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RECENT DEVELOPMENTS IN MICROFINANCE

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Our knowledge about microfinance in developing countries has been greatly enriched in recent years by the experience of numerous institutions. Different sound technologies and practices of financial services to all segments of the population have emerged; there is no single best practice or optimal approach that could be simply replicated. People and institutions have to find out what suits them best. Through trial and error, they gain the experience which may then be cast into lasting innovations. Five case studies are presented, each with its own lessons concerning viability, sustainability, and outreach: two from Indonesia, two from Nepal, and one from India. In addition, lessons are drawn from the recent financial crisis in Indonesia concerning the importance of a triad of framework conditions: prudential deregulation, macroeconomic stability, and adequate bank supervision. The data are largely based on the author's field research and consultancy work.[*]

1. BPR Bank Shinta Daya, Indonesia: Individual vs. group microfinance technologies

1.1 Lessons learned

- There are small local banks, like Bank Shinta Daya on Java in Indonesia, which have been established with private capital and never relied on subsidies. Offering competitive interest rates with positive real returns to savers, they mobilize their own resources. Charging market rates of interest to borrowers, they cover their costs and finance their expansion from their profits.

- Viability is difficult to achieve for institutions which provide credit to low-income groups only. A diversified clientele enables an institutions to better exploit the local resource potential, provide an adequate volume of financial services, and cross-subsidize its services to different, frequently interrelated segments of the population.

- By adopting group technologies, microfinance institutions (MFIs) may greatly increase their outreach, particularly to low-income people; and they may do so cost-effectively. In the short run, this adds little to the volume of their deposits, their portfolio and their profits. In the long run, however, they may expect that financial services to low-income people contribute to the steady growth of microenterpises which will in turn contribute to the growth of MFIs.

- Collaboration with a local NGO has paved the way for Bank Shinta Daya to banking with low-income groups. However, financial intermediation through that NGO proved fatal. Learning from the experience, BSD abandoned the NGO link, but adopted its some of its group guidance and training practices.

1.2 The evidence

A self-sustained rural bank...

Bank Shinta Daya is a private rural bank established in 1970 with a capital of US$ 40,000 (equivalent to Rp 92.2 million in 1995) which has financed its expansion from its profits. Its net worth as of 12/1995 was Rp 495.8 million (US$215,000), comprising Rp 179.5 million in capital and Rp 316.3 in retained earnings. Savings deposits amounted to Rp 5.05 billion: equivalent to 105% of loans outstanding (Rp 4.83 billion). Average interest rates were 15.2% to depositors and 27.4% to borrowers. The default rate was 2.0%. Its total income as per 6/1995 was Rp. 822.5 million, its net profit of the year Rp 63.3 million (7.7% of total income

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and 12.8% of net worth). With an operational sustainability ratio of 111%, BSD fully covers its costs. Its full-financial sustainability ratio of 96% indicates that it is basically self-reliant but fails to make full provision for the erosion of its resources by inflation.

... increases its outreach through group lending, ...

The bank employs two technologies: retail financial services to individuals and wholesale services through pre-existing self-help groups. Working with groups through a local NGO proved to be a disaster. Having learned from the experience, BSD now selects and trains groups at its own. As of December 1995, the bank worked with 310 groups in the vicinity with a total of 7,750 members: 7,400 of them active savers and 6,200 active borrowers . At the same time, the bank had 22,940 individual depositors and 6,456 individual borrowers.

Deposits and Loans	*Individual*	*Group*	*Total*
Depositors:			
Number	22,940	7,400	30,340
Percent	75.6%	24.4%	100.0%
% poor depositors only	71.3%	28.7%	100.0%
Amount of deposits in %:	96.9%	3.1%	100.0%
Borrowers:			
Number	6,456	6,200	12,656
Percent	51.0%	49.0%	100.0%
% poor borrowers only	29.4%	70.6%	100.0%
Loans outstanding in %:	89.3%	10.7%	100.0%

By adding the wholesale technology the bank has substantially increased its outreach in terms of number of (end-) customers: group members represent 49% of the bank's direct and indirect borrowers and 24% of the bank's depositors In terms of volume, however, group lending is of minor importance: 89% of the bank's portfolio goes to individual borrowers and only 11% to group borrowers. Group deposits are almost negligible, representing only 3% of total savings deposits in the bank compared to 97% raised from individual clients.

