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Regulatory Architecture for Microfinance in Asia

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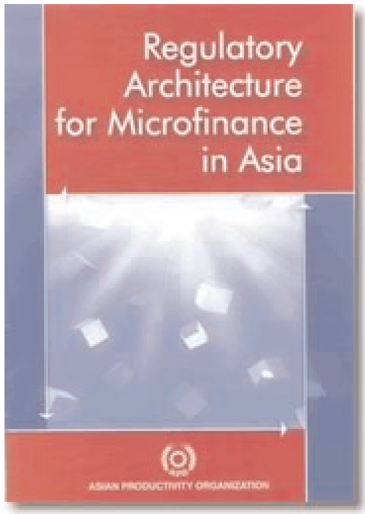
Report of the APO Survey on Micro-Financing 2003/2004



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2006
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FOREWORD

The Asian Productivity Organization (APO) has been at the forefront of efforts to raise productivity and competitiveness in the Asian region. Through various mechanisms such as the publication of technical studies prepared by experts and the organization of regionwide conferences, workshops, and other fora, the APO has contributed in no small measure to the progress being made by its member countries and their stakeholders to achieve higher productivity and greater competitiveness.

Microfinance has been recognized as a key instrument in economic growth and poverty reduction. Worldwide experience has shown that it gives microentrepreneurs access to financial services, basically loans and deposit facilities, that they have failed to obtain from traditional banking systems. It is important that regulatory frameworks contribute to the stability of microfinance institutions and the protection of depositors, especially the millions of household depositors. Appropriate regulatory frameworks will contribute to the productivity and competitiveness of microfinance institutions and provide the necessary safeguards.

Keeping the above background in view, the APO conducted a survey in November 2003 to study the legal and regulatory framework for microfinance prevailing among selected member countries. This publication highlights the results of the survey in nine countries: Bangladesh, Japan, Lao PDR, Malaysia, Nepal, Pakistan, Philippines, Sri Lanka, and Vietnam. The papers included in this volume were written by the national experts selected from the above member countries. The individual papers and the integrated report discuss the emerging structures for microfinance in Asia to assist policymakers in developing appropriate regulatory regimes. The topic chosen for this volume, "Regulatory Architecture for Microfinance in Asia," is both timely and critical.

We hope that the publication will provide useful information to all those who are directly or indirectly involved in efforts to address the issues of microfinance.

The APO would like to thank the individual national experts and the chief survey expert, Dr. Gilberto M. Llanto of the Philippine Institute for Development Studies, for participating in the survey and making this volume possible.

Shigeo Takenaka
Secretary-General

Tokyo
January 2006

Part I

Integrated Summary

THE REGULATORY ARCHITECTURE FOR MICROFINANCE IN ASIA: IN SEARCH OF AN APPROPRIATE APPROACH

Gilberto M. Llanto[1]

INTRODUCTION

In 2004–2005, the Asian Productivity Organization (APO) commissioned microfinance experts to conduct a survey of legal and regulatory frameworks in Bangladesh, Japan, Lao PDR, Malaysia, Nepal, Pakistan, the Philippines, Sri Lanka, and Vietnam. This volume reports the results of that survey. Legal and regulatory frameworks impact on the sustainability of microfinance institutions and on the safety of deposits mobilized from the public, most especially from poor people who have found in those microfinance institutions an accessible facility for deposits and other financial services. Regulation of financial institutions can be appreciated at two levels: "on a macro level, to protect the stability of the payments system, and on the micro level, to offer protection to the depositor (particularly the small depositor) from losses" (Theodore 2002).[2]

Understanding the current status of microfinance and the emerging legal and regulatory frameworks for microfinance is critical for various stakeholders in the survey countries. This is the first step in the search for appropriate regulatory frameworks, no doubt a long process but nevertheless an undertaking that each of the survey countries has recognized to be worthwhile. The papers in this volume, including the present one, discuss the emerging regulatory frameworks for microfinance in the survey countries and recommend some pathways to an appropriate regulatory architecture. The survey has a two-fold objective, namely:

a. To establish the status of microfinance and the legal and regulatory frameworks for microfinance.
b. To recommend measures that will improve the legal and regulatory frameworks.

