# Microfinance: Viable Financial Services for Development

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# TABLE OF CONTENTS

# 1.0 Executive Summary

As this is a first time research by the writer into the subject of microfinance, this paper represented a challenge that was taken in an attempt to cover new ground. Thus the paper touched on a wide range of the essential elements and components that are relevant to providing a comprehensive presentation of the concept of microfinance and the major views and issues that arise in relation to the topic.

The concept of microfinance has, over the past few decades, been developing and gaining importance as an economic development tool for providing financial services to medium enterprises, small economic agents, and the poor. This paper focuses on microfinance and examines its role in financing the informal sectors in developing economies, and discusses its contribution to overall economic development. It presents arguments in support of the proposition that microfinance is an important component of the development process. It emphasizes the link between improving access to finance and reducing poverty and suggests that with the right mix of policies, integrating microfinance in the development process can result in economic growth, improved social welfare, and better income distribution.

This paper is theoretical and policy-oriented in nature. By analyzing the informal sector and the informal financial systems, a rationale for microfinance will be developed. Additionally, by analyzing microfinance and other development alternatives, a suitable policy mix will be suggested.

The paper begins by discussing the informal sector. An argument is presented that, based on its potential for job creation and income generation, the informal sector is an essential and growing component of any developing economy. Important factors that influence the development of this sector are discussed, and characteristics that are particular to this sector and their effect on access to financial services are emphasized. This section of the paper also refers to the earlier views and policies towards the informal sector- when it was considered to be a symptom of economic dysfunction- and explains the gradual development to the present views and policies which advocate the incorporation of this sector into the overall economy.

Poverty exists mainly in the informal sectors of developing societies. This paper will show that microfinance contributes to development by improving access to finance for the poorer segments of the economy. Within this context, the following section of the paper attempts to define the concept of poverty, examine its causes and demonstrate the magnitude of the problem through statistical data. The characteristics of poverty are discussed to show that poverty is not simply a matter of low income, which is a common characteristic of all forms of poverty, but that other complex socioeconomic issues are involved. It will be shown later in this paper that microfinance can contribute to resolving many of these issues including powerlessness, insecurity and uncertainty. Similarly, levels of poverty are identified and the classifications of the extremely poor and the active poor are presented. This is important as the paper will, at a later stage, attempt to relate the different approaches to microfinance to the different levels of poverty.

Financial systems are introduced in chapter two. The role of financial systems and the importance of financial intermediation in the process of economic development are discussed. The components of financial systems are briefly described, and the informal financial sector is introduced. In this section, the paper focuses on the various types of informal financial services and argues that such services cater to the informal sector, and do a better job than formal finance in meeting its requirements. A comparison of both types of financial systems is made to support this argument. It will be noted that informal finance is to a large extent the only means of financing available to the informal sector, and it will be argued that the notion of critics of informal finance that view it as a form of predatory lending is inaccurate. The advantages and disadvantages of informal finance will be presented. It is proposed that microfinance is able to adopt many of the methods used in informal finance while overcoming its major drawbacks, thus enabling it to provide efficient financial services to the informal sector.

Chapter three of this paper discusses microfinance in greater detail. A definition of the concept is presented, and a rationale for microfinance is developed. It is argued that formal microfinance institutions are better suited to meet the requirements of the lower income clients than are the agents in the informal financial systems and that they adopt techniques used in the informal financial systems, thus making use of opportunities provided by social capital. Microfinance institutions provide services at a reasonable cost, while realizing a profit margin for the institution itself thus ensuring its sustainability. The rationale behind the level of pricing of the loans by the microfinance institutions is also examined. This chapter then discusses the demand and supply of microfinance services and investigates the reasons for the gap between them. While the paper accepts

the fact that the demand for microfinance, which comes mainly from the informal sectors of economies, is extremely large, it also examines other reasons that cause the demand not to be met including inadequate information, poor infrastructure and prohibitive government regulations. It is argued that if the demand is met this will contribute to poverty eradication. The paper further examines some of the resulting positive socioeconomic manifestations of providing access to finance to lower income people.

The different approaches to microfinance are presented including the financial intermediation approach and the poverty lending approach. It will be emphasized that the financial intermediation approach allows the microfinance institution to generate profit and become sustainable, enabling it to expand its outreach and serve more clients. The poverty lending approach is based on subsidies and mainly serves the extremely poor by providing cheap credit to clients.

It will be shown that a suitable legal, regulatory, and prudential framework is essential. To help develop this framework, we will examine the different stages of microfinance institutions development and how supervision/regulation is different at each stage. We shall also examine areas where microfinance supervision/regulation is different than that of conventional banking. The costs and benefits of supervision are discussed, and an argument will be presented supporting the idea that microfinance regulation/supervision should be designed in such a way as to avoid choking and hindering the innovations of microfinance institutions.

The paper further discusses different types of government and NGO support that microfinance institutions can receive. Forms of support should be carefully chosen in order to avoid creating a donor-dependant institution. The next section of the paper attempts to demonstrate that supporting microfinance as a tool for development is worthwhile. The advantages and disadvantages of microfinance are compared to those of other development finance alternatives. It will be suggested that a right policy mix should include both types of microfinance (financial intermediation and poverty lending), as well as other economic development tools such as aid, infrastructure development, and measures to improve education and health. Although it is difficult to quantify the marginal social benefits of microfinance, the paper suggests that the socially optimum level occurs when the marginal social benefit of spending additional funds on microfinance is equal to the marginal social benefit of spending additional funds on other projects.

The case study of Bank Rakyat Indonesia is presented in the last chapter to apply the concepts discussed in the preceding chapters, and to demonstrate that sustainable microfinance is a viable development finance tool that can meet the large demand for micro credit and savings, and contribute to poverty alleviation and economic development.

Based on our research we have concluded that the informal sector is an integral part of the typical economy of a developing country and that the empowerment of this sector would have positive and desirable effects on economic growth and welfare. The major requisite for empowering the informal sector is providing the small economic

agents and the poor with proper access to financial services. Microfinance is a development tool that is best suited to fulfill this role. The existing informal financial systems, although at an advantage over formal financial systems at providing services to small economic agents due to elements of social capital in their modus operandi, are still limited by factors such as community borders and the scarcity of funds. Microfinance overcomes such shortcomings and makes use of social capital in structuring the services it provides. It is also able to offer the required package of savings and credit products at suitable costs that also allow a margin of profit that supports its sustainability.

It was concluded that the financial intermediation approach is preferable when the goal is long term viability and large-scale outreach. The poverty lending approach is suitable when the goal is providing cheap credit to assist the extremely poor in becoming active poor.

Proper regulatory and prudential policies can further consolidate the viability and sustainability of the microfinance industry. Microfinance uses different methods and techniques for its operations; as a result, all aspects of its supervision and regulation should be conducted accordingly. Regulation should also be conducted in ways that allow institutions to remain innovative and creative.

It is also suggested that an effective microfinance industry should be mainly based on the financial intermediation approach and that it should be complemented by institutions that adopt the poverty lending approach to provide subsidized credit to the extremely poor. This, together with other development tools such as infrastructure development and education and health improvements should be combined in a mix that is

suitable to the particular condition of each economy in order to contribute to economic development and poverty alleviation.

The case of Bank Rakyat Indonesia supports the conclusion that an efficient and sustainable microfinance institution is viable and can even survive periods of economic hardships and turbulence.

# 2- The Informal Sector

## 2.1 The Formal Sector vs. the Informal Sector

Most developing economies have a common character: "the existence of a modern urban capitalist sector geared toward capital intensive, large scale production and a traditional rural subsistence sector geared toward labor-intensive, small-scale production".[1] The modern formal sector includes all businesses, firms, and enterprises that are financed by the formal financial system, and registered and supervised/regulated by the government. The activities in the informal sector are usually unrecognized by the government, and escape the attention of administrative law enforcement and regulatory institutions.

## 2.2 Emergence of the Concept of the Informal Sector

The existence of the labor-intensive informal sector was recognized in the 1970s, following the observation in developing countries that massive additions to the urban labor force failed to show up in formal sector unemployment statistics. This was mainly because the new entrants to the urban labor force seemed to have created their own employment individually or worked in small-scale family businesses. These individual workers and businesses consist of a large group of small-scale economic activities that are usually ignored by the formal sector. Many of those engaged in such businesses are successful small-scale family run enterprises with several employees who are usually relatives of the family. Some of them were eventually successful enough to enter the

[1] P. Todaro, Economic Development. 9th Edition, P.328 (06/01/2005).

formal modern sector. As such it was gradually recognized that the informal sector plays a crucial role in developing economies, as it absorbs the large additions to the labor force that the formal sector is not able to accommodate, as well as acting as a source of livelihood for lower-income earners living in rural and lower-class urban areas, who would otherwise have no source of income.

## 2.3 Defining the Informal Sector

Defining the informal sector could be complicated because typical definitions focus on what the informal sector is not, rather than on what it is. These definitions usually stress that that informal sector is non-regulated and non-tax paying. In order to better understand the informal sector, and with the objective of developing better policies for its development as well as its interaction with the formal economy, there is a need to provide a useable and acceptable definition for the concept. "The informal sector covers a wide range of labor market activities that combine two groups of different nature. On the one hand, the informal sector is formed by the coping behavior of individuals and families in an economic environment where earning opportunities are scarce. On the other hand, the informal sector is a product of rational behavior of entrepreneurs who desire to escape state regulations".[2] We can thus identify two types of informal sector activities. One can be described as activities that are more or less based on the need to cope and that have survival as their main objective. The other type involves activities that entail unofficial earnings and are related to illegal business. This second type can be further subdivided into two types. The first is unofficial business activities which evade

[2] Concept of Informal Sector. The World Bank Group. <http://lnweb18.worldbank.org/eca/eca.nsf/Sectors/ECSPE/2E4EDE543787A0C085256A940073F4E4?OpenDocument>

taxation and tend to avoid regulations. Avoiding taxation is also common in the formal sector of developing economies, due to the existence of corruption and bureaucracy. The second type consists of underground business which is usually related to crime and corruption.

The informal sector can be generally defined as the multitude of small-scale, self-employed activities, with or without hired workers, typically at a low level of organization and technology with the primary objective being the generation of employment and income.[3]

## 2.4 Characteristics of the Informal Sector

It is important to examine and understand the characteristics of the informal sector in order to develop effective and efficient policies for its development, and in order to identify the appropriate means by which microfinance can contribute to this development. The informal economic sector is typically characterized by a large number of small-scale products or services usually owned by individuals or families including those who have recently migrated from rural areas or those residing in urban areas and are unable to find immediate employment in the formal sector. Their products and services tend to be very simple, capital investment is generally minimal, and employment relationships are mostly unwritten and unformalized. Workers tend to have very little or no education, are usually unskilled, and tend to learn their skills on the job. Additionally, business entities in the informal sector usually have no access to formal financial services, and productivity and wages in this sector tend to be low compared to the formal sector. Other characteristics

[3] www.ilo.org/public/english/region/asro

shared among informal sector enterprises include "low fixed costs, reliance on family labor, use of informal financial markets for credit, recycling of goods, and lack of wage employment".[4] The informal sector includes three groups of active participants: survivalists, self-employed, and micro-enterprises. Survivalists are very poor people who generally work in this sector for the purpose of generating an income for survival. Self employed people produce goods for sale, purchase goods for resale, or offer services. Micro-enterprises are very small businesses that usually operate from a fixed location with regular hours.

Another important characteristic of the informal sector that merits particular attention due to its relevance to the subject of this paper is the influence of social capital. Traditionally, three forms of capital were identified: natural, physical and human. Together they were considered to constitute the wealth of nations and the determinants of economic development and growth. It has recently been realized that these three forms of capital only partially contribute to development and growth, and that the concept of social capital does, in fact, play a major role in the development process. According to Grootaert, "Social capital refers to the internal social and cultural coherence of society, the norms and values that govern interactions among people and the institutions in which they are embedded. Social capital is the glue that holds societies together and without which there can be no economic growth or human wellbeing. Without social capital, society at large will collapse."[5] Social capital is a broad concept and there are many definitions for the term, as well as different views on the subject in socio-economic literature. However, for the purpose of this paper, the definition of social capital will be

[4] L. Webster, P. Fidler. The Informal Sector and Microfinance Institutions in West Africa. P.5 (1996)
[5] C. Grootaert, Social Capital, the Missing Link? April 1998

confined to its aspects that relate to the informal sector and the financial systems. The focus here would be on the role of social capital in the development of the sector and its contribution to a better financial system.

Transactions in the informal sector are usually not supported by legal agreement or documentation, but rely to a large extent on social capital. It would therefore be appropriate to consider some of the aspects of social capital that are relevant to activities in the informal sector and to the operations of the informal financial systems. Some of the important aspects of social capital are:

*Social Information Sharing*: Decisions made by economic agents are sometimes inefficient due to a lack of adequate information. Sometimes one agent may benefit from providing inaccurate information to another. Social capital can remove such failures. Associations and institutions provide an informal framework to organize information sharing, diffusion of knowledge, and coordination of activities within a community.

*Collective Action*: "Group-based lending schemes work well because members have better information on each other than banks do."[6] As an example, people in a community with a high degree of social capital but not enough funds to open a deposit account may gather their small sums into a single large fund that they can deposit into one account. The same would apply in the case of the need for credit. An individual who has no collateral may still be able to secure a loan as other members of his community may cosign for him. This is obviously very important in providing low-income earning people with access to credit and saving services.

[6] C. Grootaert, Social Capital, the Missing Link? April 1998

*Social capital as an enforcement mechanism*: Within the same context, social capital plays a very important role as an enforcement mechanism. In the absence of laws and courts governing the informal sector, social capital acts to enforce the fulfillment of transactions. Associations will inform contracting parties about the penalties of noncompliance. For example, diamond merchants often trade millions of dollars worth of diamonds with a handshake. Failure to deliver will result in expulsion from the group or community.[7]

Social capital is therefore crucial to the functioning of the informal sector and the informal financial systems because it acts as the accepted enforcement mechanism, and many lending and saving techniques that are used are influenced and supported by social capital.

## 2.5 Growth of the Informal Sector

It is important to realize the significant share of the informal activities in developing economies in order to better understand the basis for the large demand for microfinance. In many developing countries, nearly half of the employed urban population works in the informal sector. As mentioned in Todaros' Economic Development, in most of the cities in developing countries, the typical share of the work force employed in the informal sector ranges from 30-70%.[8]

[7] C. Grootaert, Social Capital, the Missing Link? April 1998
[8] P. Todaro, Economic Development. 9th Edition, P.329 (06/01/2005).

According to 'The Informal Economy: Fact Finding Study[9] governments and donors need to better understand the informal economy because it has become apparent that:

> It has a significant job and income generation potential, has significant linkages to the formal sector, [and] is not merely a temporary phenomenon; although definitional and data collection problems make it difficult to gather accurate and internationally comparable information on the size and composition of the informal economy, survey-based estimates suggest that it is a significant and growing component of most developing economies. In Africa, for example, it is estimated that the informal economy provides 80% of jobs, and 90% of new jobs.

