may overlap with that of rural households in general (regardless of income), laid-off urban workers and start-up businesses.

On the issue of access to microfinance, India is the only study that explicitly addresses the issue of mission drift, with Bangladesh and China expressing doubts about reaching the "hard core poor". In India, Bangladesh, Indonesia and the Philippines the strong growth of the microfinance industry, in terms of outreach and operational and financial sustainability and efficiency, is gradually pushing the commercialization of the MFIs. The pressure to maximize returns by the new private equity, commercial and social investors is likely to result in scaling-up of operations, dampen the downward pressure on interest rates, and increase the loan size. The desire to reach massive scale may portend well for financial inclusion, but may threaten the quality of growth. In addition, a rise in interest rates and loan size would result in limiting the BOP's access to microfinance.

Trends in the Microfinance Sector

Almost universally, there is increasing interest by commercial banks, registered finance companies and other large corporate entities to enter the microfinance business, which is seen as a profitable new avenue of revenue generation. In India, Indonesia, Bangladesh and the Philippines, where the commercial profitability of microfinance institutions is well documented, the movement down market is currently happening. There is some activity on commercial banks moving down market in Sri Lanka, Nepal and Vietnam too. In India, Indonesia, Pakistan, the Philippines and *China* the reverse is also true with some of the large rural microfinance institutions looking to commercialise themselves.

In Sri Lanka some corporate entities see microfinance as a Corporate Social Responsibility activity or an image building exercise. And a few of these corporations are aggressively moving into the sector and have the resources and infrastructure to scale up rapidly.

In the current global financial and economic climate sources of funding is going to be a crucial factor in the continued growth of the microfinance sector. With the exception of Bangladesh, all other countries have yet to harness the power of savings as a crucial source of capital. In Bangladesh where NGOs dominate the sector a large share (30%) of the sources of funds for micro-credit comes from member savings, with Grameen funding 56% of total its loan portfolio from savings.

In most countries, microfinance institutions are restricted in their ability to mobilize deposits from the public. Under the Grameen model of compulsory savings they are able to generate a limited pool of funds to on lend but realize that the market demand is in flexible, open access, and daily savings services. Legislation on mobilizing deposits is high on the priority list of every country's regulatory agenda. Almost universally, with a few exceptions like Grameen in Bangladesh, BRI in Indonesia and rural banks and cooperative rural banks in the Philippines saving products are available only to members of microfinance providers, and those too come with restrictions on amount deposited at a time, time intervals of deposits and withdrawal limits.

Technology is being used in a few countries to leap frog and close the gap between the commercial banking sector and the microfinance industry on two fronts. First on the operational side technology enhances the institutional capacity of the organization itself. A comprehensive management information system (MIS) (registration, appraisal, disbursement, repayment and monitoring) is essential to achieve scale, improve efficiency, reduce costs and provide day-to-day decision-making support to management. In addition, the benefits of enhanced operational efficiency to financial management and governance are two fold – profitability and investor interest.

Secondly, technology enables an organization to provide a wider range of products and to tailor them to individual needs. The use of hand-held point of sale devices, smart cards, bio-metrics and mobile telephones can accelerate the growth and depth of outreach of the microfinance sector in the next decade.

The use of and access to technology varies from country to country. It ranges from, India, where most microfinance providers have computerized accounts and records to Nepal and Sri Lanka where majority of the MFP in the country currently maintain their accounts and records manually. Limited infrastructure in terms of electricity, telecommunications, hardware and software services are constraints to the application of computer technology to the microfinance sector in rural areas on a large scale in some countries.

Practitioners and expert increasingly recognize that the poor require a wider range of financial services to manage risk and improve their welfare. In all countries the demand for micro-insurance, remittances, individualized saving products and leasing far out numbers the supply of these products. No one country has the right mix, though India and the Philippines stands out in the micro-insurance field with some MFIs (BASIX, SEWA, ICICI in India) and (CARD-MBA, RIMANSI in the Philippines) tying-up with larger commercial insurance companies to provide a range of products. In Pakistan both the microfinance providers and the Rural Support Programmes have experimented with and piloted insurance products. In Nepal, some MFIs offer some institution-based protection schemes related to livestock death and life insurance. Bangladesh,

ahead in the provision of leasing (Grameen phone) and green-lending (Grameen Shakti), is still experimenting with insurance, primarily life insurance.

Remittances are one of the major sources of foreign currency in a most of the countries. It is a service microfinance providers need to gear up for quickly.

Despite a thriving microfinance sector in every country there has been little cross-border exchange or operation. Two examples stand out. BRAC of Bangladesh entered the Sri Lankan market after the tsunami and has rapidly scaled up to become a significant player.

In Pakistan the microfinance sector as a whole is pro-actively working towards growth. The PMN is an active and focused player identifying needs, gaps and areas of focus – outreach, productivity, operational efficiency, delivery models, funding and product range – to move the sector forward.

Few countries are taking the lead in ‘green lending’. In Bangladesh, Grameen Shakti leads the way in market-based integrated approach to promoting renewable energy technologies in rural Bangladesh. In Nepal, microfinance is being used to increase the capacity of poor households to access cheap, renewable energy. The Alternative Energy Promotion Centre (AEP) under the auspices of the Biogas Sector Partnership Nepal (BSP) was established by the Government of Nepal in partnership with SNV and Winrock International. AEP provides loans for biogas systems for domestic use that replace firewood, kerosene and LPG. As of 2007 Nepal had the highest per capita number of biogas systems in the world with 173,000 households.

III. Regulations and Government Initiatives

In contrast to a well developed formal banking and financial sector and in some cases advanced securities and debt-capital markets that are well regulated by country Central Banks, Securities and Exchange Commissions/Boards, Monetary Authority, Treasury and other regulatory bodies, the Microfinance sector is marked by a fragmented regulatory and supervisory system and the absence of an overarching national policy for the sector. Pakistan and the Philippines stand out in terms of the commitment of the government to pro-actively accommodate the evolving needs of a growing and increasingly diverse microfinance sector.

In 2007 the government of Pakistan in consultation with sector players and lead by the State Bank of Pakistan (SBP) set a reform agenda to achieve a target of reaching 3 million borrowers by 2010 (current volume being 1.3 million in 2006/7). The reform agenda has four key items: to bring the two largest players (Kushali Bank and the National Rural Support Program (NRSP)) into the regulated microfinance sector thereby expanding the outreach of the sector; restructuring of the Pakistan Poverty Alleviation Fund (PPAF) to be more than just a window of funding to MFPs but an institutional capacity builder in the management, performance, governance and operational architecture of the sector; facilitating the establishment of a market-based re-financing facility and a 5-year tax exemption for MFBs to level the playing field for NGOs looking to transform into MFB within 2007-2012.

In Sri Lanka, the Department of Cooperative Development and the Central Bank of Sri Lanka (CBSL) regulate and supervise the credit cooperatives, thrift societies, development banks and the licensed specialized banks between them. The NGO-microfinance institutions are entirely

unsupervised. The CBSL is currently working on drafting a Microfinance Institutions Act (MFI Act) that would bring the unregulated NGO institutions under some supervision, but it fails to take a comprehensive, macro view to bringing all entities engaging in microfinance under one unified regulatory and supervisory mechanism. Concurrently, the Lanka Microfinance Practitioners Association is in the process of formulating recommendations for a future policy for the sector.

In view of increasing demand of micro credit and its critical role in poverty reduction in the country, the Government of Nepal issued a 'National Micro credit Policy, 2007' with an aim to create a conducive financial infrastructure and legal environment for the promotion and development of the microfinance industry through diversified microfinance tools. Despite the well intentioned policy, haphazard implementation and poor coordination with the sector players leaves much to be desired.

Bangladesh has been unique in that MFIs have been totally unregulated until the enactment of the Micro Credit Regulatory Authority Act (MRAA) in August 2006. Unhindered experimentation after the success of Grameen Bank led to a massive expansion in microfinance programs through the 1990s and donors contributed by providing revolving loan funds and grant funding. The sustainability and commercial profitability of the larger MFIs has moved the sector from the margins to the mainstream of the financial system in Bangladesh and demand for a legal and regulatory framework has come from within the sector. There is, however, resistance to regulation by a few of the large, successful and now sustainable MFIs despite the call for a regulatory framework coming from none other than the Nobel laureate Dr. Yunus. The larger population of small and medium MFIs would benefit from a legal framework gaining legitimacy conferred by regulation.