A limitation of the present set of papers is the lack of discussion of the impact of the emerging regulatory frameworks on microfinance institutions (MFIs) and depositors. The country reports did not explicitly discuss the benefits and costs of regulation for microfinance institutions and depositors. There are benefits to being regulated, including increased access to capital, ability to provide a broad product mix (especially savings and payments), improved credibility, better understanding of clients, and ability to offer more innovative products (Theodore 2002). The downside is the direct and indirect cost of regulation. MFIs have to hire and train technical staff to deal with the formal reporting requirements set by regulators. Many MFIs complain about the frequency and volume of reporting required by regulators. Indirect costs may include decreased flexibility and increased workloads for staff (Valenzuela and Young 1999). Theodore (2002) cites the case of FINSOL in Honduras, where supervision took away some flexibility in decision-making and implementation of activities. On balance, it seems that the benefits of being regulated outweigh the costs, especially if the MFI is

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[2] Supervision is the oversight process of ensuring that regulations are adhered to, risk is minimized, and troubled institutions improved or closed (Theodore 2002). Unless otherwise indicated, the term "regulation" also encompasses "supervision."

allowed to mobilize deposits from the public, which enables it to tap a relatively cheap source of loans.

It is noted that different regulatory frameworks will have varying impacts on MFIs and depositors. There is good and bad regulation, and more research is needed in order to determine regulatory approaches that confer more benefits relative to costs. For microfinance regulation to be considered effective, it must show at least the following, according to Vogel and others (2000):

- That more banks are actually providing microfinance services.
- That more NGOs have transformed into formal financial intermediaries.
- That those transformed NGOs consequently are able to reach a larger clientele.
- That savings mobilization constitutes a major source of funding for those transformed NGOs.
- That actual examination practices remain aligned with laws and norms.
- That the costs and practices of microfinance supervision are congruent with the risks and volume of the operations involved.

An assessment of the impact of regulation can be considered in future work at APO or other organizations. This paper provides an overview of the results of the survey. The individual country reports are in Part II of this volume.

The survey countries have recognized microfinance as a vital instrument to spur microenterprise development. The experience of these Asian countries shows how microfinance has provided critical financing to meet the liquidity and investment requirements of millions of microentrepreneurs and poor households. The country reports support the view that the microfinance phenomenon has contributed to growth, employment, and poverty reduction in those countries, although this view has not been spared criticism. Microenterprises could grow into small and medium enterprises (SMEs) that can generate greater outputs and employment opportunities thereby, contributing to poverty reduction. It is in this light that the country reports view microfinance as a fundamental instrument in their strategies for development and poverty reduction.

The country reports focus on the emerging regulatory architecture that will enhance the capability of microfinance institutions to become sustainable institutions and that at the same time will protect and secure the huge volume of deposits mobilized by MFIs from a very large number of depositors, including microenterprises and poor households. However, it is essential to draw attention to the possibility of a regulatory architecture that constrains the performance of microfinance institutions. One adverse effect of inappropriate regulation is the dampening of the innovative impulse to find better technology to provide financial services to the poor. Another is the possibility of restraining outreach to thousands of microenterprises because the regulatory architecture frowns upon the provision of unsecured loans. Bank examiners deployed by regulators may cite exception after exception when they discover that loans have been given without collateral.

Thus, it is not a matter of having a regulatory framework for microfinance for its own sake but rather of having an appropriate regulatory framework that achieves the twin objectives of contributing to the sustainability of microfinance institutions and protecting depositors, without dampening innovative impulses that have successfully fashioned financial products and services that are accessible to the poor.

The country reports are concerned about the need to develop appropriate regulatory frameworks that take into account the diversity of MFIs and different contextual scenarios where MFIs and regulators interact. Various stakeholders such as donors, practitioners, government authorities, and academics have taken a keen interest in achieving this objective in each of those countries. This volume hopes to contribute to an understanding of the emerging regulatory architecture for microfinance in Asia that will enlighten decision-making.

Prudential regulations seek to protect depositors, which in the case of deposit-taking MFIs include a vast number of poor people, from excessive and unacceptable risk-taking, mismanagement, or abuse. Experience has shown that the financial services industry, of which deposit-taking MFIs are a part, is highly susceptible to various risks that, if not efficiently managed, can lead to a collapse of those deposit-taking financial institutions with huge financial losses to depositors. In some countries, non-regulated entities such as nongovernmental organizations (NGOs) have been in the forefront of efforts to develop and provide accessible financial services to poor people and to the large microenterprise sectors in those countries. It is the right time to look at the issues that surround the emerging regulatory architecture.