The growth of the informal sector is inversely related to the growth of the formal sector. This suggests that its growth can sometimes be related to "inappropriate, ineffective, misguided or badly implemented macroeconomic and social policies".[10] Other reasons for the growth of the informal sector are insufficient job creation; barriers to entry in the formal sector; the incapability of formal institutions to provide appropriate education, training and infrastructure, the exclusion of women from property and land ownership, and expectations of eventually finding employment in the formal sector.

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[9] K. F. Becker. "The Informal Economy: Fact Finding Study" July 23, 2005. <http://www.eldis.org/static/DOC15233.htm

[10] Ibid

## 2.6 Policies Concerning the Informal Sector

Early views on the informal sector tended to regard it as a symptom of an economic dysfunction; the structure and the growth rate of the formal sector were considered inadequate and not important enough to absorb the national labor force. It was thought that improving macroeconomic policies would help the formal economy absorb this labor force. However, with time it was observed that as macroeconomic conditions improved in many developing countries, the informal sector continued to grow. This caused economists to reconsider their views on the subject. This growth in the share of informal sector activities in developing economies, confirmed the views that it is an integral part of global production and industrial chains. It also became clear that the informal sector is a major supplier of relatively cheaper products which the poor can afford, and is also a major provider of urban employment in most developing economies. Consequently, policy-makers began to accept and to acknowledge the value of increasing the productivity and improving the economic conditions of the informal sector. Strategies aimed at establishing linkages with the formal sector, upgrading working conditions and developing the social infrastructure in the informal sector gained momentum. The informal sector plays a significant role in the economies of developing countries and holds great potential for poverty reduction. Poverty, as discussed in following sections in this paper, exists mostly within the informal sector of the economy. To this effect, governments and economic policy makers need to adopt an integrated approach to this sector, by taking the necessary steps to oversee the successful implementation of the strategies that aim at the development and empowerment of the informal sector as a means for alleviating poverty. Among the more important policies that need to be

adopted at appropriate levels are those that aim at improving access to credit and micro-finance. Microfinance, as will be argued throughout this paper, has positive effects on the production activities of the small economic agents as it provides them with the necessary capital to start and expand their entrepreneurial activities, thereby contributing to the efforts to eradicate the worldwide problem of poverty which is discussed in the following section.

# Poverty

## 2.7 Defining Poverty

As it exists and manifests itself in many forms, and as these forms have different characteristics; there is no distinct definition for poverty. Very low income is a common characteristic of all forms of poverty. But poverty should not be thought of as a single problem with a single solution. Poverty involves various other serious, complex, and interrelated socioeconomic issues at the individual, family and community levels. Poor people may suffer from hunger, thirst, disease, abuse, degradation, and unemployment. As a result, they may suffer physical and mental disabilities, low self-esteem, lack of self confidence, depression, fear, hatred, aggression. Poverty may also be the leading cause of crimes and social unrest. Although some people manage to break out of poverty, this is a very difficult process. Among the more important characteristics of poverty are insecurity and uncertainty the future. This means that poverty is not only measured in money terms, and it does not only mean a lack of income, it also includes people who are insecure, uncertain about the future and cannot cope with negative shocks.

As defined by Amartya Sen in *Development as Freedom*, development can be seen as "a process of expanding the real freedoms that people enjoy",[11] in contrast with narrower views of development as growth of GNP, incomes, and industrialization. This understanding is crucial for expanding the freedoms of individuals; however, freedom also depends on social and economic factors, such as access to appropriate health and

[11] S. Amartya, Development as Freedom, 1999.

educational systems. Freedom here "involves the processes that allow freedom of actions and decisions, and the actual opportunities that people have, given their personal and social circumstances".[12] Poverty can be seen as the lack of freedom to choose options of a better life. This lack of freedom also arises due to inadequate opportunities and the absence of incentives for achievement. Poverty can be regarded as a form of deprivation of basic rights of choice. Therefore development requires the removal of the major sources of unfreedom: poverty, lack of choice, poor economic opportunities as well as sources of social deprivation[13].

One of the major unfreedoms the poor experience is the lack of access to financial services. Microfinance provides the option of credit and savings services to the segments of society who lack access to formal financial services, and hence expands the freedom of action of lower income earners, which in turn helps reduce poverty.

## 2.8 Levels of Poverty

There are differences in the levels of poverty experienced by the small economic agents and the poor. For the purpose of this paper we identify two basic poverty levels, although there are probably more than two variations. The first poverty level is the extremely poor, defined by the World Bank as living on less than 75 cents a day.[14] The extreme poor include people who are unemployed, those whose incomes do not meet the requirements to overcome malnutrition, those who have no employment opportunities, or

[12] Ibid.
[13] Ibid.
[14] World Development Report 1990: Attacking Poverty. The World Bank.

those who have no earning assets or household members to support them.[15] The second level of poverty that we identify is the active poor. This refers to "those among the poor who have some form of employment and who are not severely food-deficit or destitute".[16] The main factor that distinguishes the active poor from the extremely poor is that the former have some income stream, sufficient health to avoid illness, and enough resources that act as a backbone for coping with shocks. Most of the economically active poor, however, do not meet all these criteria, but meet at least some of them.

## 2.9 Characteristics of Poverty

A number of factors can cause poor people to lack the freedom to choose a better life. Such factors can range from natural disasters, agricultural cycles, droughts and floods, environmental depletion, to centralization of power, corruption and social inequalities.

An analysis of the causes of poverty requires an examination the characteristics reflected by poor people, namely:

- A lack of income and assets that are needed to obtain basic necessities, such as education, health, food, and shelter.
- Voicelessness and powerlessness.
- A vulnerability to shocks and the inability to deal with them.

There is a need to assess the assets available to lower-income agents. Equally important, the return on the assets, in addition to the volatility and uncertainty of the

[15] R. Marguerite, The Microfinance Revolution, V.1, (31:05, 2001), 18.
[16] Ibid.

returns on the assets should be examined. This will help explain some of the issues associated with poverty. There are many types of assets: human, natural, physical, financial, and social assets. Human assets depend on education, skill, and health. An example of a natural asset is a piece of land that provides returns. Financial assets include savings. All these assets have returns which depend on access to the relevant markets, and which are vulnerable to various factors. Therefore, it is important to consider the volatility of the returns on these assets. Volatility results from market fluctuations, natural disasters such weather and unstable economic and political environments.

Generally speaking, the level of income and asset ownership is directly related to a country's overall economic performance. The wealthier a nation is, the better off its people, including the poor, because of the availability of better paid work. However, even with higher income another factor may come into play. If severe inequality of income distribution exists, this will have negative impacts: "While economic growth is systematically associated with poverty reduction, the rate at which growth translates into lower poverty depends on the initial level of inequality in the distribution of income and how that changes over time".[17] For example if a country such as Brazil, which has a very high Gini co-efficient (a measure of income inequality) of 60.0, experiences tremendous growth rates over a period of time, the gains from the growth will mainly benefit the richer portion of the population, rather than be distributed throughout the entire nation. In other words, most of the rich become richer, and most of the poor become relatively poorer. The Gini coefficient is a measure of inequality developed by the Italian statistician Corrado Gini. It is a number between 0 and 1 where zero corresponds to

[17] World Development Report: Attacking Poverty. 2000/2001, 34.

perfect equality and 1 to perfect inequality (where one person has all the income, and everyone else has zero income). "The **Gini index** is the Gini coefficient expressed in percentage form, and is equal to the Gini coefficient multiplied by 100".[18] Hence, while there is a need to target high growth rates, socioeconomic inequality must be eliminated, stable governance must be achieved, and strong institutions are needed to ensure that the poor share the benefits of growth.

As mentioned above, the poor also experience powerlessness and voicelessness, often resulting in feelings of low self-esteem, lack of self confidence, depression, fear and hatred. It is only natural that a person who is deprived of the things that all others around him have will tend to be a victim of feelings of inadequacy and loss of self-respect. Poverty also exposes people to humiliation, shame, inhumane treatment, and exploitation. This is not only one problem, but rather a web of related problems in which they can get caught. Ultimately, it leads to being deprived of economic opportunity, or even the ability of making their interests known to the public. Likewise, cultural norms and traditions can be a barrier to development and a contributor to feelings of powerlessness. For example, in most cultures, men are viewed to be superior to women. Hence, poor women are discriminated against in the household, and in the job and credit markets. Also, any form of discrimination based on gender, religion, ethnicity, and social status has similar effects.[19]

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[18] E. W. Weisstein et al. "Gini Coefficient." From *MathWorld*--A Wolfram Web Resource. http://mathworld.wolfram.com/GiniCoefficient.html

[19] World Development Report: Attacking Poverty. 2000/2001, 34.

## 2.10 Statistical Facts on Poverty

All over the world, the disparity between the rich and the poor is increasing. Fewer people are becoming richer, and a larger number are becoming poorer. Widespread hunger as a by product of world poverty is an established fact. People are suffering from hunger not because of the unavailability of food, but because they are unable to afford purchasing the food.[20]

Table 1 below includes statistics related to poverty, which should help to put the issue in perspective and allow a better understanding of the problem at hand:

[20] A. Shah, "Causes of Poverty," July 25, 2005. <www.globalissues.org/traderelated/poverty.asp>

## Table 1: Global Poverty Statistics

1. Half the world - nearly three billion people - live on less than two dollars a day.
2. 20% of the population in the developed nations consume 86% of the world's goods.
3. An analysis of long-term trends shows the distance between the richest and poorest countries was about:
    a. 3 to 1 in 1820
    b. 11 to 1 in 1913
    c. 35 to 1 in 1950
    d. 44 to 1 in 1973
    e. 72 to 1 in 1992
4. A few hundred millionaires now own as much wealth as the world's poorest 2.5 billion people.
5. According to UNICEF, 30,000 children die each day due to poverty. And they die quietly in some of the poorest villages on earth, far removed from the scrutiny and the conscience of the world. Being meek and weak in life makes these dying multitudes even more invisible in death. That is about 210,000 children each week, or just under 11 million children under five years of age, each year.
6. Today, across the world, 1.3 billion people live on less than one dollar a day; 3 billion live on under two dollars a day; 1.3 billion have no access to clean water; 3 billion have no access to sanitation; 2 billion have no access to electricity.
7. The total wealth of the top 8.3 million people around the world rose 8.2 percent to $30.8 trillion in 2004, giving them control of nearly a quarter of the world's financial assets. In other words, about 0.13% of the world's population controlled 25% of the world's assets in 2004.

Source: A. Shah, "Causes of Poverty," July 25, 2005. <www.globalissues.org/traderelated/poverty.asp>

**Table 2 outlines the global spending priorities in 1998:**

| Global priorities in spending in 1998 | |
|---|---|
| **Global Priority** | **$U.S. Billions** |
| Basic education for everyone in the world | 6 |
| Cosmetics in the United States | 8 |
| Water and sanitation for everyone in the world | 9 |
| Ice cream in Europe | 11 |
| Reproductive health for all women in the world | 12 |
| Perfumes in Europe and the United States | 12 |
| Basic health and nutrition for everyone in the world | 13 |
| Pet foods in Europe and the United States | 17 |
| Business entertainment in Japan | 35 |
| Cigarettes in Europe | 50 |
| Alcoholic drinks in Europe | 105 |
| Narcotic drugs in the world | 400 |
| Military spending in the world | 780 |

Source A. Shah, "Causes of Poverty," July 25, 2005. <www.globalissues.org/traderelated/poverty.asp>.

<www.globalissues.org/traderelated/poverty.asp>

The above staggering and established facts clearly indicate the extent of the problem, and the skewed priorities of the richest nations in the world. On July 2nd, 2005 millions of people were gathered in 10 different cities in the world with one common goal, to encourage the 8 leaders of the world's most powerful countries to focus their G8 summit meeting on poverty in Africa. Ten concerts were held in different cities around

the world to increase the awareness of the people around the world of the graveness of the poverty problem. The G8 meeting was held on July 6th 2005 in Gleneagles in Scotland. The three main goals were canceling the debts of the poorest 18 countries, promoting fair trade, and increasing the quantity and quality of aid. The G8 leaders eventually agreed to a doubling of the aid for Africa by $25 billion a year by 2010, as part of an overall increase of $50 billion for all developing countries. Of course the difficult task is to implement what has been agreed and to ensure that the aid ends up where it should be; that is, to benefit those who are really in need: the poor. When one looks at the statistical facts and develops an understanding of the magnitude of the problem, it becomes clear without doubt that poverty alleviation efforts have to be accelerated and followed through with vigor so as to change the course from decline to improvement.

## 2.11 Poverty Alleviation and Financial Services

Poverty exists predominantly in the informal sectors of developing economies, whether in rural areas or deprived urban areas. As mentioned earlier, the share of the informal sector in most developing countries is relatively large and growing compared to the formal one. Most, if not all, low-income people do not have access to adequate and efficient financial services. While the formal sector of the economy has been efficiently and adequately financed and regulated by formal financial systems, the informal sector was–until the development of microfinance- only served only by informal financial systems. Any efforts or strategies that aim at reducing poverty should thus provide for sustainable access to financial services for the small economic agents, the active poor,

and the poor, whether in rural or urban areas. The following paragraph discusses the financial systems and focuses on the informal financial system which is the provider of credit and savings services to the lower-income agents.

# 3- Financial Systems

## 3.1 The Role of the Financial Systems

An efficient and well developed financial system is indispensable to the process of economic development. It facilitates the mobilization of financial resources from savers with surplus of funds, to entrepreneurs and other borrowers with fund shortages, who then take the lead in ventures of economic development. This, in turn, "accelerates the pace of development by securing an uninterrupted supply of financial resources to people engaged in numerous economic activities".[21]

The development of financial systems and their increased capacity to supply loans to active economic agents played a significant role in global economic development. Financial intermediation, being the supply of credit and loans, was made possible by the idea of collecting money from the public and offering an interest rate as a return on such deposits, and concurrently lending the loanable funds to businesses and entrepreneurs, at higher interest rates. The depositors, financial institutions, and the entrepreneurs - if the venture is successful - all benefit from this intermediation, and help in expanding the economy. The financial system is also important in reallocating resources and capital to the more profitable sectors thus continuing to restructure the economy, which is needed

[21] Concept and ideology: Evolution of Islamic Banking. July 25, 2005. <http://www.islamibankbd.com/page/ih_1.htm

to support growth. This is evidenced by the fact that in a highly developed financial system, the greater share of investment is allocated to the growing sectors.[22]

## 3.2 Components of the Financial Systems

There are three main elements of a financial system in any economy: banks, non-bank-financial-institutions and financial markets. A Bank is a financial institution that holds a banking license and provides banking and other financial products. The essential function of a bank is to provide financial services to its clients, these services are mainly accepting deposits and mobilizing them for entrepreneurs with a shortage of money. Non-bank-financial-institutions are financial institutions that provide financial services but do not hold a banking license, and their operations are supervised and regulated by authorities. Typically non bank financial institutions extend loans and credit but rarely accept deposits from the general public. Financial markets consist of markets for bonds, equities, derivatives, and foreign exchange. [23]

The financial systems of developing countries are further characterized by their dualism. In the previous chapter we examined the roles of the formal and the informal sectors in development economies. A similar feature of dualism exists in the financial systems of developing economies. This is reflected in the coexistence of a formal financial system and an informal one. Informal finance covers all lawful financial activities, which are outside the purview of the legal, regulatory and prudential

[22] W. F. Duisenberg, "The Role of Financial Markets for Economic Growth." July 21, 2005. <www.ecb.int/press/key/date/2001/html/sp010531.en.html>
[23] About Financial Markets. The Bank Of Canada. <http://www.bankofcanada.ca/en/financial/financial_system.html>

framework of the financial authorities".[24] In contrast to the formal financial institutions, informal finance is not regulated, supervised, taxed, nor recorded by government officials.