In India the strong involvement of the public sector banks in microfinance makes it unique in that a relatively large (and growing) share of the sector comes under the purview of the Reserve Bank of India (RBI). Despite a prominent public sector role India does not have a national microfinance policy. As elsewhere, microfinance specific regulations and legal framework under which the sector operates are limited. The sector has thrived, because most of the innovative growth has been outside the purview of the government.

In Indonesia, the 1988 financial sector deregulation package, 'PAKTO 88' transformed the microfinance sector offering new banking licenses for BPRs, relaxed regulation on banking branches and deposits. In response Bank Rakyat Indonesia (BRI) restructured its rural Unit system and set out on the path of successful commercial microfinance. The 1990s saw a steady stream of financial sector reforms - reduction of subsidized loan programs, upward adjustment in refinancing rates, fully deregulated interest rates and greater control over non-bank financial institutions with a selective licensing policy. Nevertheless, the semi-formal financial institutions continue to be outside the legal framework of banks, resulting in a dichotomous microfinance sector. The 1997-98 Asian financial crises saw a major restructuring of the financial sector and the MFIs came out stronger. In 2003 banking supervision was transferred from Bank Indonesia (the central bank which retains responsibility for monetary policy and banking system development) to the Financial Services Supervisory Agency (LPJK).

Since at least 2001 efforts have been underway to pass comprehensive microfinance legislation, but vested interests have been able to stall it for years. More recently the National Development Planning Agency (Bappenas) has assumed responsibility for the microfinance legislative agenda.

The Philippines is the only country where each category of MFP comes under at least one regulatory or government body. All banking institutions engaged in microfinance (rural banks, cooperative rural banks, thrift banks) come under the regulatory authority of the Bangko Sentral ng Pilipinas (BSP). Through the General Banking Act of 2000, BSP has taken significant initiatives to enable the development of sustainable microfinance. The BSP's current supervisory approach allows for banks to take risks as long as the banks demonstrate the ability to manage, absorb and price for risks taken.

In addition, BSP is building its own capacity for regulating and supervising sustainable microfinance and branchless banking through several initiatives and as such providing meso-level services to the MF sector. These initiatives include: Inclusive Finance Advocacy Staff (IFAS) - an innovation unit, drawing on external learning to ensure optimal evolution of payment and banking models that can serve low-income groups; Core Information Technology Supervisory Group (CITSG) - a central group within BSP to address electronic banking issues and supervise institutions engaged in providing e-banking services; Institutionalization of the Micro, Small and Medium Enterprises Groups (MSME) in 2007; Supervisory Data Centre (SDC) - In 2006 BSP centralized the capture and reporting of data for microfinance within SDC.

As a result of these initiatives qualified rural banks now offer foreign currency deposit accounts, engage in trust activities and operate ATMs.

NGOs in the Philippines engaged in MF are required to register with the Securities and Exchange Commission (SEC) as non-stock, non-profit organizations. NGOs are required to disclose their microfinance activities in their annual submission of their General Information Sheet (GIS) and to file audited financial statements with the SEC, but they are not subject to prudential regulation and supervision by any government authority. Nevertheless, second tier organizations such as the Land Bank of the Philippines and the People's Credit and Finance Corporation maintain some credit supervisory authority over NGOs that borrow from them. In addition, the Microfinance Council of the Philippines Inc. (MCPI) a private sector umbrella group plays an important role in providing self-regulatory oversight of microfinance NGOs and is the repository of information on member NGOs.

Credit Cooperatives classified as non-bank financial intermediaries (NBFIs) are registered and supervised by the Cooperative Development Authority (CDA). CDA however is a weak regulatory because of its dual role of promoter and developer of the cooperative sector.

In Vietnam, the State has been an active player in the microfinance sector, but does not have a coherent national microfinance policy. Microfinance is still seen as a poverty alleviation tool and operates outside the workings of the formal financial sector. The only legal basis to operate is to partner with a mass organization, a local people's committee or a similar entity. The two major road blocks are: i) the regulation of interest rates, that limits the possibility of setting cost-covering interest rates and ii) subsidized, non-market led, supply-driven outreach undermines the sustainability of the microfinance sector and the entire financial system.

In China also, despite the large involvement of the government in the provision of rural financial services, the sector lacks a coherent regulatory framework. Some important changes in China more recently include the *Policies for Pilot Microloan Companies* and the *Guidelines on How to Greatly Develop Rural Microloan Business by Banking Financial Institutions* which have gone some of the way to clarifying the roles and obligations of microfinance providers in the country. This includes lifting many restrictions on the establishment of microloan companies, providing opportunities for NGO MFIs to register their operations, expanding the types of borrowers permitted to take loans, increasing loans size and encouraging a simplification of loan procedures.

However, while the policy guidance has been developed by the China Banking Regulatory Commission (CBRC) and People's Bank of China (PBC) to promote institutional diversification and business innovation, there is still not considered to be a clear definition on the legal status of institutions undertaking microfinance. Government decrees have also hindered the development of the sector by setting caps on microcredit interest rates, placing restrictions on shareholder structure, sources of funding and hope this is proportioned within MFIs.

Availability of Financial Services for the Bottom of the Pyramid

Current efforts to design a legal and regulatory framework that is responsive to and supportive of the needs of the microfinance sector targeting the very bottom of the pyramid are a challenge in every country. Some countries have earmarks (Nepal and Sri Lanka) or subsidies (*China and Vietnam*) but in all, the task of reaching the 'hard core poor' can be achieved only with sustainable lending. Only in Pakistan and the Philippines policy makers have successfully, taken an active role in the development and promotion of the microfinance sector. In Pakistan, as MFBs continue to streamline their systems and processes, service delivery, operating efficiencies and compliance within existing regulation, the SBP has responded with a number of sector-specific regulatory changes, such as the raising subordinated debt to meet capital adequacy ratios; branchless banking and Islamic banking. The latter two brings in target groups that have so far been outside the sector either due to their living in geographically remote areas or due to the religious beliefs.

In the Philippines, the government itself has been a promoter of meso-level institutions so as to enable and support the microfinance providers in increasing the range of products offered to the low-income target groups.

In India, an interest rate cap on small loans and the prohibition on savings mobilization from the public or even members outside of group 'compulsory savings' within the loan program works against the BOP market limiting their access to microfinance services.

In Sri Lanka, with government controlled MFIs leading the sector, political agenda's jeopardize long term sustainability and are a major barrier to reform and scaling-up of MFIs and targeting the 'real poor'. NGO-MFIs that focus on the poor and low income segments are dependent on grants and subsidized credits from foreign donors have limited outreach as they are prohibited by law to accept deposits.

In Nepal, the government in an effort to reach the poor has directed all commercial banks to allocate 3% to the "deprived sector" and all development banks and finance companies

to disburse at least 1.5% and 1% of loan portfolios, respectively, to the poor. Enforcement however has been weak and the poor and lower income clients still have limited access to microfinance services.

Large-scale efforts to provide microfinance as a tool for poverty alleviation in China are overwhelmingly government -led, subsidised and implemented by the major state-banks in rural areas. These are often decentralised and autonomous, and where implemented by the ABC have been undermined by poor rural outreach. The NGO MFI sector is completely dependent on external donor funding for programs targeting the poorest.

In Indonesia only government programs and NGOS target the low-income segment and they form a very small volume of total microfinance loans made.

Viet Nam, on the other hand, has large government funded and subsidized entities that successfully target the poor.

Policy Support for Financial Access and Inclusion

In Nepal, Sri Lanka and Vietnam regulatory reform has been well- intentioned but ineffective and in case of India, Bangladesh, *China* and Indonesia inadequate. A lack of coherent government policy, limited and poor supervision capacity and indifferent participation is a contributing factor in the low level of efficiency. In addition, subsidies and earmarks threaten financial discipline and the long term sustainability of microfinance institutions hence compromising financial access and inclusion in the long run.

In Pakistan, over 2007-08 SBP has demonstrated continued commitment to accommodate the evolving needs of a growing and increasingly diverse microfinance sector. The Government of Pakistan has certainly shown an enlightened open mindedness which has contributed to the successful growth in the sector. 2007 also saw the financial and operational separation of credit programs of multi-dimensional MFPs, the entry of BRAC and ASA of Bangladesh and the formation of the Aga Khan Agency for Microfinance, the first dedicated micro insurance company in Pakistan (providing both retail insurance and through agency-partnerships).

In Indonesia, government micro credit programs that target the poor are often implemented with little regard to microfinance best practices, as is the case of policy lending in Viet Nam.

Bangladesh is unique in its experience as a country where the microfinance sector grew in an entirely unregulated climate. The sector should rally together and ensure that laws and regulation that are put to book are relevant, progressive, supportive and effective.