... covering its costs...

In terms of viability, both technologies are profitable; but the individual technology is far more profitable. 94% of the bank's profits are derived from individual , and only 6% from group lending. The profit ratio of the individual technology is 2.6% of loans outstanding, the profit ratio of the group technology is 1.4%.

Profitability of individual vs. group technology	Individual	Group	Total
Income	97.6	2.4	100.0
Expenditure	98.0	2.0	100.0
Profit	94.0	6.0	100.0
Profit/Loans outstanding	2.6	1.4	2.5
Profit/Deposits	2.3	4.5	2.4
Profit/Fin. serv's	1.2	1.1	1.2

... and hoping for bigger profits in the future

The group technology is thus found by Bank Shinta Daya to be viable as such, but adds little to the bank's overall viability. Why then does the bank engage in business with small groups?

The bank's management explains this with future expectations. By providing financial services to group members with microenterprise activities, it contributes to their growth. As the members' microenterprises grow, so will their business with bank. Besides providing a service to the community which covers its costs and even yields a profit, the bank hopes to grasp a larger market share which might pay off substantially in the future.

2. Himalaya Finance and Savings Company, Nepal: From informal to formal finance, from group to individual technology

2.1 Lessons learned

- An adequate legal framework can greatly facilitate the establishment and growth of MFIs. When the Government of Nepal passed the finance company act, some rotating savings groups, which are of traditional origin in Nepal, merged into the Himalaya Finance & Savings Company (HFSC).

- Through new financial technologies, namely doorstep collection of small savings and long-term savings contracts, outreach to low-income groups was greatly increased without any cross-subsidization, creating at the same time a term finance instrument in a market otherwise dominated by short-term instruments.

- By linking credit to savings, HFSC was able to better manage its risks and offer lower interest rates, particularly to low-income groups.

- Like most MFIs which offer unbiased savings and credit services, HFSC, attracted far more savers than borrowers. The majority of low-income people need access to safe and convenient savings deposit facilities more than access to credit.

2.2 The evidence

From RoSCA...

Rotating savings and credit associations (RoSCAs) are, next to the moneylender, the most prevalent type of informal finance around the world. A group of people contribute a fixed amount each and, in a monthly, weekly, daily or other rotation, turn the total amount over to (mostly) one member at a time. After a cycle, the group dissolves and may freshly reorganize. In many countries RoSCAs have turned into permanent nonrotating credit associations with their own loan funds. Most have stayed informal; but some have adopted the legal status of a cooperative society. In Nepal, however, the dhikur (sg.) or dhikuti (pl.) as they are called here, took a different course. Centuries ago, they first originated among the Thakali as a social insurance institution to protect these trading communities against the vicissitudes of the trans-Himalaya trade. During the past fifty years, they turned into small enterprise financing institutions and spread to virtually all cities of Nepal. In some dhikuti, monthly collections amount to thousands of dollars. With a growing demand for scarce financial resources, funds were allocated by bidding. E.g., the lowest bidder may accept a pot of $1000 at $600, returning the balance of $400 to the participants. In recent years, improvident speculation has led to cases of defaulting and greatly damaged the reputation of the dhikuti.

...with daily savings collection at doorsteps...

In 1989, H. B. Pradhananga, then a government employee, organized three dhikuti of 25 members each. He introduced several innovations: a long-term contractual savings scheme, with

daily contributions of Rp10 (appr. US$0.16 at the 4/1998 exchange rate of US$1 = Rp63) for three years, which attracted low-income people; daily collection at doorsteps through a collector rather than at regular meetings; and access to credit at any time. Despite the absence of legal status, the number of groups rose to 200 with 5,000 participants within a year.