Formal and informal finance generally cut across all the main elements which are discussed above. For example, some non bank financial institutions are regulated and some are not. The formal financial system which generally includes banks, non-bank financial organizations and securities markets, serves the modern urban sector. Semi-formal organizations also exist as part of financial systems; these do not fall under the general legal, regulatory and prudential frameworks of the formal financial system, but rather under specific ones, such as credit unions and credit cooperatives.[25] The informal financial markets tend to serve small entrepreneurs, micro-enterprises, low-income people, and the active poor. The formal and informal financial systems co-exist and interact with each other in numerous ways. For example, mobilized savings in the informal system being deposited in formal regulated banks; and informal moneylenders may borrow from formal banks and on lend the borrowed funds to their customers.

## 3.3 Supervision and Regulation of Financial Systems

Financial systems need to be regulated and supervised for many reasons. On the micro side the main reason for regulating/supervising is consumer deposit protection, and maintaining public confidence in the system. On the macro side, due to the contagious effects of one institution's failures on the rest of the banks and the financial system,

[24] P. Popiel . Financial Systems and Financial Crises – A Practitioner's View, 27.
[25] Ibid.

supervision and regulation is necessary to prevent failures of financial systems and economic crises.

## 3.4 Introducing Informal Finance

As proposed earlier, the informal sector is a major component of any developing country's economy. It must be financed in order to achieve sustained growth. The type of finance the informal sector generates and operates is called informal finance. There are many terms that were used to describe and label the activities of informal finance, such as moneylender, un-organized, and non-institutional. Conventional thought held that these activities were comprised of predatory lending or exploitative loans. As a result, policies towards informal financial activities tended to eradicate, regulate, or substitute it with formal subsidized credit. As more students of development finance concerned themselves with financial activities beyond the scope of the formal markets and as more information became available, it was realized that these terms are inaccurate for describing informal finance. It was noticed that informal finance activities persisted over a long period of time and occasionally involved large transactions and were sometimes similar to banks' activities. For example "a system that transfers funds earned by guest workers in the Middle East to relatives living in the Philippines- guaranteeing to do so in only a couple of days- is hardly unorganized or non-institutional"[26]

Informal finance as stated in *Informal Finance in Low Income Countries* is best thought of as lying along a continuum that ranges from casual loans among friends or relatives, through loans made by merchants and traders, through loans and deposits

[26] W. Adams, Dale. A. Fitchett, Delbert. Informal Finance in Low-Income Countries.

handled by various types of informal credit and savings groups, through pawnshops, through finance companies that are not regulated, and through credit unions that are unregulated. Another definition for informal finance is financial transactions, loans, and deposits, occurring outside the regulation of a central monetary or financial market authority.

## 3.5 Types of Informal Finance

There are different types of informal financial services; these include ROSCAs (Rotating Savings and Credit Associations), RESCAs (Regular Savings and Credit Associations), merchants, pawnbrokers, loan brokers, money guards, friends/relatives, savings groups, and money lenders.

**3.5.1 ROSCA**s: offer credit and savings products, based on social capital. They are usually temporary and have a specific purpose: some people with a common goal or bond usually agree to save a pre-determined amount of money. At every meeting each member contributes an amount, which eventually comprises the predetermined amount, which then becomes available to one of the members for a viable purpose. As mentioned earlier the informal financial sector is not regulated/supervised, however the influence of social capital acts as law. For example in a ROSCA, if the person who holds the money of all the members claims ownership of the mobilized funds he/she will be ostracized in this society

**3.5.2 RESCA**s are regular savings and credit associations, and are permanent informal organizations. Mutual societies allow for mobilizing savings that could be used in the case of unexpected events.

**3.5.3 Merchants**: Individuals who are primarily merchants but also extend loans linked to the sale/purchase of their commodities. This is a minor part of merchants' activities. Loans are usually repaid in a short period of time and carry no explicit interest rate. The price of the commodity is adjusted as a compensation for the loan. The advantage they have is that through the sale and purchase of commodities, information is accumulated about the borrower, which enables the merchant to better assess the clients ability to repay.

**3.5.4 Pawnbrokers**: Individuals who typically make small loans for short periods at an interest rate and who require borrowers to exchange physical collateral for loans. As a result pawnbrokers do not rely on information about the borrowers but on the strength of the collateral.

**3.5.5 Loan Brokers:** loan brokers facilitate contacts among people with money to lend and borrowers by trading inside information about potential clients. Typically loans are relatively large and cover a longer period of time than other informal financial activities.

**3.5.6 Money Guards:** Trusted individuals who agree to safeguard cash for other individuals. They offer a secure place to deposit funds. Usually no interest is provided

and there are no restrictions as to what the money guard can do with the deposits. Amounts deposited are usually very small.

**3.5.7 Friend/Relatives:** The most common form of informal finance is loans from friends and relatives. Many of the lenders charge no interest and require no collateral. The most important feature of this form is reciprocity; "the expectation that the borrower is willing to provide a loan to the lender sometime in the future"[27]

**3.5.8 Savings Groups:** This form of informal finance involves individuals who regularly or irregularly deposit funds with a group leader. They do not distribute funds among members through any systematic rotation. These groups are part of a larger class of informal groups that pursue a variety of purposes, such as conducting financial intermediation to pay for health care, and education. For many poor people, having a safe place to save and access these funds when a need arises means a way out of poverty.[28]

**3.5.9 Moneylenders:** Individuals whose primary activity is lending money. Loans are granted for short periods, and are unsecured by collateral. Typically moneylenders lend to their long term clients whom they have information about through previous transactions. Interest rates charged are higher relative to other lenders.

## 3.6 The Role of the Informal Financial Sector in Developing Economies

In a typical developing economy, around 80-90 percent of the economic agents do not have adequate access to formal financial services. The less developed an economy is,

[27] W. Adams , Dale. A. Fitchett, Delbert. Informal Finance in Low-Income Countries, 12
[28] A, Perera. Savings Groups Helps Villagers Plan for the Future. 2005 Oxfam America

the greater the share of the informal financial activities in the financial system. According to Popiel, there are several reasons, relating to supply and demand, for informal finance to emerge and thrive.

### 3.6.1 Supply

On the supply side, financial institutions tend to be reluctant in servicing certain groups of people with lower income levels; they also tend to refrain from expanding in areas and regions where incomes are low. Additionally, formal financial institutions do not want to incur the high risk of loan default, and high cost of servicing small entrepreneurs and the active poor. High costs are incurred in relation to the gathering of information and due to the small size of the relevant account balances. However, due to the need to finance the informal sector, money lenders and other types of informal finance activities evolved.

While researching informal finance, one might be mislead to believe that the informal financial sector and moneylenders are often exploiting and using their borrowers and charging extremely high interest rates. For example, there are accounts of lenders charging 10 percent per day, and those who seek to capture the borrowers' collateral, by extending loans to individuals they know will be unable to repay. However, people do not realize that critics tend to ignore the large number of informal lenders who benefit from sustained relationships with their clients, the loans made at modest interest rates, and the "multitude of loans made and repaid without the lender foreclosing on collateral".[29] They also fail to mention people who pay high interest rates and realize higher rates of return

[29] Dale, W. Adams, Delbert, A. Fitchett .Informal Finance in Low-Income Countries, 12.

on their investments. It must be understood that typical borrowers of informal loans have weak credit ratings, thus the risks and opportunity costs involved in the transactions are usually very high. It is unreasonable to expect lenders to charge borrowers less than returns they could realize on alternative investments. In addition, in times of hyperinflation, which is common in less developed nations, informal lenders lose purchasing power, as interest rates range from 10-30 percent per week while inflation roars at several thousand percent.

### 3.6.2 Demand

On the demand side, small entrepreneurs and the active poor may choose to remain operating in the informal financial systems due to the operational rigidity, multiple information requirements and the tax reporting requirements in the formal institutions. In other words, informal markets are flexible and thus more efficient in meeting their requirements.

The share of informal financial services in the financial system reflects the demand for the types of services that are not met by the formal financial institutions. It also shows that many poor and small economic agents have a saving capacity. As long as the formal financial sector cannot meet the demand for microfinance and small economic agents, the informal financial sector will remain a necessary component of the financial system to fund an important share of economic activity in the developing world.[30]

[30] P. Popiel. Financial Systems and Financial Crises – A Practitioner's View, 31.

Sustainable and efficient financial markets are important in rural development. Formal efforts that were made in order to enhance rural development such as subsidized agricultural credit programs achieved disappointing results. It is clear that informal finance is doing a better job. However formal financial systems are necessary to support development, manage large amounts of deposits, and make large and long term loans. An argument presented by Adams is that studying these informal markets will help to identify the financial services that they provide more efficiently if compared to formal financial institutions. In addition, it may also uncover practices that could be adopted by banks and cooperatives that are providing financial services. Supporting the informal financial system and trying to learn its methods is more beneficial than trying to drive them out of business.[31]

## 3.7 A Comparison of the Formal and the Informal Financial Sectors

It is important to distinguish between the characteristics of the formal and the informal financial sector. Table 3 below summarizes the key differences.

[31] Dale, W. Adams, Delbert, A. Fitchett .Informal Finance in Low-Income Countries.

**Table 3: Comparison of Formal and Informal Financial Systems**

| Informal Financial Sector | Formal Financial Sector |
|---|---|
| The informal sector provides services to farmers, small enterprises, and low-income families. | Favors large-scale, well-off, literate clients, who represent lower risks. |
| Techniques used are simple. | Complex techniques are used, usually not understood by the masses. |
| Access to services is non-bureaucratic, and little is based on written documents. Literacy is not a requisite. | Procedures are complex and require reading and writing skills. |
| Transaction costs are low. | Transaction costs are high. |
| Informal groups are aware of problems that members may be confronted with, and can hence deal with repayment difficulties. Rescheduling is possible. | Formal sector institutions do not have close contact with the environment in which they operate. Defaulters are either prosecuted or are not sued and tend to think loans are free. |
| The volume of loans and funds available for lending tend to fluctuate. | This sector regularly has loanable funds. |
| This sector is not subsidized by the government and does not receive grants or donations. | Formal sector institutions are sometimes subsidized and receive grants, donations, and support from governments. |

Source: Comparing Formal and Informal Financial Sectors. The Global Development Research Center. http://www.gdrc.org/icm/formal-informal.html

Formal commercial banks prefer interacting with higher-income households, and large entrepreneurs and enterprises in order to reduce the risk of default. Their

operational structure is not suited to the management of large numbers of small scale depositors. The lending techniques of the informal financial sector are suitable for small scale savers and borrowers because many of these techniques are based on social capital. Additionally, informal financial institutions are close to the rural environment and have information unavailable to the formal commercial institutions, such as the conditions of the clients and the methods of production. For example in agricultural enterprises they would have better knowledge of farm size, fertility of soil, and crops harvested. Generally, they tend to have better information networking systems. They also hold informal meetings on regular basis, to discuss the situations of the clients.

The disadvantages of the informal financial sector include the lack of investment opportunities for savings which have not yet been loaned out. Informal financial institutions do not usually accumulate funds before peak seasons of economic activity when demand for loans is higher, thus the availability of funds is not as stable as in the case of formal financing institutions. There is also, to a large degree, less reliance on written records in the informal sector which contributes to inefficiency and a greater degree of risk. A major disadvantage of informal finance is that it is always limited by community borders. This is a result of the existence of social capital. For example a man who owns a store can only borrow funds from merchants and moneylenders who exist within his community. He cannot borrow funds from another village because he is not known there. Therefore the funds and resources in the informal finance are not mobilized on a large geographical area; instead they are mobilized separately within each community.

Governments have come to realize that the informal sector has a significant role to play in developing economies, and that empowering this sector is crucial to the success of their poverty alleviation policies. They are also aware of the fact that this sector is at present not being provided with adequate financial services. Policymakers are increasingly recognizing the positive impact that microfinance can have on the economy and the potential profits that can be reaped by developing this practice.

"The first credit mechanism aimed at providing finance to small economic agents and farmers were subsidized credit programs in the 1960s and 1970s, and they were managed by public entities".[32] During this period agriculture and SMEs were generally a very high priority by policymakers who assumed that the development of these two sectors required financing while farmers and small entrepreneurs were unable to afford the costs of commercial credit. Therefore state-owned development banks were assigned with the delivering of subsidized credit to small economic agents. According to Popiel, these programs failed for several reasons:

- Supply led approach failed to respond to the actual demands of the small economic agents
- Subsidized credit was not always delivered to the intended recipient. Well off farmers often received the credit.
- The public entities managing the credit programs were hardly models of efficiency and recovery rates were very poor.

[32] P. Popiel. Financial Systems and Financial Crises – A Practitioner's View, 32

- Credit subsidies constrained the amount of loanable funds; credit rationing created moral hazard and corruption; many credit programs gained political hues, and became vulnerable to political influence.[33]

During 1980s and the 1990s, development thinking and related policy prescriptions shifted towards "neo-liberalism", emphasizing market-based solutions rather than state intervention. At the same time, economic development and poverty alleviation gained priority for most policymakers and economists. "It is in this conducive context to innovation that microfinance emerged and expanded".[34] Microfinance responds to the demand for small-scale financial services of the active poor, as opposed to injecting unwanted credit to small economic agents as the supply led credit programs did. In addition, microfinance adopts many of its methods from informal finance, it is flexible, fast, and has overcome the major disadvantage of informal finance which is its limitation within community borders. The following chapter discusses microfinance in greater detail.