In India, the proposed microfinance bill first introduced in 2005 is still being debated. The bill will enhance the legal status of the NGO-MFI allowing them to accept savings in the limited form of group savings; create a consumer protection regime through a Micro Finance Ombudsmen; create a national data base in the public domain; set up a Micro Finance Development Council to advise the regulator and continued funding of the Micro Finance Development and Equity Fund. The bill, however, excludes NBFCs and S 25 companies from its purview despite the fact that they comprise the larger and more rapidly growing part of the sector and the majority share of total micro credit

in the country. In fact the more successful NGO-MFIs are increasingly transforming themselves into NBFCs so as to compete with other NBFCs on a level playing field. In fact, the current debate on the proposed microfinance bill is being titled “are we missing an important opportunity with the microfinance bill”.

China’s set of policy guidelines (such Guidelines for Pilot Microloan Companies) are also undermined by a lack of consistency. Although welcome as initial steps legitimizing the work of several institutions providing microfinance, and enabling the creation of VTBs and micro loan companies, they have been criticized as focusing on administrative regulations and departmental rules rather than the need for a framework which takes in the diversity of microfinance providers in China. However, the central government’s No.1 document for 2009 has suggested increasingly liberal microfinance policy, emphasising the role of microfinance is in ‘achieving poverty reduction and supporting microenterprises’ development as well as realizing sustainable operation of MFIs’.

Savings Regulation

Going forward the microfinance sector in every region is very aware that savings mobilization has the potential to provide the sector an important source of funds internally, given the current economic and financial situation. In all countries only licensed institutions are allowed to intermediate deposits. Currently savings products offered by MFPs mirror the conventional products offered by commercial banks. Almost universally, big market players have yet to offer the very short-term (liquid) and low threshold savings accounts popular globally among the poor households.

In most countries, microfinance institutions are restricted in their ability to mobilize deposits from the public. Under the Grameen model of compulsory savings they are able to generate a limited pool of funds to on lend, but realize that the market demand is in flexible, open access, and daily savings services. Legislation on mobilizing deposits is high on the priority list of every country’s regulatory agenda. Almost universally, with a few exceptions like Grameen in Bangladesh, BRI in Indonesia, rural and cooperative bank in the Philippines, saving products are available only to members of microfinance providers, and those too come with restrictions on amount deposited at a time, time intervals of deposits and withdrawal limits.

In Bangladesh, MFIs need express permission from the Bangladesh Bank to mobilize savings from the general public. Cooperative societies can mobilize savings from the general public under the Cooperative Societies’ Ordinance. NGO-MFIs can only mobilize savings from members as part of their disbursement programs. The Grameen Bank is unique in that under the Grameen Bank Ordinance of 1983 it is permitted to accept deposits from the general public as well as from members. And to sell bonds and debentures guaranteed by the government.

In Pakistan, the PMN is actively facilitating innovations in savings related services, and acknowledges that it is an area of microfinance that needs considerable thought and a concerted effort at innovation. Since 2005 MFPs in Pakistan have experimented with micro-insurance products. Initially focused largely on credit-life insurance they have diversified to death, disability and hospitalization (in some revised variations the product cover the spouse of the borrower); maternity-related hospitalization; housing loans; and health loans.

In India, the absence of savings in the operations of MPF has distinguished it from the microfinance sector in most other countries. The highly restrictive legal framework for deposit taking has severely constrained the offering of savings products and as a result savings form just 8% of outstanding loan balances, as against member savings making up 30% of the sources of funds for micro-credit in Bangladesh.

In India, the proposed microfinance bill does little to change this, as the bill limits the permissible savings to 'thrift' i.e. the small compulsory savings of uniform size for all members. Mandatory savings are illiquid, and increasingly do not meet the needs of the poor. The BOP would prefer to be allowed to save small variable amounts, with variable frequency. MFIs world-wide, that have the requisite accounting systems, are moving to voluntary savings with flexibility in amount and timing of savings and withdrawals. More closer to home, Bangladesh in the recently enacted MCRA 2006 explicitly allows MFIs to offer savings withdrawals on demand.

In Indonesia, in the commercially dominated microfinance sector, Bank BRI successfully finances its lending through savings mobilization. Rural fund and credit institutions (LDKP) are restricted in mobilizing savings. Only Village credit boards (LPD) are allowed to accept deposits from members at the village level and NGOs and others outside the legal framework are only dependent on grant funds.

In Viet Nam, the supply of savings products is equally standardized, as in other countries, but relatively widely available. Most MFOs and MOs, as agents of VBSP and VBARD require compulsory savings as a partial guarantee for the otherwise uncollateralized loans. The VWU requires borrowers to deposit into a compulsory 'mutual assistance fund' from which funds can be accessed as emergency loans in case of illness or death (a precursor to credit-life insurance).

Savings products such as term deposits and current deposits are offered in China by formal financial institutions such as ABC, PSBC and RCCs – in the case of the latter these consist of compulsory savings in many cases. Registered MFIs, which are set up by banking financial institutions or private capital, are not permitted to mobilize deposits. Most NGOs and government departments require compulsory savings for their microcredit projects in the form of group fund pledging as collateral or guarantee.

In 2006, the CBRC issued the *Opinions of Pilot Management to Strengthen the Collateral-based Microloan Business of Postal Savings Bank* policy, which permitted the PSBC postal to develop a collateral-based microloan pilot operation by allowing time deposit as the only collateral.

In Sri Lanka, NGO-MFIs are currently limited to giving credit because by law they cannot accept deposits or in some cases they can intermediate deposits from members only.

IV. Retail Microfinance

Structure of Microfinance Providers

Across the board with some exceptions in Bangladesh, India and Indonesia, the legal structure (or lack thereof) of microfinance providers is quite similar. Each country has the microfinance

development banks (MFDBs) usually under the supervision of the formal banking regulator, the government rural support and development programs run by various government departments and ministries, specialized MFIs like farmers cooperatives, saving and credit societies, and lastly the NGO-MFI or financial intermediary NGOs (FINGOs). In Bangladesh the big four NGOs operational in microfinance dominate the sector, in India the public sector commercial banks play a major role, in Indonesia the commercial banking sector is dominant in microfinance provision and in Vietnam policy lending predominates.

The intended target population almost universally is the agrarian rural poor with a specific focus on women. However, various studies and anecdotal evidence suggests that the 'hard core poor' at the bottom of the pyramid may still have limited or no access to financial services to meet their economic needs. Youth, minority groups and migrant populations have historically been outside the purview of the microfinance sector, but should increasingly be given the attention they deserve.

In Sri Lanka, the quasi-government MFIs dominates and tends to cater to a higher income bracket while the NGO-MFIs and member-owned Samurdhi Bank Societies have a greater depth of outreach to low income groups. The estates sector in Sri Lanka despite a disproportionate level of poverty (32% as against the national average of 15.2% in 2006/7) is least served - with just 1% of microfinance outlets located in the estate sector. The product portfolio is limited to primarily loans and savings in Sri Lanka.

In Pakistan the microfinance bank model is the most prominent, although there are a few larger NGO-MFIs based on the Grameen model. The rural support programs are not microfinance specific and maintain a close link with government development efforts.

Nepal has a similar line up in terms of MFDBs, government rural support and development programs, specialized MFIs - financial intermediary-NGO, farmer's cooperatives and saving and credit societies or thrift societies. The privately held MFDBs are better performing than the RRDBs in terms of outreach, portfolio quality, efficiency and profitability. Some of the MFDBs have also been providing remittance transfer services to the clients in cooperation with commercial banks. Geographically the hill and mountain regions are under-served, the youth population is largely untouched and the informal sector, (i.e. money lender, friends, relatives, rotating savings and credit association) accounts for about 75% of the aggregate rural credit.

In Bangladesh the NGO-MFI model dominates the sector, with the Grameen Bank being the only MFB. It serves primarily the rural and peri-urban areas with women as the majority population served. It is estimated that 70% of the poor households in Bangladesh participate in the microfinance sector, with the exception of the remote North and southwest tribal areas. It is hoped the Micro Credit Regulatory Act of 2006 will provide the legitimacy needed by the legions of small and medium MFIs outside of the few large MF-NGOs to emerge as players in the sector.

NBFCs, for profit companies registered under the Companies Act 1956, S 25 companies (not-for-profit companies under the Companies Act) are the primary microfinance providers in India, covering nearly 80% of the total number of clients, followed by NGO-MFIs (societies, trusts, cooperatives) that serve the balance. Public sector banks through the direct priority lending window have played a major role in providing credit to the low-income population.