The countries in this survey allow different types of microfinance institutions to provide microfinance services under varying legal and regulatory frameworks. Microfinance is provided by both formal and informal lenders, but the focus of the survey and the subsequent discussions is the array of regulated formal institutions, such as banks and cooperatives, and non-regulated institutions such as NGOs. Informal finance is not, therefore, covered in this report, although it certainly merits a scholarly discussion unto itself because of its ability to break the barriers to access to credit of small-scale borrowers. In the survey countries, deposit-taking institutions (banks and cooperatives) compete with non-deposit-taking institutions such as NGOs in providing a variety of products and services tailored to meet the financing needs of small-scale clientele. The survey countries have recognized the NGOs' pioneering work on some of the important microfinance innovations, and there is a common desire to legitimize their operations, in the case of countries such as Vietnam, Nepal, Pakistan, and Lao People's Democratic Republic, or to allow them to continue doing commendable microfinance work, as in Bangladesh and the Philippines. The survey countries find no reason to frustrate these organizations' creative impulses, but some countries want a firewall between the lending (allowed, legal) and deposit-taking (illegal, unauthorized) operations of NGOs. The survey countries maintain that deposit-taking should be confined to regulated microfinance institutions—that is, banks.

Deposit-taking institutions such as banks have also tried to pick up the microfinance technologies, with fruitful results. Some countries have gone to great lengths to experiment with the creation of specialized institutions such as the Fondos Financieros Privados (Private Financial Funds) in Bolivia and Entitades de Desarrollo para la Pequena y Microempresa (EDPYME) or small business and microenterprise development institutions in Peru. The FFPs and EDPYMEs face lower hurdles than typical commercial banking institutions (for example, lower minimum capital requirements) but are restricted in their ability to mobilize deposits and participate in the payments system (Theodore 2002). The downside of attempts to create specialized windows for microfinance is the creation of a huge regulatory burden. Vogel and others (1999) mention "a possibly endless proliferation of different regulatory specializations according to the development of new specialized market niches."

Recent research has tried to understand "different types of regulatory frameworks and the appropriateness of their use in the microfinance environment" (Theodore 2002). An example of this search for regulatory frameworks is the study by van Greuning and others (1998). The Nepal country report in this volume indicates that various types of MFIs are involved in providing microfinancial services; the regulatory framework for the regulation of these MFIs also greatly varies as a result. It is reported that "development banks regulated under the Development Bank Act of 1996 operate in a more relaxed financial framework than the commercial banks, insofar as microfinance is concerned."[3]

Thus, policy makers and regulators have shifted their attention to the development of an appropriate legal and regulatory architecture for microfinance.[4] Uppermost in the minds of policy makers and regulators are the following overriding questions: *whether to regulate MFIs, how to regulate MFIs, which types of MFIs?*[5]

Overall, the country reports indicate a desire to regulate MFIs and an attempt to find the right approach to regulate them. Vietnam, for example, has recently issued a Draft Decree on Microfinance to deal with NGOs that have become very active in providing microfinance services to poor households and thousands of microenterprises. In 2005, the Lao PDR government issued a Decree on Microfinance Regulation that comprehensively governs the development and operations of financially viable and commercial microfinance institutions.

But, it may be asked, regulatory architecture for which type of MFI?

There are two opposing camps in the debate concerning the development of an appropriate legal and regulatory framework for MFIs. On the one hand is the view that only deposit-taking MFIs should be regulated; on the other hand is the position that both deposit-taking and non-deposit-taking microfinance institutions should be regulated. Vogel and others (2000) maintain that a regulatory agency's basic objective is to protect the financial system from unsound—that is, excessively risky—practices by deposit-taking institutions and thereby to protect a country's payment system." In their view, regulatory agencies should not be distracted from this overriding objective by saddling them with the additional task of regulating non-deposit-taking institutions. Concern about fraud in lending that non-deposit-taking institutions may commit belongs to other institutions whose primary purpose is to deal with fraud.