[33] P. Popiel. Financial Systems and Financial Crises – A Practitioner's View,.33
[34] Ibid, 33

# 4- Microfinance

## 4.1 A Brief History of Microfinance

Institutional Commercial micro-credit and micro-savings is not a new concept. It was common in parts of Europe in the 19th century and was sometimes exported to colonies of European countries. For example, Indonesia's oldest micro-credit institution is the Badan Kredit Desas (BKD), which provides financial services to large numbers of low-income clients. Similarly, in Columbia, the Banco Caja Social has been mobilizing savings for poor clients since 1911. In Bangladesh, Muhammad Yunus, a professor and head of the Economics department in Chittagong University became "disenchanted with theories of economics shortly after the famine spread over Bangladesh in 1974 and economic theories did not seem to offer any direct solutions to the extreme and rising poverty".[35] He established the first micro-financing company, Grameen Bank. He saw microfinance as a more direct approach to the problems of inequality and poverty. The revolution of financially self-sufficient microfinance institutions began in the 1970s with Bank Dagang Bali in Indonesia. It began as a result of new financial know-how as well as the unprecedented developments in information and communication technology. In Indonesia, lending techniques were coupled with the widespread mobilization of voluntary micro-savings. These combinations made profitable microfinance and large-scale formal sector financial outreach to the poor possible. On a global level, sophisticated information systems were made possible by the innovations in communication technology, and this accelerated the microfinance revolution. Institutions

[35] I. Gendelman and G. Aiello. Communication in Microfinance: An Exploratory Case Study,

in different countries began to experiment with microfinance for the first time. Finally, the late 1990s witnessed competition among commercial microfinance institutions. This was however confined to a few countries; and for reasons as will be discussed later not all microfinance institutions were successful.

## 4.2 Defining Microfinance

Microfinance evolved as an economic development approach to provide low-income people with access to adequate financial services and to improve their overall welfare. The problem which microfinance can address is the inability of micro entrepreneurs and the active poor to make use of adequate financial services, especially loans or savings. As a result, they are unable to expand their businesses, get out of poverty, or even smooth out their consumption. Microfinance, as defined by M. Robinson,

> *refers to small-scale financial services – primarily credit and savings – provided to people who farm or fish or herd; who operate small enterprises or micro enterprises where goods are produced, recycled, repaired, or sold; who gain income from renting out small amounts of land, vehicles, draft animals, or machinery and tools; and to other individuals and groups at the local levels of developing countries, both rural and urban.*[36]

In other words, Microfinance Institutions (MFIs) are financial institutions that provide financial services to the small economic agents or to small enterprises owned by small

[36]M. Robinson, The Microfinance Revolution, V.1, (31:05, 2001), 29.

entrepreneurs in order to help them expand their businesses and increase their incomes, thereby improving their welfare and reducing poverty. Typical microfinance services and methods are listed in the following table

Table 4: Typical Microfinance Activities

**Services:**

- Small loans, typically for working capital.
- Informal appraisal of borrowers and investments.
- Secure savings products.
- Training in financial literacy
- Training in management capabilities
- Development of self confidence
- Skills training and marketing
- Social services
- **Methods:**
- Collateral substitutes, such as group guarantees or compulsory savings.
- Access to repeat and larger loans, based on repayment performance.
- Streamlined loan disbursement and monitoring

Source: J. Ledgerwood, Microfinance Handbook, World Bank (1999).

Hence the definition of microfinance should include social intermediation in addition to financial intermediation. Microfinance institutions can be non-governmental organizations, savings and loans cooperatives, credit unions, government banks,

commercial banks, or non bank financial institutions (NGOs).[37] Their clients are usually low income economic agents, the active poor, and the poor. The majority of their clients are self-employed. There are also informal microfinance institutions such as money lenders and rotating savings and credit associations.

As mentioned earlier, adequate and efficient financial services for the poor and the active poor are rarely accessible through formal financial channels. This is because banks mistakenly assume that small-scale services are not profitable. Where credit is available, it is usually provided to the poor by local moneylenders, but sometimes at very high costs to the borrowers. In some cases such services are referred to as predatory lending which _Honohan, Patrick describes as:

> *a pattern of abusive behavior in which an unscrupulous lender exploits superior knowledge, especially techniques and legal loopholes, to dupe borrowers into assuming contractual debt obligations that they cannot hope to meet, likely losing valuable collateral and transferring over time substantial net economic value to the lender despite defaulting and incurring additional social and psychological penalties.*[38]

For example, in a rural community, wealthy individuals will often offer loans and in rare cases, they will even offer savings products. However the interest that is charged on the loan is sometimes very high and the savings agreements provide little or no

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[37] J. Ledgerwood, Microfinance Handbook, World Bank (1999).

[38] P. Honohan, “Financial Sector Policy and the Poor." (37: September, 2004), _.

interest. As a consequence, the borrowers become burdened with increasing debt. The lenders who gain power over the borrowers will sometimes abuse this power.

## 4.3 Rationale for Microfinance

It is important to understand how the microfinance revolution came about, and to explore the reasons that cause micro-entrepreneurs and the active poor to prefer microfinance institutions over informal finance or subsidized credit programs. As mentioned previously, there exists a large demand for small-scale financial services, whether for credit or savings. It is important to understand the financial requirements of small economic agents and the active poor. Moreover, it is necessary to compare microfinance with other financing options, such as government-subsidized loans and informal finance as far as their abilities to satisfy these requirements are concerned. These requirements can be met by credit and savings products that combine a number of characteristics. These include security, liquidity, convenience, good service, and a suitable return in the case of savings products. They also include regular access to credit at costs and repayments schedules that do not burden the borrower but rather foster sustained growth of their business. Additionally there is a requirement for simple techniques that make use of the existing features of the informal sector in structuring the lending and savings schemes.

If we examine government subsidized loans within the context of these requirements, it can be argued that while subsidized loans have the benefit of low cost to the borrower, however, they are limited in quantity and do not use the simple techniques of the informal sector. As for informal finance, it appears that, while some types of

informal finance provide products may meet some of the mentioned requirements, they are usually offered at relatively high costs to the customers and have their limitations that relate to availability of funds, and to confinement within community borders due to social capital.

Formal commercial microfinance institutions provide services combining all the characteristics referred to previously. They are also able to provide certain services at costs that enable the realization of profit both by the institution and the client, which is necessary for sustained growth. In addition, microfinance institutions provide these services using simple techniques and tools that the rural and urban lower-income people can understand. Many of their techniques are based on techniques used in the informal financial systems. While making use of social capital in providing these services, microfinance institutions are not limited by community borders.

These institutions provide savings and credit to a wide range of the poor. Even credits of $10 can be made available to the poorest of the poor. The interest rates charged must cover the costs and allow a margin sufficient enough to ensure institutional sustainability and growth. Commercial microfinance institutions do not provide credit unselectively: the borrower must have experience relevant to the type of enterprise, and must also demonstrate a potential capability and willingness to repay the loan with the interest agreed on maturity. "MFIs may be unwilling to lend the very poorest who are likely to be the poorest credit risk".[39] The credit officers must be able to distinguish between applicants or potential borrowers that operate an efficient enterprise and are likely to repay and applicants who are unlikely to repay. Thus some low income earners

[39] D. Hardy, P. Holden, V. Prokopenko. Microfinance Institutions and Public Policy. October 2003.

are excluded from access to credit. Savings on the other hand, is not exclusive at all, in fact it is inclusive. For example a person who is not considered poor and who is living in the same area may also be able to use the savings products offered by the institution. Anyone who can meet the low minimum balance requirements can make use of the savings products offered.

## 4.4 High Interest Rates and the Costs of Operating MFIs

The interest rates charged by commercial microfinance institutions usually tend to be higher than the average interest rate of the country's commercial banks. Some regard that this is a form of discrimination against poorer clients; however the reason behind this is that the operating costs of providing many small loans is higher than providing a few large ones, in addition to the fact that their clients are normally considered to carry a high credit risk.

Operating costs of microfinance institutions are much higher than those of the banking industry standard in the same country. The costs of carrying out microfinance operations are high relative to the size of loans and deposits. Financial transactions often have a large overhead and fixed costs independent of the size of the loan or deposit.[40] These costs typically include the administrative costs of making payments, keeping the branches open, loan monitoring, with the largest cost items being salaries. These institutions are very labor intensive: "They must maintain and staff many small, widely dispersed outlets that are conveniently located for clients".[41] Moreover, the infrastructure

[40] D. Hardy, P. Holden, V. Prokopenko. Microfinance Institutions and Public Policy. October 2003.
[41] M. Robinson, The Microfinance Revolution, V.1, (31:05, 2001), 29.

and communications in the rural areas are often poorly managed and underdeveloped. Another factor is the relative cost of the loans: interest rates on loans are attractive to low-income borrowers because they are much less than the rates normally charged to such borrowers in the informal market. Thus, even though these interest rates are much higher than those of standard banks, they still appeal to those with low incomes. The highest interest rate charged and observed by a microfinance institution was 10.1%, which was charged by a Mexican village banking program during a period when inflation was 52% p.a. Other reports estimate rural moneylender rates in Mexico as high as 25-30% per month during periods of much lower inflation.[42] In addition, as will be showed in the case study of Bank Rakyat Indonesia there is empirical evidence that huge numbers of poor borrowers can indeed pay interest rates at a level high enough to support microfinance institutions' sustainability

## 4.5 Demand for Microfinance

Most of the demand for microfinance comes from the unregulated informal sectors of the economies which are not financially served by the formal sector. During the beginning and into the second half of the 20th century, credit for agriculture was seen as a high priority, while finance by small entrepreneurs was largely ignored. Indeed, until the 1980s, presence of the informal sector was generally seen as an economic dysfunction. It was thought that its presence meant that the formal sector was not large or efficient enough to absorb and integrate the labor force in the informal sector. Given such an environment, most governments' responses were focused on attempts to improve the

[42] Ibid, 30

management of the formal economy, increasing its absorptive capacity. It was thought that by improving the macroeconomic management, the formal sector would develop and consequently enable low income earners employed in the informal sector to become absorbed by, and integrated into, the formal sector of the economy.

As developing economies improved their macroeconomic management systems through various reform programs such as the IMF stabilization programs, there was an increase in the number of people employed in the informal sectors. Because the reform programs involved the shutting down or down-sizing of large state enterprises which entailed employee lay offs, many workers shifted to the informal sector, and there was a subsequent increase in the demand for low-cost goods and services. This caused policymakers to re-examine their approach towards the informal sector. In contrast to their earlier views, they have come to accept that the informal sector is a rationale response to the problems caused by poverty. Consequently, attention shifted to improving the legality, security, and financing of the informal enterprises. If the formal sector cannot absorb the labor force of the informal sector then there is logic to enhance the economic environment of the informal sector. The growing interest of policy makers' in microfinance is partially related to the recognition that the informal sector is very large, and its economic performance can be improved by providing it with adequate financial services. Thus, the trend of late has been to develop microfinance as part of the efforts to develop the informal sector.

## 4.6 Supply of Microfinance

While there is a large demand for microfinance and small-scale financial services, there is insufficient supply to meet this demand. Around 80 percent of the world's 4.5 billion people live in low/lower-middle income economies and do not have access to formal financial services. Among these 3.6 billion people, the average household is 5. This translates into 720 million households people. Half of these households (360 million) account for the unmet demand for commercial savings and credit services from financial institutions.[43] Productivity and the standard of living of these households could be improved by giving them fair and appropriate access to formal financial services. This could help improve the lives and incomes of 360 million households, or 1.8 billion people living in poverty. There was historically shortage of microfinance institutions in the developing world, which increased the financial insecurity of the poor. This, however, is gradually changing and microfinance seems to be flourishing in many parts of the world. According to a study conducted by Yunnis "at the end of 2001, more that 54 million families around the world benefited from microcredit. Of this number, 26.8 million are among the poorest, or those who live under US $ 1 a day. This is impressive progress from 1997 when we could count only 7.6 million poorest families".[44] This is strong evidence that the microfinance institutions are becoming active and reaching out to the poor. If this is the case, then why has the demand not fully been met? Is the demand by far larger than can be met by the existing network of microfinance institutions? Or is the

[43] M. Robinson, The Microfinance Revolution, V.1, (31:05, 2001), 10.
[44] Yunnis, M. Expanding Microcredit Outreach to Reach the Millennium Development Goal. Some Issues for Attention. January 2003, 1

demand growing at a faster pace than that at which this network of institutions is growing?

## 4.7 Why has the Demand not been fully met?

While the microfinance industry is thriving, the demand for commercial microfinance has not yet been fully met. There are several reasons that can explain this fact. One of the more obvious reasons is the very large demand by many of the lower-income and poor people who constitute over half of the world population. In an earlier section of this paper it was explained that most of the demand for microfinance products comes from the informal sectors of the economy which are growing and constituting a very large share of economic activities and services in developing countries. Another main reason is the "slow development of appropriate and efficient financial technology and the lack of information that prevailed until recently".[45] Accurate information regarding microfinance in developing and rural markets has been slow to reach bankers and policymakers. It is difficult to expect a rapid change in prevailing common perceptions about the subject. There has been "limited interest in microfinance amongst policymakers and managers of financial institutions, prohibitive government regulations, lack of basic infrastructure, and sparsely settled populations".[46] Many economies still lack the infrastructure (especially communication and transportation) that is required to bring microfinance products to the remote areas where they are needed. Another important reason that the demand is not being met, and one which is among the most difficult to deal with, is the fact that it is very costly for microfinance institutions to

[45] M, Robinson, The Microfinance Revolution, V.1, (31:05, 2001), 35.
[46] Ibid.

provide formal financial services in areas with small populations. Despite the large demand for microfinance, it is estimated that it is unavailable to over 80 per cent of all house-holds in developing countries.[47] Factors on both the demand and supply side have contributed to this gap.

The issue of misconceptions about microfinance merits specific attention. Policymakers sometimes mistakenly believe that it would be more expensive to deliver financial services through a non-subsidized formal microfinance institution relative to delivery through subsidized ones. As mentioned by Marguerite S. Robinson in many developing countries the formal financial sectors have been poorly advised that:

- Formal institutions cannot provide microfinance profitably because of high transaction costs the institution would have to bear.
- There is a high institutional risk due to asymmetry of information, moral hazard, and the adverse selection of borrowers.
- Institutions cannot compete successfully with the informal commercial credit market.
- Institutional commercial microfinance is not a development priority because informal commercial lenders meet the credit demand of low-income households and are generally beneficial to the poor.
- Low-income people are uneducated and backward, and so unable to participate in the formal financial sector.

[47] M. Robinson, "Microfinance in Indonesia." <http://www.findarticles.com/p/articles/mi_m1310/is_1997_Jan/ai_19208921/pg_2>

- Low-income people cannot afford commercial loans and so require government- or donor-funded credit subsidies.
- Most rural economies in developing countries do not generate a sufficient volume of business to be attractive to formal financial institutions. [48]

This misinformation slowed down the development of the microfinance industry. However, the existence of success stories of sustainable microfinance institutions challenged such arguments. As more information became available about the viability and sustainability of formal microfinance, attitudes towards the subject changed. The 1990s marked a period of development for commercial microfinance. More attention has been given to regulation, supervision and governance; there have been more visits by policymakers and microfinance practitioners to leading microfinance institutions; microfinance training programs and practitioner networks have been established; and relevant internet discussion groups and websites have been developed. The development of communication technology has helped the spread of information about the viability of commercial microfinance. As stated by Robinson, "the microfinance revolution has benefited greatly from its emergence in history at the same time as the information revolution".[49]

## 4.8 Effects of Meeting the Demand for Microfinance

Meeting the demand for microfinance will have positive effects on micro-enterprises, low-income earners, the poor, governments, and the economy as a whole.