Geographically, majority of the MFPs are located in the South and West of India with a lesser number in the North. The Central and North Eastern states have far fewer MFPs than the demand for microfinance services.

The majority of microfinance lending in China is undertaken by state-owned rural banks (Including RCCs) downscaling to microfinance lending and also consists of government departments providing subsidised lending. With the bulk of microfinance policy guidelines directed at RCCs, there remains the need for supervisory and regulatory guidelines to distinguish the diversity of microfinance providers in China. As non-governmental MFIs and lending companies are not adequately regulated for under national policy, they come under the aegis of local administrations and departments resulting in inconsistency, resulting in insecure legal structures and undermining investor confidence.

Indonesia is unique in that the formal financial service providers are the major players in the microfinance sector. In 1984, under the new financial reforms undertaken by the government, BRI transformed its sub-branch (Unit Desa) network operating at the sub-district level into commercial microfinance intermediaries. The BRI unit network is now the largest and one of the most profitable rural micro-banking networks in the developing world and perhaps accounts for about 40% of loans by value.

The general commercial banks and BPRs (People's Credit Bank) serve the top end of the microfinance market. The BPRs vary in regard to their interest in and capacity for micro-lending, those owned by local governments and cooperatives are often more micro-oriented, while those under private, for-profit ownership are often more focused on small and medium-sized enterprises. Most formal financial providers above also operate units, branches and products using Islamic banking principles.

The poor households and rural micro-entrepreneurs outside the main towns are served by the semi-formal and informal village-based institutions (BKDs), NGOs and cooperatives which are essentially outside the legal framework of banks and have an unclear legal status in the financial system. NGOs have played a relatively small role in Indonesian microfinance. Government programs however, use NGOs to facilitate the formation of self-help groups for microfinance providers. There is no mention of gender focus within target groups in the industry study.

Three formal providers dominate the Vietnamese microfinance market, the state-owned VBARD, the policy lender VBSP and the 984 People's Credit Funds (all State entities). They all provide small especially rural loans and savings accounts, but with very different approaches. The fourth, the Viet Nam Postal Savings Company (VPSC) has the potential to become an important deposit mobiliser with a convenient outreach and competitive interest rates.

The semi-formal MFOs in Vietnam form a very small sub-section in comparison with the formal sector that has an outreach of approximately 3 million clients as against the reach of the 25 MFOs which stands at 183,586 clients. MFOs are intrinsically linked to mass organizations that legally govern, sponsor or work in cooperation with INGOs to implement microfinance programs. The Women's Union, the Farmer's Union and the Youth Union all manage group loan and savings schemes, implementing INGO-supported microfinance projects and linking clients to VBARD and VBSP.

In all countries informal savings and credit groups are at the bottom of the microfinance ladder. These local, semi-structured, private entities are ubiquitous in the rural landscape and are a well-

integrated part of the community safety net. ROSCAs in Nepal, Indonesia and the Philippines, Chit Funds in India are periodic savings contributions of members, pooled and disbursed to one member at a time on a rotating basis. As in most developing countries traders, shopkeepers and money lenders are an important source of informal credit. Most interestingly, in Viet Nam money lenders are reducing their lending rates as a consequence of the increasing outreach of formal and semi-formal financial service providers.

Product and Service Gaps

In the last decade outreach expansion in the microfinance sector in every country has been impressive, but a majority of providers offer similar and standardized credit and savings products. In most countries, while credit is available to the BOP, the quality of these services and the range of products provided is not meeting the demand for well-designed, affordable and customer responsive financial products delivered flexibly and conveniently. Moving forward the growth and expansion will have to be on the product innovation front. It remains to be seen if the current financial crisis will reverse this favourable trend, illiquidity in the market may diminish the capacity of banks to finance microfinance. On the other hand, the success of the microfinance model has stirred the interest of commercial banks to down scale to the urban microfinance market.

On the savings front almost universally the limitations on timing, amount saved and withdrawals of savings, is the main obstacle preventing rural people from opening saving accounts. With the exception of Bangladesh, where Grameen is a licensed bank, in the other countries studied most actors are prohibited by law to mobilize savings outside of the compulsory savings within the group lending process. This restrictive stance on savings cut off a cheap source of wholesale funds to MFPs thereby limiting their capacity to expand outreach and provide innovative and flexible product as demanded by the clients.

In recent years diversified savings products, micro-insurance, money transfers and leasing have been introduced by a numbers of players. Beyond savings, the demand for micro-insurance and remittances remains unmet too. In most countries, with the exception of India and the Philippines, insurance companies have not yet risen to the challenge of tailoring their current products for the micro-insurance market. Pakistan has experimented with micro insurance products partnering with the private insurance companies to put out some pilot products. The micro insurance market currently focuses primarily on protecting the MFP from loan losses, but products covering health, maternity, disability, livestock, agricultural risk and enterprise insurance are slowly being experimented with in India and Pakistan.

Bangladesh, a country in which micro credit was invented has been slow to innovate and offer varied products. Flexible savings, micro insurance, leasing, remittances are only just emerging as products offered by the MFIs. Currently the micro insurance offered is often disguised as 'loan security fund'. Almost every MFI in Bangladesh offers savings opportunities for borrowers. BRAC and Grameen have a wide range with ASA and BURO Tangail more recently offering flexible saving which enable members to withdraw savings.

In Indonesia, microfinance is essentially credit oriented. BRI, the dominant player mobilizes about 2/3rd of the savings mobilized in the formal and semi-formal sector and offers a wide range of savings products with different degrees of liquidity. Savings accounts are used to build the client's rating and credit collateral. Despite the active participation of the commercial banks in

microfinance, Indonesia could be said to have a supply-led micro credit program. Savings products and remittance services are only offered by the bank BRI Units. Current regulations prevent rural banks and cooperatives to engage directly in remittance services, some are however partnering with third parties to offer money transfer services. The micro-insurance demand remains unmet, insurance companies have not yet risen to the task.

In Vietnam too, the market for microfinance services is not very diversified. With a specialized agricultural bank, agricultural loan products are more easily available. VBARD offers investment and working capital loans for crops, as well as loans for fisheries, livestock, handicrafts, trade and rural infrastructure. Remittances form an important part of the formal financial landscape and are channelled through the formal system directly or through agent arrangements. Insurance penetration rate is low in Viet Nam than elsewhere in the region with more than 90% of the population not having any formal insurance policy. Most insurers target the middle-income market, as this section is still underserved there is little incentive to move down market.

In China the rural banks and microloan companies operating on a commercial basis provide other traditional financial services such as saving and remittances however these are targeted at the 'low hanging fruit' and are do not cater for the poorer segments of the market. Also, s]as in other microfinance industries in past years, the adoption of a 'one-size-fits-all' methodology on a small-scale by NGO microfinance programs has not provided the impetus for innovation and diversification of products. The ABC, RCCs, and PSBC have all begun to offer insurance services using the partner-agent model. Generally however, the outreach of insurance products into rural areas is extremely low, including general life and health insurance products. Non-bank financial institutions are offering insurance products however these are not offered as a part of diversified microfinance portfolios.

As mentioned earlier, India MFIs are handicapped on the savings front due to restrictive laws, but they have been creative about providing credit for a wide range of purposes, and are ahead, together with the Philippines, in the provision of micro-insurance as compared to other countries in Asia.

To the extent that micro insurance has grown today, a large portion of it comprises credit life insurance which automatically bundled with micro-credit. Providing insurance as a standalone product for the poor has not been easy. Microcredit is demand driven whereas micro insurance requires significant marketing and sales effort and some changes to the existing institutional structures and capacity that serve the insurance market. Other issues that countries have to address are staff capacity and incentive structures, distribution channels within MFIs and most crucially the ability of insurance companies to provide suitable, sustainable micro insurance products and services.

In India, ICICI Bank has also been working closely with its insurance subsidiaries-ICICI Lombard General Insurance and ICICI Prudential Life Insurance on the micro insurance front, wherein the products offered include life insurance, health and personal accident insurance, weather insurance and loan care.

Microfinance in the Philippines has a long history of growth and innovation. The range of products and financial services provided are one of the widest. From traditional micro-credit, the

several hundred microfinance institutions that operate throughout the country provide microfinance for agriculture and agri-related risks, housing, services for Overseas Filipino Workers, micro-insurance and business development services.

Use of Technology

In South Asia, India is the only country where the use of technology is wide-spread from MIS, specialized auditing, account (loans, savings and deposits) tracking, internal accounting and financial reporting to the use of PDA application to capture field transactions. Nepal and Sri Lanka are primarily on a manual system. In Bangladesh, use of technology is limited to the large four MFPs and that too at the headquarters level. In most countries limited infrastructures in terms of electricity, telecommunications and mobile phone networks, and hardware and software services are constraints to the application of computer technology by the MFIs. As a result operational efficiency in India is higher than in any other major region offering microfinance.