Prudential regulation and supervision should be applied only to deposit-taking institutions. Valenzuela and Young (1999) add that NGOs should not be allowed to capture voluntary deposits from the public. In practice, however, perhaps because banks are not accessible to the large number of people and micro-entrepreneurs operating in the informal sector, NGOs and even cooperatives have been found to be involved in some form of deposit-taking. The Nepal country report confirms this: "It has been found in practice that large number of cooperatives and NGOs in remote areas are still undertaking lending and deposit-taking activities without any approval from Nepal Rastra Bank (the central bank). Even the licensed cooperatives have been accepting saving deposits from non-members i.e., from general public." Sri Lanka faces a similar problem of numerous unlicensed MFIs mobilizing savings from the public. The Sri Lanka country report observes that "in terms of the Banking Act of 1988 and the Finance Companies Act of 1988, institutions other than licensed commercial banks, licensed specialized banks, and registered finance companies are not permitted to collect deposits from the public. But there are numerous microfinance NGOs in the country that violate these regulations and collect savings from the public."

On the other hand, there is a contrary view that regulatory agencies, which are mandated to protect the stability of the financial system, should be concerned with the lending behavior

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[3] However, the Nepal country report indicated that "recently government has promulgated a comprehensive Bank and Financial Act 2004 for the effective efficient legal implementation of Acts. At least five former Acts—the Commercial Bank Act of 1974, the Development Bank Act of 1996, the Financial Company Act of 1985, the Agricultural Development Bank Act of 1966, and the Nepal Industrial Development Corporation Act 1989—have been abandoned." This seems to imply that the lenient treatment of development banks engaged in microfinance will no longer continue.

[4] For simplicity, henceforth, the term "regulatory framework" or "regulation" shall mean both the "legal, regulatory and supervisory framework" or "laws, regulation and supervision" affecting microfinance, unless otherwise indicated.

[5] Valenzuela and Young (1999) report that many countries around the world—from El Salvador to Zambia—are beginning to think about whether and how to regulate microfinance. Regulation and supervision have become 'hot' topics in the microfinance field, according to these two researchers.

of both deposit-taking and non-deposit-taking institutions since their risk-taking ultimately affects the financial system. Hannig and Mugwanya (1999), for instance, contend that there may also be a need for government regulation of other institutional types that are likely to pose a risk to the stability of the financial system. These "institutional types" are the credit-only MFIs, which they qualify should be "large" to be subject to regulation. They concede that the lack of supervisory capacity means that probably only the largest microfinance institutions can be meaningfully regulated. This implies the possibility of engaging other entities in the supervisory process, e.g., second-tier institutions.

Both currents of thought are amply detected in the individual country reports, reflecting the vigor of the debate.

Thus, the discussions underscore the importance of understanding the emerging legal and regulatory architecture for microfinancing.[6] *What is the existing policy stance toward microfinance? What is the state of microfinance regulation and supervision in the countries to be surveyed? How does the legal and regulatory architecture contribute (or not contribute) to the efficiency of MFIs? How adequate is it in protecting the deposits of millions of poor clients? What steps or measures could be undertaken to improve the legal and regulatory architecture?*

The growing literature on the subject of microfinance regulation and supervision holds varying views on the subject. The analysis given in the country reports shows the ferment in thinking that has kept policy makers, MFIs, donors, researchers, and other stakeholders attentive to the rapid pace of thought and large variety of approaches to this consuming subject. The subject is clearly important, especially in view of the aftermath of the Asian financial crisis, which brought home the adverse impact and risks that inadequate regulatory frameworks and practices and the weaknesses of regulatory agencies could create for the financial system. Instead of contributing to the stability of financial systems and the protection of deposits, weak regulatory frameworks and inept regulators could themselves be the very source of instability of the financial system and risks to deposits that they have professed to prevent.

In this regard, one is reminded of Christen and Rosenberg's (2000) advice: there is no need to rush the regulation of microfinance. Regulation that comes too early can hamper innovation in financial services and institutional forms (Valenzuela and Young 1999). There is certainly not a "silver bullet" of regulation and supervision—a one-size-fits-all approach—because individual country situations differ and microfinance is at different stages of development. However, considering the analyses offered by the country reports, one can support the thesis that "the future of microfinance lies in a licensed setting," because it is the "only setting that will permit sustainable microfinance services for the poor" (Christen and Rosenberg 2000). In that setting, microfinance regulation is important, but countries will have to consider the timing of the introduction of regulation, as Christen and Rosenberg stress. Microfinance cannot simply be placed in "conventional credit categories (consumer, commercial, or mortgage credit)" (Jansson 2001); thus, traditional regulatory and supervision approaches may not apply.