...to finance company...
Deregulation after 1990 created a fertile ground for financial innovations in Nepal. After the enactment of the Finance Company Act in 1992, H B. Pradhananga took a big step on the evolutionary scale of organizational morphogenesis: he registered his business as the *Himalaya Finance and Savings Company Ltd., HFSC*. The new legal status created enough confidence for the participants to abandon the group structure. By May 1996, HFSC comprised 49 branches all over the country and with 600 daily deposit collectors, each serving 125-400 clients. Due to new regulation, the number of branches, including the headoffice, was subsequently reduced to six, and the remaining units were transformed into collection offices, covering 43 of 75 districts in Nepal. By converting salaries into commissions of 3% and increasing the daily collections to Rp10-500 (further increased to Rp50-500 as of 4/1998), H. B. Pradhananga was able to reduce the number of collectors to 98, collecting Rs10,000-15,000 each per day and serving 52,000 depositors.

...with innovative microsavings and microcredit products
Savings contracts are for three years: a novelty in a country largely devoid of term finance. Savings products include savings collected at doorsteps at 7% interest p.a. and savings deposited at the office at 11%. Loan products comprise collateral-free loans for savers and collateralized loans for others: 2-year business loans of Rp100,000-2m at 21% interest; 2- to 5-year agricultural loans of Rp10-500,000 at 15-19% p.a.; 2- to 5-year housing loans of Rp0.1-3m at 20-21%; 2-year vehicle hire-purchase loans of Rp50-150,000 at 24% p.a.; and personal loans up to 50% of accumulated savings at interest rates 3% above the respective savings interest rates. The share capital of HSFC as of 4/1998 is Rp100m ($1.6m): earned within a 10-year period. As savings mobilization in finance companies is limited to ten times the share capital, H.B.P. plans to transform the finance company into a bank for which no such restrictions exist.

3. India: Linking formal and nonformal finance, or banks and self-help groups

3.1 Lessons learned

- In India, as in Indonesia, Thailand, the Philippines, Burkina Faso, Nigeria and Zimbabwe, thousands of self-help groups gained access to banking services through the linkage banking approach. This has enabled banks to lower their transaction costs and increase repayment rates from around 40% to near-100%. NGOs have been instrumental in the process.

- NGOs acting as financial intermediaries are advised to adopt sound and profitable banking practices and convert their financial activities into a banking operation with an appropriate legal status. Examples are SEWA in India; BPR Jatiarta Swadaya in Yogykarta, a rural bank subsidiary of Yayasan Bina Swadaya; and Bank Purba Danarta in Semarang, a commercial bank established by Yayasan Purba Danarta.

3.2 The evidence

From unsustainable subsidized targeted credit...

Rural finance in India has been the mandate of NABARD, the National Bank for Agriculture and Rural Development. Since 1980 NABARD has provided $2b in subsidized targeted credit through 150,000 primary lending institutions for 49 million rural household. Repayment performance was dismal. Well into the 1980s the rural interest rate structure was inverted, with deposit rates exceeding interest rates on loans, undermining savings mobilization and institutional self-reliance. In the early 1990s Regional Rural Banks charged 10% on loans under the NABARD program: 13.9% below the average break-even rate of interest, thus undermining institutional viability. Despite massive subsidies, vast numbers of the rural poor remained beyond the reach of the government programs. In addition it was found that large volumes of credit were obtained by the wrong people at the wrong time for the wrong purpose. During the 1990s the Indian government has been revamping its development policies in the direction of a market economy.

... to business relations between formal and nonformal financial institutions...
In this context, NABARD, together with the Reserve Bank of India, RBI, decided to experiment with linkage banking, which APRACA had been propagating among its member institutions since 1987. Inspired by the design of the linkage banking project in Indonesia, NABARD adopted its chief principles of working through existing institutions (banks, self-help groups and NGOs, with NABARD in the role of lender of last resort), institutional autonomy (with participating institutions working out their own business terms and conditions), institutional viability (through cost coverage from the interest rate margin for all participating institutions) and self-reliance (through savings mobilization). During the test phase, the number of participating self-help groups (SHGs) grew from 255 in 1992/93 to 620 in 1993/94 and 2,112 in 1994/95. During the first two years of national implementation, the number of SHGs grew to 4,757 in 1995/96 and 8,598 in 1996/97: 13% of them linked directly with banks without facilitation by NGOs, another 45% linked with banks with NGOs as facilitators, and 42% linked with NGOs as financial intermediaries. As of 31 March 1997, 120 banks and 220 NGOs were involved: still a minute fraction of the banking and NGO sectors in India. Presumably due to NGO influence, 76% of the SHGs are women‘s groups.