In South East Asia, the Philippines stand out in the use of technology in sector growth and this is supported by government initiatives and a robust regulatory framework.

In all countries the use of ICT and mobile phone networks are recognized as the next big push. Mobile banking and tele-marketing are being used to leap frog the constraints of limited physical infrastructure and offer a greater diversity in small-balance savings products, insurance, remittances and leasing. Technology is also pushing countries to test individual lending methodology moving away from the group lending model.

In India the sector has seen record growth rates in the last two years, and even as it increases outreach it continues to be amongst the most efficient in the world. Pakistan is proactively working to achieve efficiency levels comparable to India. High growth brings with it the need to maintain sustainable profit margins and the pressure to emphasize commercial behaviour and hence the charges of mission drift. The challenge is to achieve growth with equity and efficiency.

Mission Drift and the Missing Middle

In the rush to grow most MFPs acknowledge the risk of 'mission drift'. The sector as a whole targets the poor, especially women, but it is unclear as to how deep the poverty outreach is in reality. While in countries like Nepal, Sri Lanka, Vietnam and the smaller players in Bangladesh, where a larger proportion of MFPs are not operationally and financially sustainable, the focus is still on the poor. In India, Indonesia, the Philippines, *China* and maybe Pakistan the desire to reach massive scale, maximize returns and commercialize operations has certainly moved the sector away from the original mission of micro-credit to alleviate poverty.

The growth of the microfinance sector and its gradual move 'up market' has highlighted the demand for financial services outside the traditional BOP market by small and medium enterprises. This is increasingly being referred to as the 'missing middle' where the market is looking for more flexible and individualized credit services – loan size, loan terms and varied repayment – together with business development training and technical assistance. This group of small and medium entrepreneurs tends to be urban based and has insufficient access to the formal banking system. Its demand for individual customized loans is a challenge for the microfinance industry that has to date worked with the group lending model. However, increasingly even the clientele at the BOP is demanding more flexible and individualized service. The question that comes up is: In the push to move 'up-market' do the successful MFPs view funding SMEs as the next frontier for the microfinance industry?

With this rise in demand-driven service and change in the mix of clients there has emerged a demand for ancillary business development services by target groups. MFIs on the other hand, see the need for technical assistance and training for themselves and are coming together to create an industry infrastructure that supports capacity building within the sector, namely: standardized reporting specialized auditing, organizational governance, rating agencies and client credit reference services. What is needed in all countries is a strong meso-level infrastructure with direct contact and coordination between the semi-formal and the regulated providers who serve the market.

Need for a Regulatory Structure

To date in most countries the microfinance sector has grown on the margins of the formal financial sector and as an anomalous part of the civil society social sector. There is recognition in all countries that microfinance has come of age and needs a well defined regulatory structure and standardized institutional framework that can move the sector forward. In most countries the demand for a regulatory and legal framework is coming from within the sector. The growth, effectiveness and operational sophistication of the industry now demands formal legal and regulatory structure for the sector to flourish and provide the innovative and expanded product and service range that the clients demand. Lack of a legal framework is clearly a constraint for MFIs trying to access capital from both the commercial and grant monies.

Regulation on savings is universally seen as imperative for the sector to move forward. In the current economic climate deposit mobilization from the public will be an important source of wholesale funding.

The current global financial crisis lends urgency and need for a supportive but effective regulatory framework. The lack of oversight and tight supervision of the global financial system is often cited as one of the major causes of the current debacle. For the microfinance sector to grow on several fronts - outreach, efficiency and profitability, scale and professionalism - a legal framework will provide both clientele (savings, insurance) and investors (capital) the confidence in the institutions they invest in.

V. Microfinance Meso-Level Organizations

The microfinance sector in most countries is supported by a diverse set of institutions, comprising national associations, networks, apex institutions or issue-based entities all supported or promoted by governments, by voluntary sector agencies both national and international, by bi- and multi-lateral agencies and even the private sector. Ideally, the meso level institutions seek to:

- enhance the capacity of retail MFIs through training courses;
- build up technical expertise and disseminating operational best practices;
- develop and disseminate the use of performance measures and promote financial transparency in retail MFIs;
- help create an enabling environment for retail MFIs; and
- build a greater awareness among policy-makers as to the needs of the sector.

There is demand for other support services too - MIS/IT, specialized microfinance audits, organizational and institutional capacity building (finance, operations, human resources,

governance) and product rating, credit reference and market research. Depending on local skills levels there are a few private companies that provide technical assistance and consultancy services to the sector.

In Asia as elsewhere, capacity building is essential for microfinance practitioners to consolidate their portfolios and prepare for significant expansion, and eventual transformation to fit into the legal and regulatory framework of their countries. Both microfinance practitioners as well as formal financial institutions have to develop their respective capacities to cooperate with one another to forge successful partnerships for sustainable microfinance. In addition to ensuring the bottom line of profitability, both investor and client retailer of financial services for the poor have to be aware of their social responsibilities, and ensure a balance of financial, social and environmental impact. Capacity building must be informed by the available knowledge on the ground and inspire innovation at the operational and policy levels. Practitioner led, practitioner informed research combined with rigorous scientific methodology of data collection and analysis can inform high quality curriculum and training materials that can be tailored and adapted to meet the specific needs of users. Particular emphasis is needed on improving the efficiency and productivity of financial service providers to manage growth in a sustainable manner.

Government support for building the institutional infrastructure is for the most part absent. This may stem from the fact that many of the government development programs that include a microfinance component are often managed without considerations of microfinance best practices, creating an unsustainable source of cheap funds, and an unfair competition to commercial microfinance providers.

Pakistan is unique in that it has a few strong meso-level institutions that have been instrumental in proactively initiating and pushing the microfinance industry agenda forward. The Pakistan Microfinance Network (PMN) is dedicated to improving the outreach and sustainability of microfinance in Pakistan. PMN acts as a disseminator of microfinance information with the aim of enhancing the scale, quality, diversity and sustainability of microfinance providers in Pakistan and publishes the Pakistan Microfinance Review. It has gone further to include research, social performance management and setting up of a Pilot Credit Bureau. It also seeks to become the voice of the different stakeholders in the microfinance industry and has been selected as one of the 10 partners under the SEEP Network Technical Assistance and Action Research Project.

The Pakistan Poverty Alleviation Fund (PPAF), a national apex association wholesales funds to MFPs and also supports outreach and diversity of financial products offered, grants for small scale infrastructure projects; training and skill development and social sector interventions. PPAF is committed to market development and the emergence of a professional microfinance sector.

India too has a few strong meso-level institutions, but is also supported by a quality private consulting world that focuses on the civil society sector. Sa-Dhan in India is the primary network of microfinance institutions and plays a crucial role in increasing the capacity and improving the quality of its member organizations. Sa-Dhan provides the platform for peer learning and exchange; the policy advocacy and legal reform; training and seminars; market research and information dissemination; performance monitoring and benchmarking; and hosts an annual conference and other industry events. The recent highlight, that enhances the cause of

transparency and timely reporting, has been the publication of 'Quick Report 2007: A snapshot of Microfinance Institutions in India' within four months of the closing of the financial year.

China's considerable challenges in establishing a best practice microfinance industry is supported by the work of the China Association of Microfinance (CAM). As the network of a nascent microfinance sector, CAM has a broad membership consisting of stakeholders including MFIs, government administrative departments, domestic and international organisations as well as academics. While a key focus of CAM is to continue to encourage the government to provide a conducive and structured environment for the microfinance industry, it also focuses on raising funds for MFIs in the absence of wholesale funds or guarantee institutions.

The Philippines has a wide variety of meso-level institutions. Each category of MFPs – NGOs, rural banks and cooperative has an apex body. The Microfinance Council of the Philippines, Inc. (MCPI) has a predominantly NGO membership but has a vision to becoming the national network. The Rural Bankers Association of the Philippines (RBAP) and the National Confederation of Cooperatives are the other two networks. On the training and technical assistance front, in addition to the above, the Asian Institute of Management, Bayan Academy, CARD MRI Development Institute (CMDI), Punla sa Tao Foundation and Social Enterprise Development Partnership, Inc. provide a combination of practitioner-led and more formal specialized training courses. PinoyMe, a private consortium of academics, MFIs, corporations, foundation and NGOs is seeking to bring together stakeholders from multiple sectors to widen the access of the poor to financial services through capacity building, resources mobilization, business development services and knowledge management. Lastly, there are the PCFC facilitated Regional Microfinance Associations, for its partner MFIs that share best practices and credit information of borrowers among the membership.