[48] M. Robinson, The Microfinance Revolution, V.1, (31:05, 2001).
[49] Ibid, 37.

Gaining access to formal financial services will help the poor and small economic agents expand their income activities, increase their earning powers and hence improve their overall welfare. Microfinance institutions offer loans as small as $10, and sometimes as high as $10,000. An incremental approach to loan size allows borrowers to start with small loans, and to increase the size of their borrowings gradually depending on their repayment records. These services will help low-income people to better manage their enterprises, grow their existing businesses or start new ventures, in addition to minimizing the risk of zero-income at any given time.

On the occasion of the International Year of microfinance 2005, a number of success stories have been put to light to demonstrate how lower-income earners can benefit from microfinance to grow their businesses, improve their lives, and provide better opportunities for their children. The case of a flower vendor in La Paz, Bolivia, by the name of Fortunata Maria de Aliaga, who sold flowers for the larger part of her life, was presented. Fortunata worked hard to give her children an opportunity she never had: schooling.

> *"Then, 15 years ago, Fortunata learned about Banco Sol, a bank affiliated with ACCION International. Together with three other women, she qualified for a loan that allowed her to buy flowers in bulk at a much cheaper rate. With a strong repayment record, Fortunata was approved for larger loans and began to borrow on her own. Today, Fortunata is proud to report that she put her savings to good*

*use. All three of my children finished school," she beams. "And I even had money left to make some improvements to my house!"* [50]

Once these investors and entrepreneurs have reached the loan ceiling of the microfinance institution, they are then eligible for minimum standard loans from commercial banks, provided they have a good repayment records.

Microfinance is also a tool for building up the self-confidence of the poor, by showing respect for customers, by demonstrating trust in their clients, and by helping set the example that poor households are well regarded and worthy of trust. Microfinance Institutions play an important role in this respect, because through access to credit, low-economic agents are able to expand their businesses, increase their income, and avoid exploitation. Having access to savings, insurance, and other financial services allows the working poor to improve their lives, decrease risks and realize returns on their savings. This will have a positive effect on economic development and social welfare: as children are more likely to receive education, the need for child labor decreases, health conditions improve, and more jobs are created over time. In the long run governments benefit as well because they do not need to provide credit subsidies or cover losses of subsidized credit programs, while positive externalities are being created. The economy as a whole benefits from increased production in the informal sector.

Access to financial services is a very important tool for reducing poverty. There is however a debate as to the optimal way to provide these microfinance services. Policymakers, economists, and microfinance practitioners should be able to determine the

[50] "What Clients Say." International Year of Microcredit 2005. July 22, 2005. <http://www.yearofmicrocredit.org/pages/whyayear/whyayear_whatclientssay.asp>

best approach for large-scale outreach and for supplying these financial services in order to meet the vast demand, and to carry the benefits to as many low-income clients as possible in the long run.

## 4.9 Different Approaches to Microfinance

There are generally two different approaches to microfinance: the 'financial intermediation' approach and the 'poverty lending' approach. The financial intermediation approach stresses the importance of large-scale outreach to the active poor, both to borrowers who can repay small loans and also to potential savers. The large demand for microfinance underscores the importance placed on self-sufficiency; the financial intermediation approach is one way to meet this demand. The poverty lending approach has one main focus, which is reducing poverty through subsidized credit; this is often complemented with services such as training, literacy programs, family planning, and health services. Under this approach, donor- and government-funded credit is provided to the extremely poor, usually at below market interest rates and the goal is to reach the poorest of the poor, in order to overcome poverty. Grameen Bank represents a leading example of the poverty lending approach, while bank Rakyat Indonesia and BancoSol in Bolivia represent the other side of the spectrum, the financial intermediation approach.

There seems to be one basic and common goal in microfinance, which is financially servicing small economic agents who lack access to credit. The debates and differences between the two approaches are in fact related to the means of achieving the common goal, rather than to the goal itself. Many institutions that use either approach to

provide micro credit have served millions of customers successfully, and have reached the poor. However it seems that reaching millions of customers on a long term basis and sustaining competing institutions is better achieved through the financial intermediation approach. The data available on microfinance indicate that institutions that provide subsidized credit tend to fail; and that even successful institutions following the poverty lending approach can, in aggregate, only meet a small portion of the demand for microfinance. This is understandable since donor funds and government subsidized credits are limited in quantity and can only meet a limited part of the demand. Furthermore, some donors will find alternative investments with higher returns to which they will channel their funds. In the end, the donations provided will never be sufficient to meet the demand for microfinance due to the infinite demand and the limited quantity of subsidized and donor credit.

The financial intermediation approach has demonstrated that is able to provide services, both credit and savings, to low-income families on a large scale, and to do so with profit which in turn makes it self sustainable, as the profits, along with the savings are used to provide more credit. Institutions such as Bank Rakyat Indonesia (BRI) and BancoSol are evidence that microfinance can be achieved and sustained without donor or subsidized credit.

### 4.9.1 Poverty Lending Approach

The poverty lending approach uses donor funds and subsidies to fund loan portfolios. The advantage of this approach is that it targets the extremely poor; the lowest economic agents who cannot access financial services through the formal financial

system or through sustainable microfinance institutions. This approach however, leads to a donor-dependant micro credit institution because of the ongoing subsidies and cheap credit they offer clients. "Even established poverty-focused programs like Grameen Bank would have trouble making ends meet without ongoing subsidies". [51]

### 4.9.2 Financial Intermediation Approach

The financial intermediation approach uses subsidies or sizeable borrowings to cover the costs during their first years of operation only, and tend to learn from the best practices of fully sustainable microfinance institutions. This leads to self-sufficient and sustainable microfinance institutions and large-scale outreach, since these institutions finance their loan portfolio commercially, enabling them to multiply outreach by leveraging additional capital.

**Table 5: Polarized Perspectives in Microfinance[52]**

| **Breadth of Outreach - aim is to reach many of the poor (financial intermediation)** | **Depth of Outreach - aim is to reach the poorest of the poor (poverty lending)** |
|---|---|
| Institutionalist | Welfarist |
| Minimalist | Integrative |
| Self-sufficiency | Subsidizations |
| High Interest Rates | Low Interest Rates |
| Market-led | Government-Influenced |
| Group Lending | Individual Lending |
| Credit-Led Approach | Savings-Led Approach |
| Urban Operations | Rural Operations |

Table 5 summarizes the main differences between the financial intermediation approach and the poverty lending approach.

[51] Mcguire, P. The Asian Financial Crisis – some Implications for Microfinance." Microbanking bulletin, Boulder, CO: Economics Institute. 1998. P.3
[52] J, Lashley. Microfinance in the Eastern Caribbean: Demand and Delivery Options. October 2003.

Financially sustainable microfinance is achieved through institutions that deliver services to clients at interest rates that enable those institutions to cover costs and generate a profit. The term 'Commercial Microfinance Institutions' refers to institutions that finance their loan portfolios from locally mobilized savings, those that access commercial debt and for-profit investment, and those that use retained earnings to finance their operations.

## 4.10 Reaching Scale through Financial sustainability

A successful microfinance industry must include a large-scale outreach in the provision of financial services to lower income people. The industry has several thousand microfinance institutions that focus on poverty reduction, but only a minority is concerned about financial self-sufficiency and sustainability. The best means of providing large-scale outreach financial services to low-income people is by regulation and the promotion of self-sufficiency. Two countries that started the microfinance revolution were Indonesia and Bolivia. In Indonesia, Bank Rakyat Indonesia (BRI) started engaging in microfinance services in 1984, with the dual aim of increasing client reach and profits. It started out with subsidies and donor funds, in order to cover the start-up costs. Since 1986, it has been profitable, and since 1987 it has not been receiving any form of aid, subsidy or donations. In December 1999, the BRI Units had $802 million in 2.5 million outstanding loans, $2.3 billion in 24.1 million savings accounts, and a loan repayment rate of 98%.[53] Even at times of severe national crises, the bank has performed extremely well. During a meeting with potential investors, Laksamana Sukardi, the

[53] M. Robinson, The Microfinance Revolution, V.1, (31:05, 2001), 35.

Minister of State Enterprises, said "It is not an exaggeration for me to say BRI is the best bank in Indonesia".[54] At the time, the bank was offering up to 45% of its shares to the public via an initial public offering: "The BRI Units have taken a profitable, sustainable approach to large scale microfinance, based on locally mobilized savings without subsidies or funds from the government or donors. The provision of credit and savings services on commercial basis had a positive effect on the lives of millions of poor households."[55] Table 6 shows the data on BRI as of December 2001:

Table 6: BRI Statistics for 2001

| December 2001 | Micro credit | Micro savings |
|---|---|---|
| Number of Active Clients | 3,100,358 | 29,869,197 |
| Micro account portfolio value | $1,710,576,471 | $3,226,964,706 |
| Minimum Amount | $5 | $2 |
| Maximum amount | $6,000 | N/A |
| Microfinance as percentage of total portfolio | 31% | 38% |
| Percentage of micro accounts with less than $500 | 90% | 90% |

[54] R. A. Witular, The Jakarta Post, October 14, 2003.
[55] "Indonesia: 20 Years of Large-Scale Microfinance at the Bank Rakyat" July 23, 2005. <http://www.worldbank.org/wbi/reducingpoverty/case-Indonesia-20Years-BankRakyat.html>

Source: [1] "Bank Rakyat Indonesia"

<http://www.swwb.org/English/1000/ADDRESS/gnbi/add_gnbi_rakyat.htm>

The figures in the above table clearly indicate a sizeable operation and a large outreach evidenced by the large client base. It also indicates growth of clients and outreach relative to the data on 1999. The success story of BRI will be presented separately in a later chapter.

Bancosol, another pioneer in microfinance, started its revolution in the 1990s by providing large-scale commercial micro credit. Bancosol is a privately owned bank for micro entrepreneurs providing profitable loans "to more than one-quarter of Bolivia's bank clients".[56] "The bank aims to provide credit and deposit facilities to micro entrepreneurs in the poorest sectors of the Bolivian economy, broadening their employment opportunities, encouraging investment and increasing the level of income they can generate, while operating as a commercially viable operation, yielding a profit to its share holders".[57] This another success story in the way of a self sufficient and sustainable microfinance operation.

In general, the 1990s witnessed a significant development of microfinance practices which helped in bringing the potential positive contributions of microfinance to the attention of policy makers. However, there are still several developing countries in which the proper perception of the importance and viability of microfinance to financial

[56] M. Robinson, The Microfinance Revolution, V.1, (31:05, 2001), 34.
[57] G. Dauncey. "A Sustainable Economy" July 24, 2005.
<http://www.earthfuture.com/seconomy/sei01.asp>

institutions, as well as its huge potential contribution to poverty alleviation, is not stressed enough.

## 4.11 Supervision and Regulation of Microfinance

As a natural response to the rapid growth of the microfinance institutions around the world, knowledge on how to supervise and regulate these institutions is extremely important. In other words, there must be a "framework for addressing regulatory and prudential issues which impact the operations and the institutional development of MFIs".[58]

### 4.11.1Rationale and benefit of Supervision

First we need to examine the rationale for the supervision and regulation of the financial systems.

- Microeconomic Side:

A primary reason for regulating and supervising financial institutions is consumer protection for public depositors in financial institutions. This is of particular importance when the depositors are low-income agents, the poor, and the active poor, as they cannot afford to lose their deposits. The impact of a bank failure will be much more drastic that in the case of higher income people. Furthermore, financial institutions must be supervised and regulated to protect borrowers and avoid asymmetry of information and its consequences. Asymmetry of information, in this case, is when clients, whether

[58] H. Greuning and J. Gallardo, "A Framework for Regulating Microfinance Institutions: The Experience in Ghana and the Philippines," World Bank Policy Research Working Paper No. 2061, (February 1999), _.

borrowers, investors, or depositors, are not in position to judge the "soundness" of a financial institution, and are not able to influence the institutions' management. Hence, a third party is needed to control the "soundness" of the financial institutions in the country.

- Macroeconomic Side:

Another crucial reason for supervision and regulation is the contagious effects of one institutions' failure on the rest of the banks and the financial system, regardless of their "soundness." Supervision is crucial to prevent the systemic failure of a financial system as a whole. Indeed, this is what occurred during the East Asian Crisis, as a result of implementing financial market liberalization without ensuring that an adequate regulatory and supervisory system was in place.

With respect to microfinance, it is argued by Patrick Honohan that microfinance is too small to threaten the mainstream financial system in case of failure. The direct risks to system financial stability from insolvency of microfinance institutions are limited by their small scale. The consequences could be severe to low-income households and small firms simply because the institutions take deposits from these households and provide credit to the firms. However, the total assets of microfinance intermediaries are small, therefore the insolvency could rarely be large enough, in relation to GDP or to mainstream finance, to cause a system failure.[59] Even though the financial system as a whole might not be greatly affected, the fact that microfinance is growing and the

[59] Honohan, Patrick. "Financial Sector Policy and the Poor."

concept is developing very rapidly, requires caution so that peoples' confidence in the microfinance system is not lost due to the insolvency of an institution.

Regulating and supervising microfinance institutions would also be required for: "defining the roles of its banking and financial sector regulatory authorities (such as the central bank, ministry of finance, or bank superintendency), setting out rules for entry and exit of financial institutions, determining and limiting their business and products, specifying criteria and standards for the sound and sustainable operation of the industry".[60] Without regulation and supervision, the financial sector of a country would be vulnerable to a multitude of risks that could cause dire economic and social consequences. A thriving microfinance industry will have to depend on a solid system of regulation and supervision.

### 4.11.2 Costs of Supervision

Among the important aspects to consider in relation to financial supervision are the costs associated with establishing and implementing a regulatory framework for microfinance. Supervision and regulation entail many costs for the regulatory agency as well as for the institution being regulated.

Costs to the supervisors may be very high because MFI branches are usually small, located in remote areas, and could have poor record keeping systems. In addition skilled supervisors are scarce in developing countries, and the opportunity cost for

[60] Ibid, 5.

assigning them to MFIs could endanger the effectiveness and soundness of the formal financial system.

As for the costs to the supervised institutions, complying with regulations and supervision can be burdensome, time consuming, and expensive for a MFI. This could translate into a drawback for effective microfinance when the costs are passed on to the clients through higher interest rates.