...as a commercially viable proposition
RBI has declared linkage banking a regular banking program in India, authorizing banks to lend to unregistered SHGs, and SHGs to accept savings deposits from their members. RBI has also moved away from interest rate regulation. The interest spread of participating banks and NGOs averages 5.5% p.a. SHGs charge around 2% per month to end-users, with some going as high as 3-4% per month. Questioned about what appears as exorbitant interest rates by preferential credit standards, SHG members cited the standard moneylender interest rate of 10% per month and indicated that the interest earnings are ploughed back into the SHG loan fund, thus increasing access to credit from their own internal resources on an increasing scale. With bank loans disbursed amounting to $3.38m and a volume of $3.04m of NABARD refinancing, the scheme is still of a modest size by Indian standards. Yet NABARD considers some of the program‘s features remarkably successful and worth emulating: a considerable increase in rural savings; a reduction in bank transaction costs by 40%; a substantial reduction in borrower transaction costs; and a near-100% repayment rate.

4. Bank Rakyat Indonesia: an agricultural development bank with self-sustained microfinance operations

4.1 Lessons learned

- In a deregulated policy environment, ailing government-owned agricultural development banks, dependent on government dole-outs for subsidized targeted credit, may turn into profitable institutions which mobilize their own internal resources and serve vast numbers of low-income people at market rates of interest.

- In the case of Bank Rakyat Indonesia (BRI), the number of depositors (16.2 million as of 12/1996) exceeds the number of borrowers (2.5 million) by a ratio of 6.5:1.

- In terms of outreach and volume of financial services, BRI, with some 3,500 village units, has outperformed the totality of almost 10,000 small local MFIs.

- Both, BRI village units, and small local MFIs of the formal and semiformal financial sectors, have weathered the recent Asian financial crisis relatively well.

4.2 The evidence

The failure of subsidized trageted credit - in a repressive policy environment

Until 1983, century-old BRI was a major provider of subsidized targeted credit through 3,300 bank units (*unit desa*) and a staff of 14,300 in rural areas. Heavy losses resulting from poor repayment rates (around 40%), plus fiscal cuts, had made the bank unsustainable.

Making microfinance viable – in a deregulated policy environment

After the financial deregulation of June 1983, the government as the bank‘s owner decided to commercialize its operations by transforming the units into self-sustaining profit-centers. With TA from the Harvard Institute for International Development, the bank calculated microsavings and microcredit transaction costs and carefully crafted two commercial products: a rural savings scheme with a lottery component (SIMPEDES) which proved to be immensely attractive; and a nontargeted credit scheme (KUPEDES) open to all: with simple procedures, short maturities, regular monthly instalments, flexible collateral requirements, incentives for timely repayment, and market rates of interest amounting to 2% flat per month (equal to an effective rate of 44% p.a., minus 11% for timely repayment = 33% p.a.) to cover all costs and risks. Nominal interest rates were drastically higher than the previous subsidized rates of around 12%, but much less so in actual fact as under-the-table payments had all but disappeared. As of 1984, all of BRI‘s village units were turned into profit centers with profit-sharing incentives for staff and penalties for excessive arrears for managers in terms of loss of credit authority. Programs carried out on behalf of the government and of donors were kept from the village units and confined to the branch level (including the Bank Indonesia linkage banking project designed and implemented by the author as GTZ team leader). During 2/1984-12/1996, a total of 18.47m loans had been made, with a long-term loss ratio (total overdue one day or more, including amounts written off, divided by total which has fallen due during 2/1994-12/1996) of 2.15%; and a 12-month loss ratio of 1.59% for 1-12/1996. Total payments in arrears one day or more as a percentage of total loans outstanding as of Dec. 31, 1996, excluding write-offs, amounted to 3.64%. Consolidated profits at unit level amounted in 1996 to $177m, or 10.4% of loans outstanding.