Bangladesh, Nepal, Sri Lanka, Indonesia and Vietnam all have varying quality of meso-level resources. Credit Development Forum (CDF) in Bangladesh, a network of MFI-NGOs, acts as a common platform to share learning, information and exchange on microfinance best practices and technology, training and research. And as a sectoral advocate for the creation of a supportive regulatory policy environment. CDF also provides network linkages to regional and international micro finance bodies. The Palli Karma Sahayak Foundation (PKSF) is an apex micro credit funding and capacity building organization.

Nepal, the Rural Microfinance Development Centre Ltd a wholesale funder has taken on providing intensive training and technical assistance to promote and develop new MFIs and its partner organizations. RMDC has a strong relationship with the central bank and has played a vital role in developing a conducive legal and regulatory environment for the microfinance sector in the country.

Rural Finance Nepal (RUFIN), a joint Nepali-German project, provides technical assistance to the Agriculture Development Bank; The Centre for Microfinance (CMF) established in 2000 with support from CIDA and Ford Foundation conducts training and research on microfinance; the National Federation of Savings and Credit Union Nepal (NEFSCUN) established in 1988, is an apex organization for savings and credit cooperatives in the country. The Credit Information Bureau Limited (CIB) is the repository of credit information of

the customers and commercial borrowers of all banks and financial institutions and disseminates to them on demand.

In Sri Lanka, the sector is represented by the Lanka Microfinance Practitioners Association (LMPA) established in 2006 and supported by GTZ and Plan Sri Lanka. The network with a membership of 80 MFIs is still very much in the early stages of development. MFIs like SEEDS, SANASA have their own specialized training centres. Other technical resources that the microfinance sector can access are the formal banking sector, the University and international organizations.

Institutional support for the microfinance sector in Indonesia comes from a diverse set of institutions. Perbarindo, the long established national association of BPRs has been providing training and technical support and is now developing capacity building and performance tools in collaboration with GTZ and Bank Indonesia under the Pro-Fi (Promotion of Small Financial Institutions) project.

The Indonesian Movement for Microfinance Development, GEMA PKM, has been an industry network which has been an active partner in drafting the new laws and regulations on microfinance and in promoting awareness and adoption of best practices in microfinance as a tool for sustainable poverty reduction and economic growth. A nascent Indonesia Microfinance Association (IMA), responsible for the annual Indonesia Microfinance Conference, is also being established.

The Credit Union Coordination Board of Indonesia, BK31 is the national apex organization for financial cooperatives aims to strengthen the development of autonomous and self-reliant cooperatives.

In Viet Nam the emerging microfinance sector is supported by the Viet Nam Association of People's Credit Funds (VAPCF), the Viet Nam Microfinance Working Group (MFWG) and the newly set-up M7 Network. The VAPCF established in 2005 seeks to foster dialogue with state agencies and disseminates key legal information on new government decrees and decisions; facilitates training and consulting to the members; and maintains a website that facilitates information sharing within the membership.

The MFWG, revived in 2003, serves as a hub for lobbying and advocacy efforts. Like the VAPCF it facilitates dialogue with the SBV and other government authorities; facilitates regular sharing of lessons learned within the membership; works to raise the awareness of microfinance and links practitioners to microfinance training events; and maintains a database of microfinance programs in Viet Nam. The semi-annual publication of the Viet Nam Microfinance Bulletin has been its key achievement, providing outreach and financial data of 25 MFOs and VBSP.

As is evident the meso-level institutions in most countries are young and still work in isolation with little information sharing and exchange and at varying capacity and skills level. Clearly there are no central microfinance training and support networks; more so, there is little contact between the formal regulated finance sector and the microfinance (both semi formal and unregulated) sector. In some countries of the private consulting firms that provide training and technical assistance few are local.

Since the mid-1990s the Banking with the Poor Network has acted as Asia's regional network. Today, the BWTP Network draws together some 35 institutions, comprising MFIs, commercial and central banks, wholesale and support institutions, technical assistance providers and microfinance networks from ten Asian countries (Bangladesh, India, Indonesia, Nepal, Pakistan, Philippines, Sri Lanka, Thailand, Vietnam and Australia). The aim of the network is to expand the outreach of financial services, and to encourage innovative dialogue and productive linkages between microfinance organisations and formal financial institutions in Asia and the Pacific. FDC, in its role as Secretariat of the BWTP Network, is also working towards transforming the Network into a unique platform for cooperation and peer learning in Asia. The BWTP Network and FDC host biennial Asia Microfinance Forums and annual Asia Network Summits.

MFI Rating and Credit Risk Assessment

In the Asia region, India is the only country with a credible rating agency – M-CRIL: Micro-credit Ratings International Limited. The Philippines has the Philippines Coalition of Microfinance Standards that provides a set of performance standards to serve as guidelines or benchmarks to assess the operations of Philippine NGOs involved in microfinance. In Viet Nam PlanetRating, part of the PlaNetFinance a French organizations has recently entered the market. In Nepal, wholesale lending organizations (like RMDC, SKBBL) appraise their applicant institutions themselves before making approval of a loan.

At a time when microfinance has enjoyed a great deal of success and exposure MFIs face a distinct challenge when trying to encourage prospective donors and financial markets to back their activities. Although evaluations and assessments are available to MFIs from credible agencies, these tend to be expensive, and lack a common standard that can be applied to the entire industry. M-CRIL, India aims to be a regional resource to the microfinance sector. What is required is a credit rating system that takes into account the nuances of the field, and sends a clear signal to donors and investors of their sustainability.

In all countries there is little institutional infrastructure addressing client credit risk. With expanding outreach and rising levels of competition MFIs in every country need a sector-wide credit information sharing system. There are a few credit bureaus in some countries but they have limited membership within the microfinance sector and do not span the entire range of microfinance providers.

VI. Funding sources

Globally, as of June 30, 2003 development investors (private sector arms of bilateral and multilateral agencies) and social investment funds (socially motivated privately-managed investment funds financed by both public and private capital) have allocated over a US 1 billion for the microfinance industry, of which 90% is accounted for by development investors. It is interesting to note that Asia (East Asia and South Asia) the largest and poorest microfinance market attracts only 5.6% of development investor capital and 6.6% of social investment funds. One possible explanation is that Asian MFIs have been able to secure funding from governments and regional multilateral lenders at subsidized rates more easily than MFIs in other regions. In

addition many profitable MFIs in East and South Asia have successfully intermediated funding from domestic sources including deposits and bank loans.²

Under the current economic climate domestic financing in the form of deposits and bank loans will remain the predominant source of funding for microfinance. Mobilizing deposits, both savings and current account, is the key to having a permanent and stable source of funding which is also cost-effective. Commercial banks moving down market will expand the industry, but it remains to be seen how much of that happens in the current global financial reality.

In Asia, Bangladesh because of the successful big-four – Grameen, BRAC, ASA and PROSHIKA – stands out as the most self-sufficient. Internal saving of members and interest and service charges from credit disbursed, accounts for approximately 59.5% of funds for the microfinance sector in 2005. Other sources like local banks, government wholesale agencies and NGOs account for 32.6% of fund and external sources like international donors and NGOs contribute only 7.9% of fund for the microfinance sector.

In recent years the Indian microfinance industry has become one of the most leveraged in the world due to the rapid expansion of commercial bank lending and the enhanced interest shown by private equity funds and social investors and venture capital. Most MFIs started with grants and concessional loans from apex financial institutions and have gradually made the transition to commercial funding. The lack of resource options given that they cannot take deposits and a decline in availability of grant funding has led the Indian microfinance sector to diversify its funding base. As of March 2006 ICICI Bank's lending had grown to constitute about two-thirds of total lending to the sector with about 60% of its lending coming under the partnership model. SIDBI and FWFB are two other major sources of funding.

In India, two innovative examples stand out. The ICICI bank has tied up with Grameen Foundation USA to set up Grameen Capital India (GCI). The partnership model enables the bank to service the poor clients effectively, with substantial risk sharing between the bank and the partner NGO/MFI. Under this model, ICICI Bank forges an alliance with existing MFIs wherein the MFI undertakes the promotional role of identifying, training and promoting the micro finance clients and ICICI Bank finances the clients directly on the recommendation of the MFI. Secondly, under the securitization model, ICICI Bank buys out the portfolios from MFIs. The MFIs continue to service the clients and act as a collection agent. Here again, the MFI shares the credit risk with the bank. Under, the on-tap securitization model, the MFI receives an advance purchase consideration to create a portfolio of loans that could then be periodically sold to ICICI Bank.