One might argue that another indirect cost of supervision could be the hindering of innovation; complying with regulations and being supervised may limit the ability of a MFI to experiment with new techniques and methods, whereas flexibility and adaptability are essential features of an efficient microfinance institution.[61]

As an example, "Bancosol's management estimates that complying with the bank superintendency's reporting requirements during its first year of operations generated a cost equivalent to 5% of the loan portfolio".[62] Thus the costs of regulation must be evaluated within the context of the expected benefits. Ideally, there would be a large number of microfinance institutions that need to be regulated and supervised in order to justify the resources that will be used up in the process. A study conducted by Rhyne about the experiences (costs and benefits) of MFIs with supervision and regulation concluded that "The institutions involved in this study are overwhelmingly pleased to be regulated. All report that the benefits of being regulated outweigh the costs".[63] Regulation and supervision have brought MFIs the benefits they sought: "Greater access

[61] D. Hardy, P. Holden, V. Prokopenko. Microfinance Institutions and Public Policy. October 2003
[62] Ibid, 6.
[63] E. Rhyne, "The Experience of Microfinance Institutions with Regulation and Supervision" (September 10, 2002), 1

to sources of funds for both equity and debt, especially commercial sources; ability to achieve growth and quantitative outreach goals: to serve more people; improved, more professional operations through meeting higher standards of control and reporting; greater ability to offer products beyond microcredit, especially savings and transfers; and an enhanced legitimacy in the financial sector." [64]

These benefits are weighed against the costs of establishing and implementing a regulatory framework. Costs in the case of supervision are difficult to estimate. However, "CGAP estimates that the cost of supervision is as much as 5 percent of total costs during the initial year and 1 percent thereafter."[65] This estimate could be used as an indication when measuring the benefits against the costs.

### 4.11.3 A Framework for Regulation

Hennie van Greuning and Joselito Gallardo have produced a working paper in order to provide a framework for supervision and regulation. Two countries were selected for in-depth analysis of their experiences in implementing a microfinance regulatory framework. The criteria used for selecting the countries were the "Existence of a significant microfinance industry and a variety of semi-formal and formal channels for microfinance and the ongoing dialogue among stakeholders on issues in the legal and regulatory framework for microfinance."[66] Based on this, Ghana and the Philippines were selected. The authors state that, "In more recent years, the government authorities in

[64] Ibid.
[65] Ibid.
[66] H. Greuning and J. Gallardo, "A Framework for Regulating Microfinance Institutions: The Experience in Ghana and the Philippines," World Bank Policy Research Working Paper No. 2061, (February 1999), _.

Ghana and the Philippines have moved forward to articulate a vision and strategy for microfinance and its role in poverty alleviation programs".[67] In addition, these countries began adjusting their legal systems and their banking and financial laws and regulations to take advantage of the outreach made possible by microfinance.

The study focused on issues relating to the legal systems and judiciary processes, as well as the regulatory and supervisory environment for microfinance. The key issues relating to the legal system and judiciary environment were as follows:

- Procedures and requirements for legitimizing status as an MFI, such as organizational format for becoming established, and rules and regulations for registration;
- Standards to be met and requirements to be complied with in order to obtain such status as a licensed microfinance institution, including the range of institutional formats within a tiered structure;
- Procedures stipulated and requirements to be satisfied in order to access non-deposit wholesale commercial funds, e.g., through large-value certificates of deposit, commercial paper issues or securitized instruments; and,
- Characteristics of the legal structure and judicial system which permit or prevent assets to carry the burden of debt.[68]

The assessment and comparative analysis carried out in relation to the regulatory and supervisory environment focused on the following key issues:

- The principal prudential standards required to be observed and complied with by licensed or authorized banking and financial intermediary institutions;
- The primary methods by which observance and compliance are carried out, including frequency of offsite mandatory reports and onsite examinations;

[67] Ibid.
[68] Ibid,1.

- Sanctions and penalties for non-observance or non-compliance; and,
- Rules for entry and exit as licensed banking and financial intermediary institutions.[69]

The World Bank's overall strategy for helping countries to develop microfinance includes key measures to be adopted in the overall legal, prudential, and regulatory framework to build up institutional capacity and to establish the infrastructure of financial systems. The regulation and supervision of MFIs should be an integral part of the strategy to develop a market-based financial system.

Different microfinance institutions have different organizational and operational characteristics. "The risk-based approach to financial regulation shows that while there may be no major variances in the structure of their assets, MFIs are differentiated by the structure of their liabilities".[70] This means that there are differences in how they fund their assets and operations. Certainly, not all microfinance institutions need to be regulated in the same way. However, supervision and regulation "based on the typology of institutions rather than on intermediation activities creates incentives for *regulatory arbitrage*".[71] This is because organizers will seek a license category with the least required mandatory regulation. Greuning and Gallardo further define this framework: "A regulatory framework model identifies *thresholds* of financial intermediation activities which would *trigger* a requirement to satisfy *external or mandatory* regulatory

[69] Ibid, 2.
[70] H. Greuning and J. Gallardo, "A Framework for Regulating Microfinance Institutions: The Experience in Ghana and the Philippines," World Bank Policy Research Working Paper No. 2061, (February 1999), 7.
[71] Ibid.

guidelines."[72] Table 7 below summarizes the key features of the model and identifies activities triggering a need for regulation.

**Table 7(A): Microfinance Regulation**

| Type of institution | Ownership | Main source of funds for operations and loans | Activities that trigger regulation | Form of external regulation | Regulatory authority |
|---|---|---|---|---|---|
| Informal community-based Thrift & Credit Self-Help Group- Funding from community members and loans from NGOs and MFIs. | Community and village residents | -Fees and assessments on members<br><br>-Members' savings deposited with SHG | None | None | None |
| Category A: Other people's Money (NGO) – Funding from donor funds | Local and Foreign donors through a trust | Grants and donated funds | None- provided microfinance loans do not exceed donated funds | Registration as non-profit society or trust | Registrar of societies and/or Trusts |
| Category A: Other people's Money (Microfinance NGO) – Added funding via commercial loans/securities issues | Grants and Donations converted to share capital | -Grants and donated funds<br><br>-Concessional and commercial borrowings (Wholesale deposit instruments) | -Generating liabilities from commercial<br><br>-Concessional sources to fund operations and loans | -Registration as limited liability company<br><br>-Rating by Credit Rating Agency<br><br>-Licensing by bank authority as non-bank finance company | -Registrar of companies<br><br>-Central bank authority or superintendency<br><br>-Securities Regulatory agency |

[72] Ibid.

**Table 7(B): Continued**

| Type of Institution | Ownership | Main Sources of funds for operations and loans | Activities that trigger regulation | Form of external regulation | Regulatory authority |
|---|---|---|---|---|---|
| Category B: Members' Money funding from members' contributions | Members joined by recognized closed common bond | Share capital contributed and savings deposited by members | Accepting deposits from members, and making loans to members | Registration as a financial cooperative<br><br>[Large institutions- may fall under jurisdiction of Banking Law] | -Registrar of Cooperatives, or of Societies<br><br>Or<br><br>-Central Bank authority/superintendency for larger cooperative institutions |
| Category C: The Public's Money – Funding from the retail public deposits | Individual and institutional investors, and shareholders | -Contributed share capital<br><br>-Commercial borrowings<br><br>-Wholesale deposits<br><br>-Retail public deposits | -Accepting wholesale<br><br>-Retail public deposits for intermediation into loans and investments | -Registration as limited-liability company<br><br>-Licensing by banking authority as NBFI, or limited-service or full-service bank | -Registrar of companies<br><br>-Central Bank authority or superintendency. |

Source: Adapted from Chart 1 and Table 2, H. Greuning, J.Gallardo, "A Framework for Regulating Microfinance Institutions," World Bank Policy Research Working Paper No. 2061, (February 1999).

### 4.11.4 Microfinance Supervision vs. Conventional Banking Supervision

Areas that supervisory and regulatory agents should inspect during supervision include capital adequacy, asset quality, management, earnings, and liquidity. The tables

below list the areas in which microfinance supervision differs from the supervision of conventional banking.

The following tables (8 through 12) are adapted from E. Rhyne, "The Experience of Microfinance Institutions with Regulation and Supervision" September 10, 2002.

Table 8: Capital Adequacy

| | |
|---|---|
| Capital Adequacy Ratio | • Minimum capital requirement lower<br>• Leverage ratio higher |
| Adequacy of Reserves | • Provisioning policy should fit microcredit terms |
| Ability to Raise Equity | ▪ Unconventional owners (NGOs, donors) may have difficulty with this |

## Table 9: Asset Quality

| | |
|---|---|
| Portfolio Quality | • No need for concern about large loan concentration<br>• Focus on quality of delinquency management systems |
| Write-offs and Write-off Policy | • Should fit microcredit terms and experience |
| Portfolio Classification system | • Treatment of loans with unconventional form of guarantee |
| Productivity of long term assets | No change |
| Infrastructure | ▪ Allowance for low-cost infrastructure suitable for reaching the poor |

## Table 10: Management

| | |
|---|---|
| Governance/Management | • Unconventional owners and sometimes managers |
| Human Resources | • Different staff profile, salaries<br>• Importance of incentive systems |
| Controls, Audit | • Internal audit must take lending methodologies into account |
| Information technology | • Delinquency monitoring focus |
| Strategic Planning and Budgeting | No change |

Table 11: Earnings

| | |
|---|---|
| Return on Assets | • May be higher than the norm |
| Return on Equity | No change |
| Efficiency | • Administrative costs expected to be well above standard commercial banking<br>• Indicators and benchmarks specific to microfinance are needed here |
| Interest Rate Policy | ▪ Interest rates are well above standard commercial banking |

Table 12: Liquidity

| | |
|---|---|
| Productivity of Current Assets | No Change |
| Liability Structure | • May differ substantially from most other banks |
| Liquidity Ratio | No change |
| Cash Flow Projections | No change |

It is evident from the above tables that differences in supervisory issues can be found in most areas of the inspection process. Therefore the regulations applied in the case of microfinance may be different from those used for conventional lending institutions, even though the underlying principles remain the same. In general the

repayment rates in microfinance institutions tend to be higher than those of other financial institutions, because of the existence of social capital within informal sector, the rural sector, and urban communities. Therefore, as long as an MFI accepts deposits from customers, the focus of supervision and regulation should be more on operational risk management rather than lending risks.

Regulation and supervision of microfinance institutions has gained much attention over recent years. While supervision and regulation is necessary to ensure the efficiency and solvency of most financial systems, the microfinance industry is different in that sense. There is ongoing debate about the importance of supervision/regulation and the different ways of implementation. It can clearly be seen from table 7 that microfinance institutions differ in their structure depending on their stages of development. Therefore it is important to determine the stage the microfinance industry and the individual institutions are in, in order to develop a regulatory framework for microfinance. As argued by Fernando, banking authorities should not attempt to fully define regulation for microfinance institutions in its premature stages of development in order to avoid choking off innovations and adaptations which are vital to the development of this industry. [73]

[73] N.A. Fernando. Do Governments in Asia have a role in Development of sustainable microfinance services? Some Views.

## 4.12 Forms of Government and Donor Support towards MFIs

Now that this paper has examined the basic elements of microfinance, a question arises as to what donors, including governments and NGOs, can do to support microfinance institutions. The forms of support and the timing of support must be carefully chosen to suit the needs of the MFI at its different stages. The support must be provided without creating aid dependence. It should be designed so as to avoid weakening the incentives to achieve sustainability and as well as to avoid driving out competition. The first form of support could be providing a one-time start-up grant (capital injection). This would help the MFI cover its start-up costs, incur losses the first few years and eventually realize profits. Another form of aid could be providing the institution with a start-up loan that has a long repayment period. This will cover the high initial start-up and fixed costs, while creating an incentive for the MFI to innovate and reduce costs in order to repay the loan. Other forms of support include training facilities, assistance with computerization and record keeping. The most important factor to consider in strategies for supporting microfinance institutions is to avoid creating a donor-dependant agency. The idea is to extend the adequate and timely support without hindering the evolution of a viable and sustainable MFI.

## 4.13 Government and Donor Policy Mix for Microfinance

Another question arises of whether supporting microfinance institutions is worthwhile. As mentioned earlier in the essay, the costs associated with establishing and running MFIs tend to be very high. Many MFIs incur losses and earn below market returns on capital especially during the start up phase. To begin answering the question,

one must evaluate the positive and negative effects of both poverty lending and financial intermediation microfinance and compare these to other finance options available through the use of donor funds. Such options may include direct income support, training and educational programs, and the development of infrastructure projects.

As mentioned previously, there are two approaches to Microfinance. The poverty lending approach and the financial intermediation approach. The poverty lending approach aims solely at assisting the poorest of the poor, and usually relies on subsidies and donor funds. On the other hand, the financial intermediation approach aims at providing financial services to micro-enterprises through large-scale sustainable outreach while generating a profit and attracting investors. The disadvantage of the poverty lending approach is that it relies on subsidies and donors funds. If such funds are retrieved, the institution may collapse. In addition, there is no incentives structure and this could lead to high overhead costs, lack of innovation, and operational inefficiencies. Donor-dependent institutions may crowd out sustainable MFIs, as the latter are discouraged from entering markets that are already served by the donor and government funds. On the other hand, the disadvantage with the financial intermediation approach is that the extremely poor are unlikely to be served, as the MFI will be looking to minimize costs and risks and to generate profits.

### 4.13.1 Advantages of Microfinance

The main goal of microfinance is serving the financial needs of the poor, the active poor, and micro-entrepreneurs. This is an objective that carries a social value and one on which most policy makers would agree. Therefore the obvious motivation to

support MFIs is to support the disadvantaged segments of society which contributes to increased employment, economic growth, and improves the overall social welfare including income distribution.

### Helping the Poor Gain autonomy:

Microfinance can help the poor in a number of ways where aid or income support cannot add value. Aid and income support lead to aid-dependence. With microfinance, successful micro-entrepreneurs are able to expand their business and eventually gain dependence and autonomy, and may not need support in the future. Thus microfinance is capable of eradicating some of the socio economic features of poverty discussed earlier in this paper including powerlessness and voicelessness.

### Informational Advantage of MFIs:

Another argument for supporting MFIs is the advantage they have over other forms of assistance in terms of availability of information. Microfinance seems to overcome the disadvantage of asymmetry of information to some extent, as it operates in villages influenced by social capital. Since MFI branches are located within very close proximity of the towns and villages, they have closer relationships with their clients than other forms of formal aid. As a result credit officers are able to acquire more information about their clients.

## Providing Choice to Clients:

Another advantage MFIs have over other subsidized loans is that the client has the freedom of choice as far as important economic matters, choices relating to the timing, scale, and form of savings and borrowings. The poor need savings as well as credit, and credit alone cannot solve the problem of the lack of access to financial services. With the option of savings available through MFIs, clients may be able to choose the optimal level of savings and credit in order to smooth out consumption over time.