Making microfinance sustainable – by responding to the demand for depositing savings
With this model, BRI became one of the most successful rural-mandate banks in Asia-Pacific. With liquidity first provided by the World Bank, BRI broke even in 1990: fully mobilizing its loanable funds through village-level savings and generating excess resources thereafter. Since then, BRI's *unit desa* network has been completely self-reliant (mobilizing its own resources) and viable (covering its costs from the margin and making a profit). As of 31 Dec. 1996, BRI served 2.49m borrowers with a total amount of loans outstanding of US$1.71b (1996 exchange rate); and 16.17m depositors with savings balances of $2.97b. The ratio of borrowers to savers of 1:6.5 is an indication of the strong demand of rural people for deposit facilities, far in excess of the demand for credit.

Outreach of national BRI vs. local MFIs
BRI, with 3,482 village units as of 12/1995, outperformed the totality of 1,948 formal (BPR) and 7,413 semiformal MFIs, mobilizing Rp6.02tr from 14.48m savers compared to Rp1.45tr mobilized by 9,361 MFIs from 4.60m savers; and providing Rp 3.19tr to 2.26m borrowers, compared to Rp1.88tr provided by MFIs to 2.45m borrowers. BRI has demonstrated that in a deregulated policy environment, a government-owned agricultural development bank is capable of serving vast numbers of microsavers and microborrowers at competitive interest rates: mobilizing its resources internally, covering its costs, and financing its own expansion. In a more theoretical vein: BRI has proven that institutional viability, sustainability and outreach to low-income people are compatible.

5. The Agricultural Development Bank of Nepal: Transforming an unsustainable credit program into viable MFIs

5.1 Lessons learned

- In contrast to BRI, the Agricultural Development Bank of Nepal (ADBN) is solving the problem of unsustainable subsidized targeted credit by transforming its small farmer credit operations into autonomous local MFIs owned and managed by the farmers.

- However, with a legacy of government intervention and donor assistance, the transition to full institutional autonomy and sustainability is a cumbersome process.

5.2 The evidence

From unsustainable development banking operations...
Since 1975 the Agricultural Development Bank of Nepal, ADBN, has built up its Small Farmer Development Project, SFDP: a subsidized credit program targeted at the poor: 70% of the population. Major donors were IFAD ($27.5m) and ADB-Manila ($30m). By mid-1996 SFDP had reached 189,000 heads of households in some 23,000 small farmer groups. Credit disbursement and technical support were administered through 422 SFDP offices. With repayment rates since its inception barely above 40% and loss ratios fluctuating in the 20-30% range, the program incurred substantial losses. With a savings mobilization rate of less than 1% throughout its existence, it fully depended on donor resources. As a subsidized targeted credit program, SFDP turned out to be unviable and unsustainable.

...to local MFIs
With TA from GTZ, ADBN started an experiment in 1993, turning the SFDP operations of four offices in Dhading, one of the poorest districts of Nepal, into four Small Farmers Cooperatives Ltd., SFCLs, owned and managed by their members. Each comprises on

average 709 small farmers in 100 groups (73% of them male or mixed and 27% female) organized in turn in 11 intergroups. This transformation has achieved a miracle: The SFCLs started mobilizing their own resources, which reached 20% of all loans outstanding within the first two years of their existence; the repayment rate of ADBN channeling loans almost doubled to 79%; and the repayment rate of loans from internal resources jumped to 98% as of 7/1995. When I visited one of them, SFCL Chatredeurali, in 4/1998, 70% of the loans outstanding had been disbursed from internal resources.

The challenge of institutional autonomy and sustainability
After the successful completion of the experiment, ADBN has now entered into the phase of national implementation of the transformation program. By January 1998 the operations of 53 SFDP offices had been converted into autonomous SFLCs, with a total outreach of 31,481 families (representing a population of about 200,000), Rs23.6m ($0.37m at the current exchange rate) internal resources and Rs271.0m ($4.3m) loans outstanding. While ADBN continues to establish new small farmer groups through its existing network of SFDP offices which will eventually be converted into SFCLs, it is planned that within six years about 4-500 SFCLs will have been established with an outreach of more than 200,000 predominantly poor families (i.e.,. a population of 1.2 million). Given their low level of transaction costs and the excellent repayment performance, their viability seems to be secure. However, full institutional autonomy, independence from local politial interference, self-reliance (including the cessation of loan channeling on ADBN's terms), appropriate supervision and the establishment of an apex structure are among the many issues that need to be assured if the SFCL are to fully evolve into a self-sustained movement with an ever-increasing deepening of financial services to the rural poor. The significance of this experiment extends far beyond SFDP. Many government-owned agricultural development banks in the region might want to take a close look at it through an exposure program.