In addition, Micro-Credit Ratings International Ltd. (M-CRIL) a specialized rating and microfinance research agency has pioneered and successfully introduced the credit rating of Microfinance Institutions (MFIs) in Asia. M-CRIL is also pioneering an initiative to develop social rating as a complementary activity to its credit rating service. It is hoped that such capacity within the sector, in India and in the region will push the frontiers of the industry and enable it to attract non-grant monies.

² CGAP: Focus Note 25, January 2004, Foreign Investment in Microfinance: Debt and Equity from Quasi-Commercial Investors http://collab2.cgap.org/gm/document-1.9.2569/FocusNote_25.pdf

In Pakistan, the performance of the microfinance sector is in sharp contrast to the wider macroeconomic context within the country and globally. Total funding available to the sector increased by 33% over 2006-07. The three sources of funding that make up the majority of funds available are paid-up capital, donor grants and subsidized debt. There has been a steady increase in savings (from 11 to 13% of total liabilities for the sector) and commercial debt (from 8 to 11% of the total capital available to the sector) as a source of funding for the sector. Experts in the sector are grappling with alternative trajectories, one to innovate and gain efficiencies or to consolidate in the traditional mode and at the same time surviving the current global financial crisis.

Indonesia, where commercial finance dominates, equity participation by private investors and savings deposits are the major sources of funds for the microfinance industry. Government and donors fund the rural development programs and the small number of financial service NGOs and other MFIs operating in the rural areas.

In the Philippines, Government Financial Institutions (GFIs) intermediate funds to the retail MFIs. The People's Credit and Finance Corporation (PCFC), is the only agency mandated by law to provide financial services to the poor through wholesale funds to retail MFIs. The Land Bank of the Philippines, also a GFI, on lends ODA funds received from multilaterals. The NGO-MFIs receive program and technical assistance funding from USAID, UNDP, IFAD, ADB and the EU. In addition, large international organizations like Grameen Foundation, USA, Oikocredit, Plan International, World Vision, and CARE Philippines also provide wholesale funds and technical assistance. More recently local commercial banks and two international banks, namely Citibank and HSBC have opened loan facilities to retail MFIs.

Nepal, Sri Lanka, China and Vietnam are countries where the microfinance sector relies heavily on government subsidized funding and international donors.

In Nepal the sources of funds for microfinance programs in the country are the Deprived Sector Credit funds from commercial banks, wholesale lending organizations and a few international donors. Commercial banks contribute to the microfinance industry as wholesalers and equity investors and are required to disburse at least 3% of their total loans outstanding to the deprived sector.

There are three wholesale funding agencies operating in the Sri Lankan microfinance sector. These are the government owned National Development Trust Fund (NDTF), Stromme Microfinance, backed by the Stromme Foundation of Norway, and Consorzio Etimos, a funding agency based in Italy. The NGO-type MFIs are restricted by law from accepting public deposits and further restricted from obtaining off-shore debt and equity funding due to prevailing exchange control restrictions. Accessing local funding is also somewhat of an issue as local banks and other commercial funding agencies are still reluctant to lend to or invest in the microfinance sector due to the perception of high risk. Donor funding that surged in the aftermath of the 2004 Tsunami is after five years seeing a phasing out. There is interest among the off-shore microfinance funding agencies but a restrictive legal environment and a cumbersome approval process serve as deterrents.

In China, dependence on grants from external donors for microfinance funding has been steadily declining; from 30.4% of total revolving fund in 1997, 13.3% in 2003 to 7.9% in 2005. On the other

hand, loans from banks have increased in recent years from 8.3% in 2003 to 16.9% by the end of 2005.

Only in 2008 was the issue of funding of newly established microloan companies addressed in China in policy guidelines. These companies are now permitted to source funds from 'not more than two banking financial institutions' while also continuing to finance from shareholders and donated funds. This is resulting in an increase the funding of Village and Township Banks (VTBs) and microloan companies. Despite these positive moves, micro lenders operating on a commercial basis still have restrictions on funding sources and the amount of funds borrowed (cannot exceed 50% of net capital). ACCION International, ASA of Bangladesh, and IFC under World Bank have all participated in the bidding process of microloan companies.

In 2006 the China Development Bank provided wholesale fund to the China Foundation for Poverty Alleviation which marks the first time a government institution has provided wholesale funding for NGO sector microfinance lending. However, commercial investment, especially from foreign sources, is restricted, with microfinance investment funds wishing to invest in China are not permitted to initiate the formation of VTBs not to own more than 10% of shares in an MFI. Also, foreign banks wishes to set up MFIs have been permitted only to provide loans and not accept deposits. There has been an increase in the number of foreign banks such as KfW, HSBA and Standard Chartered and international financial institutions such as the IMF purchasing shares in rural commercial and cooperative banks or setting up microloan companies to provide microcredit at commercial rates.

In Viet Nam government is the largest source of funds for the formal financial service providers in the microfinance industry. They also have access to donor credit lines, but the semi-formal sector gets all its funding from key donors namely GTZ, AusAid, Ford Foundation, CIDA and Belgian DGDC. Policy lenders (VBSP, VDB) and CCF the apex institution that on lends to PCFs access government budget funds and ODA credit. Competition between the commercial banking sector and the specialized financial institutions has encouraged financial deepening as both seek to reach lower income clients.

VII. Impact of Microfinance Activities

With few exceptions, the spectacular growth of the microfinance sector in Asia has been fuelled by conscious efforts of national governments, NGOs, and the donor community (bi- and multi-lateral), all view microfinance as an effective poverty alleviation tool. Countries have attempted to examine the economic and social impact of microfinance, but there are few studies that accurately assess the benefits and probably non that can be compared over time and countries. However, in countries where impact assessments have been reported in Industry Assessments (Nepal, Bangladesh, India, Vietnam, *China* and the Philippines) benefits identified vary widely:

- better food security and nutrition,
- better housing and health,
- better school enrolments for children,
- women's empowerment and mobility,
- higher average household income and/or a more secure and consistent cash flow over the year,

- higher levels of literacy,
- building of human capital and assets and community participation,
- self-employment and employment of family member,
- employment creation- employment of non-family labour.

Impact assessments are however, plagued with methodological issues: the difficulty of obtaining a comparable control group; disentangling credit benefits from the benefits of complementary development inputs of social programs and limiting the number of attributes that define an assessment are only a few of the constraints. The industry has yet to standardize the framework used for such assessments. Parameters and framework vary depending on who commissions the assessment –government, donors, internal industry stakeholders or investors.

In India, the microfinance sector is one step ahead, distinguishing between impact assessments and social performance indicators. In India social impact attributes studied differ from those undertaken in Nepal and Bangladesh. Assessments in India are done more in tune with rating for external investors rather than as impact on poverty alleviation. Poverty audits and gender targeting, the two essential attributes of micro-credit, make up only a small component of social audits. (mission drift, interest rate caps, restrictions on deposit mobilization)

Micro-Credit Ratings International Ltd. (M-CRIL) in India is a specialized rating and microfinance research agency that has pioneered and successfully introduced the rating of MFIs in Asia. M-CRIL is pioneering an initiative to develop social rating as a complementary activity to its credit rating service. Of note here is the fact that such services cater to the ‘successful-end’ of the microfinance sector that probably makes up a very small proportion of the industry in most countries with the exception of India and the Philippines, where there are a larger number of financially sustainable MFIs. Undertaking such rating initiatives is expensive and usually commissioned by an interested stakeholder rather than universally done to mark the progress in the sector over time.

In contrast, financial performance indicators for the sector have to an extent been standardized and are almost routinely included in annual reports of MFIs. There are now industry systems to track financial sustainability with clear definitions and indicators for reporting on financial performance. Moreover, the interest shown by commercial banks and other private investors in microfinance, will only further fine tune and standardize financial reporting to bring it up to the corporate world’s level.

In the current global financial climate the microfinance sector will have to guard against settling for a low-level equilibrium. Most impact assessments are silent on negative impacts and cautious in highlighting the limited success programs have. The limited number of impact assessments done reflect the broader difficulty the sector faces in conducting such studies.

VIII. Opportunities and Challenges

The microfinance sector has emerged as an effective strategy to addressing poverty and empowering the poor. The capacity, the quality and range of microfinance institutions and the infrastructure that supports it varies widely within countries and from country to country. Financially sustainable, commercially viable MFIs co-exist alongside donor subsidized entities and basic community revolving funds. In every country, a few large institutions account for the bulk of

outreach, with Bangladesh being the most extreme where Grameen, BRAC, ASA and Proshika account for 86% of the microfinance market. The market in India, Indonesia and the Philippines is more vibrant, where banks and non-bank financial institutions are gaining greater importance. In Nepal, Sri Lanka and Vietnam there continues to be significant government involvement in service delivery, with micro credit used at a policy level.