## Commercial MFIs choose to finance better projects:

A sustainable microfinance institution does not rely on donor funds for its operations. As a result, it will screen its borrowers so that financing will go to the best projects and the least risk of default. In contrast donor funds and aid may not reach their intended target and are sometimes dispersed to unviable projects and to relatively higher income people who are not in real need of cheap credit or aid. "Unless an elaborate system of means-testing is in place, direct income support tends to be spread too thinly because much goes to those who need it less".[74] This allocation of donor funds may also occur as a result of corruption

## Support of Sustainable MFIs may be of Low-Cost in the Long Run:

A successful sustainable microfinance institution will cover operating costs and generate a profit. Such an institution may be able to pay back some of the aid it received to its donors. The donors would then be able to allocate their resources to new projects

[74] D. Hardy, P. Holden, V. Prokopenko. Microfinance Institutions and Public Policy. October 2003

such as education, training, and infrastructure. Thus it can be assumed that supporting a sustainable MFI may result in reducing costs for donors over the long run.[75]

### 4.13.2 Other Forms of Assistance

Having established the benefits of microfinance, one must consider the other options available for the allocation of scarce development resources and donor funds. One option is for the funds to be used for direct income support, development of infrastructure projects, and education and training. The advantage of this type of assistance is that it can be directed to the poorest of the poor. In addition, training and education provides the poor with human capital which will eventually yield a return. Infrastructure projects can provide the poor with better drinking water, better transportation, and possibly a better information network, leading to an improved social welfare and a better quality of life. The major disadvantage of direct income support however, is that it will create a donor-dependant society and will hinder the development of a sophisticated commercial financial sector.

### 4.13.3 An Optimal Mix of Resources

The question that arises here is whether to use available resources to support MFIs or to allocate the resources to other developmental projects. A viable microfinance system should incorporate all components discussed above. It should include sustainable microfinance institutions that operate on commercial basis to help micro-enterprises expand their businesses, create more jobs, and upgrade social welfare. It should also

[75] Ibid

include donor-dependant microfinance institutions operating on the basis of the poverty lending approach with the aim of reducing poverty. This caters for the extremely poor who are not served by the sustainable MFIs. Funds should also be directed to infrastructure development, education, training, and other development projects. Supporting both types of MFIs and providing for other development projects should prove to be worthwhile.

Todaro argues that there is a relationship between income, health and education (human capital). With higher incomes, governments and people can spend more funds on education and health. Similarly, with better health and education, higher incomes are possible. Investing in education and health is investing in human capital, which has substantial effects on productivity in less developed countries. Due to these relationships, development policy needs to focus on income, education, and health simultaneously. With the incorporation of both types of microfinance institutions as well as development projects that invest in human capital, these relationships can be achieved.

Development funds should be allocated among such programs in a way that maximizes the overall net benefits to society. Therefore another question arises as to the optimal mix of allocated resources between microfinance and the other projects. The marginal social benefit of allocating funds for MFIs, and the marginal social benefit of allocating additional resources for development projects have to be calculated. If the marginal social benefit of spending more funds on microfinance is greater than that of spending on other projects, then more resources should be allocated to microfinance as this would increase the overall welfare. The opposite is also true. Therefore the optimal

level of resource allocation between microfinance and development projects is the point where their marginal social benefits are equal. However, it is argued by Honohan that it is finding empirical data on the impact of microfinance on society is not an easy task. So far quantifying the marginal social benefits of microfinance has proved to be very difficult.

It is important to understand that these policies are only suggestions. Every economy is different, and every country is at a different stage of development, and for each unique situation, a unique, appropriate, and effective policy mix is needed. Hence there is no homogenous set of policies that can achieve the most efficient results.

# 5. Case Study: Bank Rakyat Indonesia

The purpose of this case study is to provide an example of the operation of an existing microfinance institution. The Bank Rakyat Indonesia example is particularly relevant to this study because BRI, at different stages of its life, has adopted the two approaches to microfinance that have been analyzed in this paper. BRI also supports the view that there is enough demand for micro-credit as well as for micro-savings and that the viability of MFIs can be sustained through the mobilization of micro-savings without relying on donors for funding purposes. The case study is also interesting as it provides us with empirical data that portray the actual operations of an MFI such as the volume of loans and deposits, distribution of loans by economic sectors, repayment performance, profitability, and staff productivity.

## 5.1 A Brief History of BRI

Bank Rakyat Indonesia is a state-owned commercial bank that proved to be one of the largest and most successful microfinance institutions in the developing world. The bank is divided into four main strategic business units: micro banking, retail banking, corporate banking, and investment banking. The microfinance services are provided by the micro banking unit (BRI Units). In 1983 the bank started a reform process with the objective of transforming its failing operation into a profitable one. Since then, the bank's main objective has been to provide a comprehensive package of financial services to rural communities. BRI effectively covers the entire nation and its physical networks are the most extensive in Indonesia: "BRI has 318 branches that are located in the district

capitals and municipalities. Furthermore, the bank has an even more extensive network of 3,724 retail outlets at the sub-district level known as the BRI Units".[76] After the reforms of 1983, "the outlets were transformed from a loss-making channeling agent for the government subsidized credit program for rice cultivation (BIMAS) into commercial microfinance intermediaries."[77] Even during the times of the severe financial crisis in the late 1990s, the bank outperformed any other financial institution in Indonesia.

The bank was established in 1895 during the Dutch colonial period and was called *De Poerwokertosche Hulp-en Spaarbank der Inlandsche Hoofden.* After Indonesia's independence the bank was renamed Bank Rakyat Indonesia – the Indonesian People's Bank. As part of the government program by which BRI was assigned an active as an agent of development with primary responsibility for the agricultural sector, the bank opened 3600 Unit Desas (Village Banks) during the 1970s. The results were mixed, the a large credit program with subsidized interest rates for rice farmers – called BIMAS – was designed to promote national rice self-sufficiency. Since the Unit Desas provided channeled subsidized credit to rice farmers at very low rates and the operating costs were very high, BRI was burdened with annual operational losses. In addition to not being sustainable, the subsidized loans often did not reach the intended target: poor farmers. [78] Therefore the only way to sustain the program was through subsidies from the Ministry of Finance. Loan recovery gradually deteriorated and the capital stock was eroded which required frequent injections of fresh funds. "In the early 1980s, the BIMAS lending volume declined, loan defaults climbed above 50% and the program was rapidly

[76] K. Maurer and .H Seibel, Agricultural Development Bank Reform: The Case of Unit Banking System of Bank Rakyat Indonesia (BRI)
[77] Indonesia Country Profile. Asia Resource Centre for Microfinance
[78] Bank Rakyat Indonesia. Asian Resource Centre for Microfinance.

approaching its collapse."[79] This approach to local finance was ineffective and unsustainable.

During the early 1980s, major political and economic changes took place in Indonesia. A new cabinet was formed and a new finance minister took office. The new government launched some major reforms, including a major financial sector reform. The reform was intended as decisive step towards financial liberalization/deregulation of Indonesia's financial system. The reforms included a complete liberalization of interest rates charged on loans and deposits, and the massive support of the BIMAS program by the government was clearly going to be discontinued. The main objective of the reforms were:

- To move towards a predominantly market-based financial system.
- To provide effective protection, as needed, so that the general public could benefit from the services offered by the financial system.
- To build a financial system that would support the stable, healthy growing national economy.[80]

BRI was faced with a difficult choice, either to shut down the Unit Desas, or to introduce measures that would increase the viability and self-sufficiency of the units. The decision was taken to convert the Units into a rural banking network that would meet a wide range of financial needs in a flexible and financially viable way: "We decided in 1983 to begin a new program for rural finance based on principles of commercial

[79] K. Maurer and .H Seibel, Agricultural Development Bank Reform: The Case of Unit Banking System of Bank Rakyat Indonesia (BRI)

[80] Ibid.

finance."[81] Thus the people's bank was taking its first steps toward becoming a viable microfinance institution.

## 5.2 Reforms of Bank Rakyat Indonesia

A total number of 3,626 units had to be converted from unprofitable BIMAS units to profitable rural banking units. However, "almost one third of the Units did not have the potential of reaching viability within a foreseeable period of time".[82] They were not closed down; instead, they remained as designated village service posts (PPD) which would only operate for a few days per week, depending on the number of customers. At this point each unit had a separate balance sheet and profit and loss statement. A new accounting system which emphasized transparency was introduced, and this helped in the evaluation of the performance of each Unit. Today most of these PPDs have been upgraded to full units; in fact, "the number of units is roughly the same as it was at the outset."[83] At the time of reforms BRI did not have a good model or an example to follow; they "could find no example of a financial institution in any developing country that provided microfinance profitably on a large scale."[84] Therefore, Indonesia was a pioneer in implementing financial reforms in many ways, and the reform of the Unit Desa system is a prime example.

Before implementing any reforms three questions had to be addressed. First, would there be enough demand for micro-loans at high interest rates to cover all the costs

[81] The Microfinance Revolution v.2
[82] K. Maurer and H. Seibel, Agricultural Development Bank Reform: The Case of Unit Banking System of Bank Rakyat Indonesia (BRI)
[83] Ibid.
[84] The Microfinance Revolution v.2

and allow for the generation of a profit? Second, would there be enough demand for micro-savings for people to place their savings and for BRI to use the mobilized savings for loans? The third question was how long it would take for the reformed BRI to break even? To address the first issue, the demand for credit in several geographical locations was studied. The studies revealed that the demand was very large and that the poor borrowers were paying much higher interest rates to local moneylenders than they would be paying BRI. As for the second issue, similar studies were conducted in many parts of the country to assess the potential for micro-savings services. Again the studies revealed a large demand for micro-savings services.[85] As for the last question, assumptions and predictions were made, and it was estimated that BRI would break even in two years. In fact this was achieved in just under two years. BRI has been profitable every year since.[86]

In 1984 a single non-subsidized and non-targeted loan product for rural credit was introduced under the name KUPEDES. "Kupedes is a credit facility provided by BRI Unit (not BRI branch office or other bank) to develop and improve eligible small business".[87] This loan was made available to any creditworthy customer who owned any kind of eligible enterprise. Loans were offered for up to 24 months for working capital, and up to 36 months for investment. Borrowers had to have sufficient collateral that would cover the value of the loan. The collateral was in the form of land, small buildings, and even motorcycles. The minimum amount for the loans were set at Rp.25,000 while the maximum amount was Rp.25,000,000.[88]

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[85] Ibid.
[86] Ibid.
[87] Kupedes. BRI Website.
[88] Kupedes. BRI Website.

BRI's strategy is based on the notion that its financial viability and self-sustainability were a function of its ability to mobilize local savings to finance the large demand for loans. Immediately after the KUPEDES was introduced, the bank introduced SIMPEDES, a rural savings product, which allowed an unlimited number of transactions, carried positive real interest rates, and had no opening fees. The initial minimum deposit was set at Rp.5000. Prizes and lotteries are offered as a tool to attract more savings.[89] After three years of operation, it became clear that the Unit system was self-sustainable and financially viable. In 1984, only 14% of the Units were profitable. Two years later 72% of the units were profitable. Performance and results have been good since then: "the system has been profitable since 1986 and without subsidy since 1987."[90]

## 5.3 Performance after the reforms

Following the reforms at BRI and its return to profitability, the government introduced additional economic reforms known as PAKTO. This allowed for entry of other financial institutions into the new and profitable financial market. It aimed at promoting competition among banks: "New financial services such as factoring, consumer credit, venture capital, and securities dealing and underwriting were opened up to commercial banks, and the minimum reserve requirement was lowered to a uniform 2% on all deposits."[91] This led to strong competition among banks and resulted in a boom in bank deposits in the following years. BRI greatly benefited from the boom as "The Units added one million new depositors every year and the deposit volume

[89] Bank Rakyat Indonesia. Asian Resource Centre for Microfinance, 1.

[90] The Microfinance Revolution v.2

[91] K. Maurer and H. Seibel, Agricultural Development Bank Reform: The Case of Unit Banking System of Bank Rakyat Indonesia (BRI)

increased annually by 80% on average. In the sixth year of operation in 1989, the BRI Unit system achieved self-sufficiency in funding when the volume of deposits was equal to the loan amount outstanding."[92]

Another important reform package was introduced in January 1990 when the Central Bank announced the cancellation of 34 government-sponsored credit programs. This meant that banks had to mobilize their own funds. "The situation was further aggravated in February 1991 when the finance minister withdrew an amount of US$ 4.2 billion in deposits from the banking system (so-called Sumarlin-shock) to curb the growth in money supply and counter the danger of overheating of the economy."[93] As a result, BRI was faced with a liquidity problem and the reaction was to impose a ban on credit extension. For two years, BRI did not accept any new borrowers. The number of borrowers dropped during 1990-1992 (See Table 13). More importantly, loan repayments declined from 98% to 95% in 1991 (See Table 14). The BRI management learned an important lesson from this unexpected reaction. The lack of available loans would effect on borrowers' motivation to repay any current outstanding loans.

[92] Ibid.
[93] Ibid.

## Table 13: Deposits and loans in BRI Units, 1984-2000 (Amount in Rp billion)

| | Deposits | | Loans outstanding | | Deposit to loan |
|---|---|---|---|---|---|
| Year | Accounts | Amount | Number | Amount | Ratio |
| 1984 | 2,655 | 42 | 640,746 | 111 | 38% |
| 1985 | 36,563 | 85 | 1,034,532 | 229 | 37% |
| 1986 | 418,945 | 176 | 1,231,723 | 334 | 53% |
| 1987 | 4,183,983 | 288 | 1,314,780 | 430 | 67% |
| 1988 | 4,998,038 | 493 | 1,386,035 | 542 | 91% |
| 1989 | 6,261,988 | 959 | 1,643,980 | 847 | 113% |
| 1990 | 7,262,509 | 1,695 | 1,893,138 | 1,382 | 122% |
| 1991 | 8,587,872 | 2,541 | 1,837,549 | 1,456 | 174% |
| 1992 | 9,953,294 | 3,399 | 1,831,732 | 1,649 | 206% |
| 1993 | 11,431,078 | 4,325 | 1,895,965 | 1,957 | 220% |
| 1994 | 13,066,854 | 5,232 | 2,053,919 | 2,458 | 213% |
| 1995 | 14,482,763 | 6,016 | 2,263,767 | 3,191 | 189% |
| 1996 | 16,147,260 | 7,092 | 2,488,135 | 4,076 | 174% |
| 1997 | 18,143,316 | 8,837 | 2,615,679 | 4,685 | 188% |
| 1998 | 21,698,594 | 16,146 | 2,457,652 | 4,697 | 344% |
| 1999 | 24,235,889 | 17,061 | 2,473,923 | 5,957 | 286% |
| 2000 | 25,823,228 | 19,115 | 2,715,609 | 7,827 | 244% |

Source: K. Maurer and H. Seibel, Agricultural Development Bank Reform: The Case of Unit Banking System of Bank Rakyat Indonesia (BRI)

## Table 14: KUPEDES repayment performance

| Year | 12-month Repayment rate | Arrears ratio |
|---|---|---|
| 1984 | 99.0% | 5.4% |
| 1985 | 98.2% | 2.1% |
| 1986 | 97.3% | 4.5% |
| 1987 | 97.0% | 5.8% |
| 1988 | 95.4% | 7.4% |
| 1989 | 97.7% | 5.4% |
| 1990 | 98.0% | 4.1% |
| 1991 | 95.1% | 8.6% |
| 1992 | 96.6% | 9.1% |
| 1993 | 97.8% | 6.5% |
| 1994 | 99.3% | 4.5% |
| 1995 | 98.9% | 3.5% |
| 1996 | 98.4% | 3.7% |
| 1997 | 97.8% | 4.7% |
| 1998 | 98.1% | 5.7% |
| 1999 | 98.3% | 3.1% |
| 2000 | 98.9% | 2.5% |

Source: K. Maurer and H. Seibel, Agricultural Development Bank Reform: The Case of Unit Banking System of Bank Rakyat Indonesia (BRI)

The following decade witnessed growth at Bank Rakyat Indonesia but at a slower pace. The number of depositors grew in terms of accounts and volume at a faster pace than the number of borrowers. By the end of 1997 the outstanding number of deposit accounts was 18 million, and the number of loans was 2 million; the deposit-loan ratio was 2:1 (see table 13). In addition, BRI witnessed increased staff productivity as can be seen in table 15. The number of active borrowers per credit officer and the number of deposit accounts per teller increased significantly during 1993-2000. As a consequence, administrative efficiency increased. (See Table 15 below).