6. Indonesia: Deregulation without supervision

6.1 Lessons learned

- An adequate policy environment is a crucial determinant of viability, sustainability, and outreach for any type of MFI. This entails interest rate deregulation; liberal practices of establishing banks and branches; and an appropriate legal framework, particularly for small local MFIs with low equity capital requirements.

- The articulation of demands for an adequate policy requirement must come from below, ie. from the MFIs themselves; it should not be left to governments, central banks, or the IMF.

- In Indonesia, prudential deregulation of interest rates and the banking sector, macroeconomic stability and communication between the government, the central bank and the banking and MFI sector, have greatly contributed to financial deepening, MFI growth and increased access to financial services by low-income groups. However, banking supervision proved inadequate, causing a financial, economic and political crisis.

- As MFIs cannot rely on adequate bank supervision by central banks or bank superintendencies, they are advised to establish their own networks with apex organizations of external auditing, inspection and supervision.

6.2 The evidence

Financial deregulation: a story of success

In Asia, Indonesia has served as a model case for the deregulation of the policy and legal framework since 1983, paralleled by macroeconomic stability and the deregulation of the foreign trade regime. This resulted in considerable financial deepening: an upsurge of domestic savings mobilization, credit disbursement, number of banking institutions, and outreach. The upsurge has been most impressive in microfinance. Deregulation of the monetary and banking system proceeded in the following steps:

- 1983: Interest rate autonomy is given to all banks, state-owned and private. Bank Indonesia (BI) as the central bank drops direct interest rate controls and adopts market-oriented monetary policies. Between 1983 and 1990 savings mobilization increased 6.7-fold, bank loans outstanding 6.4-fold. From 1990 to 1995 savings mobilization increased 2.5-fold, bank loans outstanding 2.4-fold.
- 1988: BI deregulates the institutional framework by easing the establishment of new banks and the opening of branch branches. A new rural banking law permits the establishment of rural banks (BPR) with an equity capital of Rp. 50 million, requiring the existing semiformal financial institutions to be eventually transformed into banks (BPR). 1,643 rural banks (BPR) were established until 1995. The total number of registered small financial institutions grew from 8,003 in 1990 to 9,271 in 1995; the number of commercial banks from 171 to 240; and the number of their branches from 3,563 to 5,191.
- 1990: BI withdraws most of the interest rate subsidies. Commercial banks are required to allocate at least 20% of their portfolio to the microeconomy, either directly or through MFIs.
- 1991: In response to some spectacular bank failures, BI steps up bank supervision and imposes a capital adequacy ratio.
- 1992: A new banking act deregulates bank ownership. Only two types of banks are recognized: commercial banks und rural banks (BPR) with a paid-in capital of Rp10b (US$. 4.82m, at 1992 exchange rates) and Rp50m ($24,100), respectively.

Inadequate supervision: a story of failure

Weaknesses in bank supervision had been apparent all along, to which BI responded in 1991, though ineffectively. The fact of politically instigated lending was also known, but not its excessive extent. The belief was upheld that in a climate of rapid economic growth, the healthy portion of the banks‘ portfolio might outgrow the sick portion. However, within the framework of an autocratic political economy without democratic controls, this belief turned out to be erroneous.

The triad of financial system development

Three regulatory reform measures are essential for sustained financial and economic growth: prudential deregulation, macroeconomic stability, and effective bank supervision. Indonesia performed well on deregulation and stability, but failed on bank supervison. This, in the wider framework of the Asian financial crisis of 1997, led to a bank run, the collapse of the Rupiah, soaring inflation, massive unemployment, and, last not least, political instability. Microfinance was least affected, indicating that MFIs at the local level were more successful in sound banking and the avoidance of political influence. The chief lesson of the Indonesian experience is that financial deregulation without adequate bank supervision can be disastrous.

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