The country reports acknowledge the conundrum that regulatory authorities are still developing an understanding of the microfinance phenomenon, making sincere attempts to flesh out an appropriate regulatory framework, and building the required capacity for effective regulation. It cannot be denied, however, that the search is on for appropriate legal and regulatory frameworks.

[6] The individual country reports give a picture of attempts to deal with these essential questions and the pertinent details which are conveniently left out in this integrative paper. This paper provides an overview that may help clarify certain issues that those countries need to address in their search for an appropriate regulatory framework for microfinance.

GOVERNMENT POLICY AND LEGAL FRAMEWORK FOR MICROFINANCE

The survey countries all agree that microfinance is a component of the development tool kit and is expected to help the governments' drive for poverty reduction. All countries have made official policy pronouncements about the expected role of microfinance in development strategy, especially poverty reduction, and have provided different levels of support to microfinance. Likewise, various laws provide a supportive framework for microfinance. The Philippines has issued a clear microfinance strategy in a document called *The National Strategy for Microfinance*, which has the following key principles:

- An enabling policy environment that will facilitate the increased participation of the private sector in microfinance.
- Greater role of the microfinance institutions in the provision of financial services.
- Market-oriented financial and credit policies (e.g., market-based interest rates on loans and deposits).
- Nonparticipation of government line agencies in direct credit provision to end-borrowers.

Some countries such as Vietnam and Lao PDR have felt the need to issue decrees on microfinance regulation in a bid to provide legal clarity for the activities of microfinance institutions. This is important especially in countries where NGOs are not recognized as legitimate microfinance institutions. This contrasts with the situation in Bangladesh, where the government has long worked very closely with NGOs in providing microfinance services to poor people. NGOs are allowed to register under several laws, to receive funding from the government, and to legitimately and openly operate as microfinance institutions. In Nepal, the licensing of NGOs for limited banking functions by Nepal Rastra Bank was a bold step in promoting microfinance in a bid to provide accessible finance services to the poor. Sri Lanka handles it differently: there is "no particular legal mechanism for a wide variety of MFIs operating" in the country. However, NGOs are allowed to register with the Department of Social Services under the Societies Ordinance of 1891.

In addition to policies and laws supporting microfinance, some countries have established special funds—e.g., Microfinance Social Development Fund (Pakistan), People's Trust and Development Fund (Philippines), National Development Trust Fund (Sri Lanka)—to provide loan and training funds to microfinance institutions such as NGOs, which lend directly to poor borrowers. Table 1a/b on the following pages is a broad summary of the treatment of microfinance in the survey countries. The details are in the country reports.

The survey countries report different types of support provided by the government to microfinance apart from the laws and decrees that have legitimized microfinance. In general, governments make funding available to various MFIs through government-owned banks and institutions, such as Palli Karma Sahayak Foundation (PKSF) in Bangladesh and the People's Credit and Finance Corporation in the Philippines. Government-owned or -organized institutions act as wholesale loan providers to MFIs, mostly NGOs that in turn provide loans directly to end-borrowers. In other cases, government banks directly provide microfinance services to poor borrowers; examples are the Vietnam Bank for Social Policies and the Lao PDR Agriculture Promotion Bank.

Bangladesh, the "birthplace" and "cradle" of microfinance, has fully supported microfinance institutions (basically, the NGOs), providing them lavish state funding support. The motivation is the government's "Interim Poverty Reduction Strategy Paper 2003," which gives micro-credit "an important role in poverty reduction strategy." A plethora of government-funded and -sponsored micro-credit programs and other programs meeting social objectives—for example Jatiya Mohila Sansgtha (National Women Forum), a credit program known as the "Self-Employment Credit Program" for poor unemployed women—run parallel

Table 1a. Policy, Legal, and Regulatory Frameworks for Microfinance in Asian Countries: Bangladesh, Japan, Lao PDR, Malaysia, Nepal