**Table 15: Staff productivity and efficiency**

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|
| Staff productivity: | | | | | | | | |
| # active borrowers per credit officer | 440 | 466 | 503 | 541 | 527 | 478 | 490 | 534 |
| # deposit accounts per teller | 3,008 | 3,320 | 3,598 | 3,887 | 4,220 | 4,962 | 5,614 | 6,181 |
| Efficiency: | | | | | | | | |
| Administrative expenses/average loan portfolio | n.a. | 10.1% | 9.7% | 9.4% | 9.4% | 8.4% | 8.1% | 8.4% |

Source: K. Maurer and H. Seibel, Agricultural Development Bank Reform: The Case of Unit Banking System of Bank Rakyat Indonesia (BRI)

It is also worth noting that BRI's lending activities are not concentrated in one economic sector. As can be seen from table 16 below, the loan portfolio is fairly spread out between trade, salaried individuals, agriculture, and industry. In addition to wide sectoral coverage, this could be viewed as a risk minimizing factor (no concentration of risk).

**Table 16: Distribution of KUPEDES loans by economic sector (December 2000)**

| Economic sector | Number of borrowers | Loan amount (US$ million) | Share |
|---|---|---|---|
| Agriculture | 589,834 | 177.0 | 22 % |
| Industry | 66,329 | 19.2 | 2 % |
| Trade | 1,154,838 | 338.6 | 42 % |
| Fixed salary employees | 817,041 | 242.9 | 30 % |
| Other | 87,566 | 38.1 | 5 % |
| Total | 2,715,608 | 815.8 | 100 % |

Source: BRI Microbanking Division

## 5.4 The financial and Economic Crisis

In July 1997 the currency crisis that occurred in Thailand led to the worst financial and economic crisis for Southeast Asian countries in decades: "Within a few months, the country's currency - the *Rupiah* - experienced a dramatic 80% plunge in its value against the US dollar, followed by sharp increases in inflation (77% in 1998) and interest rates."[94] The situation was worsened with the ousting of President Suharto. The financial system was on the verge of collapsing when the government intervened and provided a blanket guarantee cover for all bank deposits. As a result, "Many private banks were closed down, and major state banks merged."[95] Surprisingly, BRI remained unaffected by the crisis. In fact BRI benefited from being a state-owned bank and a safe haven for deposits. The number of deposit accounts increased from 18,143,316 in 1997 to 24,235,889 in 1999, and the actual volume increased from 8,837 billion Rupiahs to 17,061 billion within the same time period (see table 13). Loans, on the other hand,

[94] Ibid.
[95] Ibid.

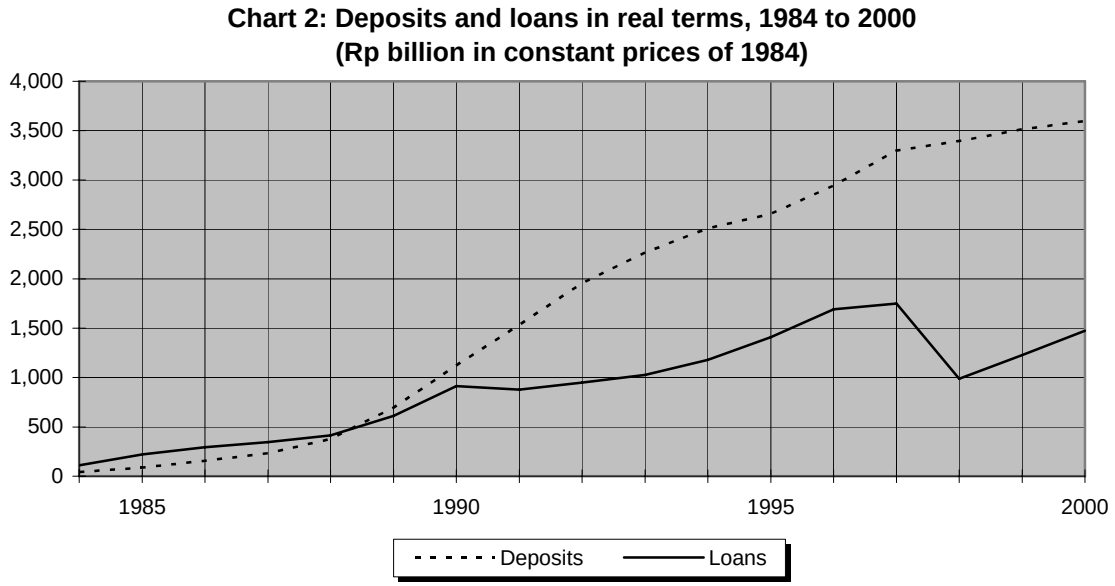
stagnated for about 2 years, and during 1998, the number of loans even declined to 2.4 million compared to 2.6 million for the previous year.

During 1999, the crisis was almost over for BRI, however it had left some scars: "The surge of inflation to a rate of 77.6% in 1998 dampened the performance in *real* terms, i.e. after taking into account inflation."[96] In real terms, deposits continued to grow but at a slower pace after the outbreak of the crisis, while loans marked a sharp decline during 1997-1998 (See Chart 2). "Even in the wake of the recent financial crisis in Indonesia, repayment rates for BRI were 97.8 percent in March 1998". [97]Overall, the profitability of BRI was not affected by the economic crisis as can be seen in Table 17, net income in 1998 was 861 billion Rp, double its level of 1997 (417 billion Rp).

**Table 17: Profitability of BRI Units[98]**

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|
| Net income (Rp billion) | 140 | 265 | 403 | 423 | 417 | 861 | 1,190 | 1,160 |
| Average annual assets (Rp billion) | 3,344 | 5,401 | 6,482 | 7,680 | 9,224 | 14,068 | 19,487 | 21,676 |
| Return on Assets (RoA) | 3.1% | 4.9% | 6.2% | 5.5% | 4.5% | 6.1% | 6.1% | 5.4% |

[96] Ibid
[97] P, Mcguire. The Asian Financial Crisis – some Implications for Microfinance." Microbanking bulletin, Boulder, CO: Economics Institute. 1998.
[98] K. Maurer and H. Seibel, Agricultural Development Bank Reform: The Case of Unit Banking System of Bank Rakyat Indonesia (BRI)




Source: Agricultural Development Bank Reform: The Case of Unit Banking System of Bank Rakyat Indonesia (BRI)

## 5.5 Lessons learned from BRI

The previous sections of this chapter examined the phases in the life of BRI since its inception, and followed the developments that occurred at the bank. A number of important lessons can be deduced from the BRI case study. The earlier problems faced by the bank, the reforms introduced in 1983 and the consequent return to a profitable and efficient operation demonstrate the following[99]:

- **In order to minimize overhead costs, credit should be made available to all creditworthy micro-credit customers.** It is more expensive to serve only one sector of the economy as opposed to serving all productive enterprises.

[99] Ibid

- **Credit decisions should be based solely on a borrower's willingness and ability to repay - and this decision should be left to the bank.** The amount of the loan should be based on the need and the repayment capacity of the borrower. Loan credit officers make the lending based on their assessment of the client's creditworthiness. The decision should be left to the banking professionals to achieve efficiency. If the decision making is shifted to government officials the credit worthiness criterion is diluted.
- **Access to credit on a long term basis is more important than cheap credit. Interest rates should be set to cover the costs of the bank so that the bank is financially viable, and can therefore provide credit over the long term as needed.** As mentioned earlier, the financial intermediation approach is at an advantage to the poverty lending approach if the ultimate goal is creating a long term, large-scale and financially viable microfinance institution.
- **Almost all households want to and are able to save, and serving their need to save is just as important as serving their demand for credit.** Non-credit services should be a part of the financial products package made available by the financial institutions to its clients.
- **Operating a large network of small banks efficiently requires a combination of simplicity and transparency, standardization, and delegation of authority and responsibility.** The transparency of the Unit Banking Systems lies in the simplicity of the credit and savings instruments as well as the financial statements. Savings, loans, training, reporting, and

operational procedures are standardized. With simplicity and standardization it is possible to create an efficient and well-supervised system.

BRI is a bank that experienced both approaches to microfinance. It adopted the poverty lending approach since inception and up to 1983. When it launched its reforms and restructuring programs the decision was taken to adopt the financial intermediation approach. The two approaches were discussed earlier in this paper, and the BRI case provides a good example of both the difficulties that can face a microfinance institution as well as the success that can be achieved by adopting appropriate strategies and policies. It also clearly demonstrates the viability of a microfinance service that provides a combination of financial products that cater to the needs of the poor and low-income segments of the economy. Bank Rakyat Indonesia has introduced many innovations in the microfinance field. For example, in 1984 the bank encouraged clients to save more by launching free bi-annual lotteries for SIMPEDES account holders. "The lotteries are held in the branches, winners are located within a small area so most people either won or know someone who won and it makes these lotteries very popular".[100] Additionally, it introduced unlimited number of withdrawal transactions. "Since 2002, BRI started to put online its unit network, with already around 10% (450 units) effectively on-line by August 2004. BRI introduced a new facility called Simpedes Berkartu, or Simpedes with a card + in 2004". [101] At the core of its reform strategy, BRI introduced rural credit and savings products, but the bank also adopted unique techniques and features that relate to

[100] Bank Rakyat Indonesia. Asian Resource Centre for Microfinance, 2

[101] Ibid, 3

the specific context of Indonesia. As a result, there are currently “4100 locations spread over and profitable rural financial network that functions as Agent of development”.[102]

[102] Kupedes. BRI Website

# 6.0 Concluding remarks

Our analysis of the role of the informal sector and the problems of poverty in developing countries clearly support the views that any effective strategies for development or poverty alleviation have to develop and implement policies that aim at enhancing the socio economic environment of the informal sector. Lack of access to adequate financial services in the informal sector is one of the major problems that need to be addressed by the developmental agendas proposed by policymakers in developing countries.

Our examination of the role of financial systems in mobilizing resources and allocating to the entrepreneurial activities of the economic agents in the informal sector reveals that around 80 percent of the small economic agents in a typical developing economy are unable to make use of financial services. It further reveals that the informal financial intermediaries that assume this function in developing countries is limited in their capability to provide such services at the levels, or in the form that would result in a significant contribution to development and poverty reduction. Subsidized credit was also seen to have limitations in terms of continuity and in terms of reaching its intended targets due to a variety of reasons.

As such the rationale for microfinance is developed. There is a large demand for financial services in the informal sectors and among the poor and low-income earners. This demand is not adequately met by existing formal or informal financial systems or subsidized credit programs.

The in-depth analysis of microfinance as a tool for development demonstrates that it has obvious advantages over the alternative options of financial services available to the lower income agents. It is not alien to the informal sector as many of its techniques are based on social capital. It is not limited by community borders and serves a larger and more diversified customer base. Access to credit on a long term basis is more important than cheap credit. If it is based on the financial intermediation approach microfinance can be sustainable, particularly if it functions in an adequately regulation environment. Regulation here needs to be tailored to the specifics of MFIs and not to simply mimic regulation of formal financial institutions.

Our analysis of the demand and supply of microfinance services reveals the existence of a large gap which is attributed to a number of factors including the very large demand, the lack of basic infrastructure, and the lack of information which until recently slowed down the growth of the industry. This however, is changing: the information revolution is contributing to the spread of microfinance and the industry has witnessed significant development in the past decade. One can envisage that meeting the demand for microfinance would have significant positive socio economic effects that would result in improving the economic conditions and enhancing the social status of the lower-economic agents.

The comparison by the paper of the two different approaches to microfinance in greater depth suggests that the financial intermediation approach to microfinance is preferable when the goal is viability, self-sustainability, and large-scale outreach for a microfinance institution. The poverty lending approach is suitable when the goal is

cheaper credit for lower-income people and the objective is a direct reduction of poverty. In the longer run, however, as discussed, the quantity of subsidized credit is limited. Therefore, while the poverty lending approach should continue to be directed to extremely poor segments of the society to enable them to escape poverty trap, the ultimate goal should be the eventual transformation of these extremely poor to active poor who would then be able to make use of microfinance institutions that operate on the basis of the financial intermediation approach.

This paper recommends that an ideal policy for development finance should be based on a mix of resources allocated between microfinance and developmental projects. It suggests that the microfinance industry should witness the growth of competing microfinance institutions using the financial intermediation approach in addition to institutions or programs using the poverty lending approach to assist the extremely poor become active. Additionally, resources should be allocated to other development projects such as direct income support, infrastructure development, and education and health programs. The funds should be allocated in such a way that the marginal social benefit of allocating additional resources to microfinance should be equal to the marginal social benefit of allocating additional resources to developmental projects. These are, of course, suggested policies. In practice, there is no one homogenous solution or set of policies that would provide the most efficient results. This is partly due to the fact that every economy is at a different stage of development and is characterized by its own particular conditions.

The case study of Bank Rakyat Indonesia was presented as a case in point to demonstrate that sustainable, large-scale, self-sufficient, profitable, and viable microfinance is possible. Before the 1983 reforms, BRI approached microfinance using the poverty lending approach. It was not serving all creditworthy micro-credit customers; instead it was providing subsidized credit for the agricultural sector only. After the reforms, it embraced a financial intermediation approach serving all sectors of the economy, and became an example of a very successful and profitable microfinance institution in the developing world. The case of BRI also demonstrates that a solid microfinance institution can sustain its operation even during times of adverse economic conditions.

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