Most countries face similar opportunities and challenges, some more so than others.

Opportunities across the region include:

- Getting the long term policy and regulatory reform right
- Access to commercial funding – banks, private investors
- Number of successful MFIs graduating to join the leaders
- Expanding outreach with the down-scaling of commercial banks
- Savings / deposit mobilization as a sustainable source of funding
- New Products with the use of technology.
- Partnerships across sectors

Challenges:

- Organizational capacity of MFIs outside of the few large and successful ones
- Existence and institutional capacity of Meso level institutions – networks, credit bureau, financial and social rating agencies, training and TA, business development services
- Limited product range, current clientele needs– micro insurance, remittances, savings, new products frontiers (agriculture and agri-based industries, housing, SME – historically credit for petty trade)
- Access to technology
- Mission drift
- Policy lending as against market discipline
- Legal and regulatory framework

The greatest opportunity for the sector is the attention it has received in the last five years, and the general acknowledgement that microfinance is an effective poverty alleviation tool. Governments, MFIs, the development community and private investors are all focused on creating a supportive policy environment, developing the financial infrastructure and viable institutions and supporting pro-poor product innovations to ensure permanent access to financial services for the majority, as against “the exclusive financial systems that have for decades benefited and protected the wealthy”, Maria Otero, President and CEO ACCION International.

In all countries without exception, concerted action in changing the legal and regulatory framework to create an enabling environment has been under way for the past several years. Some countries, especially the Philippines, are further ahead on the reform agenda, but all see this as a major hindrance to move the sector to the next level.

In Pakistan, India and the Philippines, country, and more recently, regional microfinance networks play an important role in creating a conducive environment for the growth and expansion of the sector. The networks are almost invariably membership organizations that provide a wide range of

services to the membership as well as represent and advocate for the sector as a whole. The primary objectives of meso-level organizations vary but include all or a combination of the following:

- To advocate for policies which promote an enabling environment for microfinance
- To develop the capacity of their members through training courses offered directly by the network or through partnerships with other training providers.
- To facilitate information sharing and dissemination and exchange for the entire microfinance industry
- To promote performance standards and best practices
- To liaise on behalf of members with banks and investors and respond to their funding needs
- To conduct research on issues and product innovation within the sector

In most countries the meso-level institutions themselves need to build their capacity and technical skills to effectively support and represent the membership. There are structural and operational challenges that limit the scale and outreach of these institutions. Within the meso-level structure the biggest challenge is how to meet the ever expanding range of needs of a very diverse membership.

In addition to the support infrastructure required, there is need for collaboration among MFIs to share client databases in specific geographic areas so as to reduce overlapping and strengthen credit ratings. Rapid expansion has resulted in over indebted clients with multiple loans because of keen competition between MFIs. Client credit rating to avoid portfolio risk and rating of credit institutions from the perspective of investors are two services that the industry needs urgently.

In Asia, the sheer numbers pose a challenge. The phenomenal growth in outreach still leaves many without access to micro credit or microfinance services. There is limited access to the remote rural hinterlands because of inadequate physical and economic infrastructure. In addition, the unwillingness of MFIs to operate in these areas results in the entrenching of poverty among the population. The ultra poor, the marginalized castes, minorities, migrants and the destitute are still excluded. Add to this, the 'mission drift' alluded to by the larger MFIs and the basic objective of poverty alleviation is jeopardized. It is hoped that the use of ICT, namely mobile telephones and point of sale devices can enable transactions in broader geographic areas.

More than a challenge, in countries like Bangladesh, India, Pakistan and the Philippines the industry faces two dilemmas, one of sustainability versus expansion in client base and second of small versus larger loan size. To work towards sustainability MFIs need to professionalize and upgrade staff skills (especially in finance), use of technology, systematize and streamline operations with management information systems and achieve cost efficiencies. To achieve an expansion in client base MFIs would have to expand horizontally to service the increased numbers as against the vertical professionalization of all functions within the institution.

Sustainability, as well as interest caps (especially in India) on small loans has prompted MFIs to provide larger loans and hence all together forgo the target population of the very poor. In such instances 'mission drift' becomes a default option, leaving the MFI little room to manoeuvre.

So far the focus of growth in the microfinance sector has been credit and a very limited range of often rigidly designed products. Going forward, more than credit, savings is going to be the key that leads the sector. Product innovation on the savings front will provide the much needed capital to grow and a diversified range of savings products will automatically expand the outreach of the sector. Despite the clear role savings play MFIs have been slow to respond to the need for the poor to save due to regulatory restrictions. With the exception of Grameen in Bangladesh and BRI in Indonesia, most MFIs are limited to compulsory savings of members as part of the microfinance package and unable to mobilize deposits from the general public. These restrictions ultimately raise the cost of doing business as access to low-cost capital for on-lending is denied the MFIs.

Microfinance remains primarily a supply-driven endeavour with a limited number of methodologies applied to provide mainly working capital to poor micro-entrepreneurs with limited response to client needs and demands through product innovation and flexibility. The opportunity lies in responding to clients demands for new products. ICT and mobile telecommunication can facilitate the great leap forward with the introduction of services like money transfers, remittances, micro insurance, flexible micro-savings, in addition to more efficient deposit taking and lending activities. In addition, innovations in ICT can also facilitate operational efficiency by reducing transaction costs for both institutions and clients, improve productivity and expand outreach. To take advantage of and use these innovations to improve their services MFIs need strong and supportive meso-level infrastructure. ICT can be used as a tool to improve operations such as MIS systems; lessen information asymmetry between MFI and client and between competing MFIs; knowledge sharing among MFIs, investors and the government and increase impact and outreach with ATMs, mobile-banking, e-payments and loan collection.

In most countries, historically the microfinance sector has been resilient to external financial and economic crisis. In Asia, the microfinance sector in most countries has largely been funded by international donors, government development funds and individual deposit mobilization, with India and to a certain extent the Philippines being the exceptions. Hence the effect of the global liquidity contraction on the cost and availability of funding to MFIs is still to be seen and will depend on the funding structure of the institution. In countries where domestic commercial banks have taken to lending to MFIs money will be tighter and slower to come by and will come at a higher price.

The current global financial crisis and the food and commodities price hikes that preceded it have left the microfinance clientele weakened. With purchasing power eroded, savings contraction affects both repayment capacity and the stability of future deposits. MFIs may in the medium term face a portfolio risk as the credit worthiness of their clients deteriorates.

Foreign currency exposure is an added dimension though not so critical in Asia as most MFIs/NGOs cannot by law borrow in foreign denominations. In contrast Latin American and Eastern European MFIs have had un-hedged foreign exchange exposure in past years. With that in mind, the growing interest shown by institutional investors, private equity and venture capital funds is a double edged sword. In as much as it helps grow and expand the sectors outreach and efficiency it is good, but it renders it more vulnerable to external shocks of capital availability and investment interest.

The policy implications of the current global situation cannot be ignored. Short term government action - mass loan forgiveness, interest rate caps, state government credit programs, to name a few - in response to the current crisis in the formal financial sector and economic downturn could roll back the successes of the last few years. A tighter and more conservative regulatory regime may thwart the progress made so far. On the other hand the current crisis may move governments to look at regulatory reform for the sector as a whole rather than the piece-meal legislation being considered in several countries currently.

At the very least the current crisis has highlighted the need for a secure funding base. The sector has to strengthen its balance sheet through local equity funding and deposit mobilization. On the deposit mobilization front governments in partnership with practitioners and experts have to deliver a re-structured regulatory and legal framework within which the microfinance sector can flourish.

Endnotes

ⁱ The microfinance industry reports summarised for this chapter are:

- Ghate.P, 2007, 'Microfinance in India: A State of the Sector Report', Microfinance India: New Dehli.
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All FDC/BWTP Network publication are available from the BWTP Network website: www.bwtp.org

ⁱⁱ Asian Development Bank, 2008, 'Key Indicators for Asia & the Pacific - 39th Ed.', ADB: Manila.

ⁱⁱⁱ *ibid.*

^{iv} ADB, 2009, 'The Global Economic Crisis: Challenges for Developing Asia and ADB's Response', ADB: Manila.

^v ADB, 2009, 'Asian Development Outlook 2009: Rebalancing Asia's Growth', ADB: Manila.