Characteristic	Bangladesh	Japan	Lao PDR	Malaysia	Nepal
Policy/legal basis	Government's "Interim Poverty Reduction Strategy Paper 2003": Micro-credit plays an important role in poverty reduction strategy. Under the Grameen Bank Ordinance of 1983, a special act to support microfinance, NGOs register under one or more acts of parliament or ordinances. The laws do not categorically address microfinance activities. Most NGOs have microfinance programs, which are exempted from oversight by Bangladesh Bank (the central bank) or other regulatory agencies. These are: the Societies Registration Act of 1860, the Companies Act of 1913, the Cooperative Societies Act of 1984, the Charitable and Religious Trust Act of 1920, the Trust Act of 1882, and the Foreign Donations (Voluntary Activities) Registration Ordinance of 1978.	Microfinancing is not suitable for poverty alleviation because Japan is a developed country. The Small and Medium Enterprise Basic Law became effective in 1963 to support micro-businesses. The Deposit Bank Regulation of 1890, the Banking Regulation of 1890, the Banking Code of 1928, the Mutual Financial Bank Code of 1951, the Credit Association Law of 1951, the Small and Medium Scale Enterprise Cooperative Law of 1949, the Civil Code, Commercial Code, and Code of Civil Procedure.	Microfinancing is a tool for growth and poverty alleviation. In 2005, the government issued the Microfinance Regulation that comprehensively governs the operations of private MFIs and the development of financially viable and commercial microfinance institutions.	Microfinancing is an important instrument for poverty alleviation. Micro-credit programs are seen as complementing the government's efforts in reducing poverty. The Development Financial Institutions Act 2002 (DFIA) covers financial institutions tasked by the government to provide micro-credits. The government provided loan capital to Amanah Ikhtia Malaysia (AIM), an NGO, in the form of grants as well as interest-free loans to be distributed to the poor. There is no regulatory framework for microfinance NGOs, which are not allowed to mobilize deposits from the public.	Nepal Rastra Bank Act of 1955; Financial Intermediary Act of 1998; Comprehensive Bank and Financial Act of 2004; ADB/N and other financial institutions like NIDC, under special charters. Cooperatives function under the Cooperative Act and require NRB licence for savings mobilization. NGOs are registered under the Society Registration Act of 1978 and require a financial license from NRB for lending and savings mobilization. Licensing NGOs for limited banking functions by Nepal Rastra Bank was a bold step in promoting microfinance. Registration under the Cooperative Act of 1991, obtain financial intermediary banking license from NRB; registration under Society Registration Act of 1977, obtain microfinance license from NRB under the Financial Intermediary Act of 1998; registration as Microfinance Development Bank under the Development Bank Act of 1995.

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Characteristic	Bangladesh	Japan	Lao PDR	Malaysia	Nepal
Regulatory agency	Bangladesh Bank In 2000 Bangladesh Bank set up a “Microfinance Research and Reference Unit” to protect the interests of depositors and ensure the transparency and accountability of MF-NGOs’ micro-credit operations.	Bank of Japan	Rural and Microfinance Committee of the Central Bank of Lao PDR	Bank Negara Malaysia	Nepal Rastra Bank
Supervisory approach	Traditional	Traditional	Traditional	Traditional	Traditional
Regulated MF providers	Grameen Bank	Banks, Credit Associations, Credit Cooperatives, or Agricultural Cooperatives; government-owned National Life Finance Corporation	Agriculture Promotion Bank (APB), government-owned policy bank focusing on the agricultural Sector; Lao Development Bank (LDB); one registered cooperative: Cooperative de Crédit de Soutien aux Producteurs (CCSP)	Bank Simpanan Nasional or National Savings Bank; Bank Pertanian Malaysia or Agriculture Bank of Malaysia; and an Islamic bank, Bank Islam Malaysia	Commercial Banks; Regional Rural Development Banks; Micro Finance Development Banks; Cooperatives; Licensed NGOs
Non-regulated MF providers	Microfinance NGOs	None	Village Revolving Funds; three donor-funded microfinance projects by NGOs	Amanah Ikhtiar Malaysia	NGOs
Functions of regulated MFIs*	Provide loans; accept deposits	Provide loans; accept deposits	Provide loans; accept deposits	Provide loans; accept deposits	Provide loans; accept deposits
Functions of non-regulated MFIs	Provide loans; accept savings from members	Not applicable	Provide loans; accept deposits from members	Act as conduit of government loans to target poor households	Provide loans
Minimum capital of regulated MFIs	No specific regulation on minimum capital requirement of MFIs (NGOs). The Microfinance Research and Reference Unit of Bangladesh Bank suggested MFIs with a substantial amount (cont’d. on next page)	Required	Required for banks; lower requirement for MFIs	Required	Required

*Refers to two basic functions only: providing loans and mobilizing deposits.

(continued on next page)

Characteristic	Bangladesh	Japan	Lao PDR	Malaysia	Nepal
Minimum capital of regulated MFIs (cont.'d)	of savings be instructed to get mandatory licenses from Bangladesh Bank as financial institutions. The government will implement suggestion.				
Minimum qualifications for Board of Directors	No information	No information	Required	Required	No information
Collateral allowed	Without physical collateral, group guarantee; peer pressure; joint liability; third-party guarantee	Traditional collateral; for National Life Finance Corporation, 80% of loan without collateral and with guarantors	Traditional collateral; for non-regulated MFIs, without physical collateral, group guarantees, joint guarantees	Traditional collateral; AIM uses group guarantee (Grameen approach)	Regulation does not accept group guarantee as a legitimate form of security, nor does the regulation recognize other non-traditional collateral—joint liability, peer pressure, third-party guarantees—as legitimate forms of security
Loan loss provisioning	Unclassified 5%; substandard 5%; doubtful 5%; bad and loss 100%	No information	Special mention 10%; substandard 20%; doubtful debts 50%; bad 100%	Required	Required
Capital adequacy	Required for banks; none for MFI–NGOs	Required	Required for banks	Required	No information
Limits on level of unsecured loan	None for MFI-NGOs	No information	No information	Required	No information
Interest rates	Market determined; subsidized in some government-funded credit programs	Regulated and fixed by the government	Market determined; with a plan to phase out subsidized interest rates of Agriculture Promotion Bank	Regulated by the government	Deregulated but central bank has power to control
Deposit mobilization	From the public, by regulated banks	From the public, by regulated banks	From the public, by regulated banks and cooperatives	From the public, by regulated banks	From the public, by regulated banks
Reports submitted to regulator?	Yes	Yes	No information	Yes	Yes
External audit?	Yes	Yes	No information	Yes	Yes

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Table 1b. Policy, Legal, and Regulatory Frameworks for Microfinance in Asian Countries: Pakistan, Philippines, Sri Lanka, Vietnam

Characteristic	Pakistan	Philippines	Sri Lanka	Vietnam
Policy/legal basis	Under the Microfinance Sector Development Program, Microfinance Policy in June 2000 to develop a pro-poor financial system. The Microfinance Ordinance of 2001, MFI Licensing Rules, Prudential Regulations.	National strategy for microfinance. The General Banking Act of 2000, Executive Order No. 138, Agriculture and Fisheries Modernization Act; Social Reform and Poverty Alleviation Act	No particular legal mechanism for a wide variety of MFIs operating. Only rural development banks and Sanasa Bank are registered with the Central Bank as licensed specialized banks regulated by the Banking Law Act of 1988. Other MFIs have used one of these methods of regstration: the Cooperative Societies Law of 1972, Companies Act of 1972 (some NGOs are registered with the Registrar of Companies under this Act), the Societies Ordinance of 1891 (a large number of NGOs are registered with the Department of Social Services under this Ordinance), Acts of Parliament (an NGO is required to arrange for a bill to be introduced into Parliament, generally as a private member's bill, and to publish notices in the government gazette and in newspapers in case anyone objects to its establishment), signing of a Memorandum of Understanding with the Ministry of Planning and Implementation (this method is adopted for international NGOs).	Law on the State Bank of Vietnam, Law on Credit Institutions, Civil Code, Cooperative Law, Draft Decree on MFIs (Decree on Organization and Operation of Small-scale Finance Institutions in Vietnam) for NGOs.
Regulatory agency	State Bank of Pakistan. A special Microfinance Division has been established.	Bangko Sentral for rural banks, Cooperative Development Authority for cooperatives	Central Bank	State Bank of Vietnam for banks, Central Credit Fund–PCF network, State Bank of Vietnam for NGOs under Draft Decree on MFIs
Supervisory approach	Traditional	Risk-based supervision of banks; co-ops not adequately supervised	Traditional	Traditional supervision of credit institutions
Regulated microfinance providers	Small Business Finance Corporation; Khushhali Bank; First Microfinance Bank Limited; development financing institutions; specialized banks	Rural banks, cooperatives	Banks	Vietnam Bank for Agriculture and Rural Development, Central Credit Fund–PCF network, Vietnam Bank for Social Policies; rural joint stock banks
Non-regulated MFIs	NGOs	NGOs	NGOs, community organizations	Government ministries; NGOs; mass organizations

(continued on next page)

Characteristic	Pakistan	Philippines	Sri Lanka	Vietnam
Functions of regulated MFIs*	Provide loans; accept deposits	Rural banks—lending; deposit mobilization from public; coops—lending; deposit-taking from members only	Provide loans; accept deposits	Banks—lending; deposit mobilization from public; coops—lending; deposit mobilization from public
Functions of non-regulated MFIs	Provide loans	NGOs: lending (deposit-taking is prohibited)	Provide loans	NGOs, mass organizations—lending (deposit-taking is prohibited)
Minimum capital	Required	Required	Required	Required
Min. qualifications for Board of Directors	Required	Required	No information	Required
Collateral allowed	Peer pressure, group guarantee; third party guarantee; leased assets; maintenance of equivalent amount as a deposit under lien; mandatory savings with or without collateral; pledges, mortgages, hypothecation or assignments to any kind of movable or immovable property for the purpose of securing loans and advances	Without physical collateral, pledges of movable assets; mortgage of immovable property; joint and several liability signatures; group guarantee	Group guarantee; peer pressure; third party guarantees; mortgage of property	Loans can be given without physical collateral; pledges of movable assets; mortgages of immovable property; non-binding guarantees (guarantees just by reputation but not backed by assets) by mass organizations (e.g., women's unions); third-party guarantees (whether or not backed by assets). However, other types of non-traditional security, like joint liability, peer pressure, and group guarantees, are not officially recognized.
Loan loss provisioning	Required	Required	Required	Overdue less than 91 days, 20%; overdue 91 to 180 days, 50%; overdue more than 180 days, 100%
Limits on levels of unsecured loans	No information	Required	No regulation	In general, credit institutions may set own limits; however, the State Bank of Vietnam has, issued certain guidelines on limits of unsecured loans of certain types of clients, e.g., farm households
Capital adequacy	Required	Required	Required	Required
Interest rates	Market-oriented	Market-oriented	Market-oriented	Mix of market and subsidized interest rates
Submit reports to regulator?	Required	Required	Required	Required
External audit?	Required	Required	Required	No information given
*Refers to two basic functions only: providing loans and mobilizing deposits				

to private-driven microfinance institutions (NGOs). The provision of credit has been a key component in Bangladesh's poverty reduction programs.

Lao PDR, recognizing the importance of rural microfinance, has established a Rural and Microfinance Committee (RMFC) to promote activities in the sector. In 2005, the government issued a Microfinance Regulation that comprehensively governs the operations of private MFIs and the development of financially viable and commercial microfinance institutions. The general vision for the future development of the rural microfinance sector will focus on the expansion of outreach and use of a diversity of independent private and public MFIs with varying lending technologies. It is envisaged that the development will anchor national laws and other legal instruments supportive of microfinance. Owing to the rudimentary character of its financial markets, Lao PDR plans to use the government-owned Agriculture Promotion Bank as the main microfinance provider.

In Vietnam, the government recognizes microfinance to be an integral instrument for poverty reduction. Microfinance provides opportunities to the poor to build their assets, enhance their income-earning capacity, achieve consumption, and better manage their risks. The government intervenes heavily in the microfinance sector through state-owned banks and budgetary allocations for national programs, which invariably have a credit component that is used to support the implementation of state objectives. The government created the Vietnam Bank for Social Policies (VBSP) in late 2002 to replace the Vietnam Bank for the Poor and to conduct policy lending programs that used to be implemented by different institutions and government agencies. The VBSP is now the first policy bank specializing in policy lending, including micro-credit to the poor. The State Bank of Vietnam (SBV) has been an active partner of the government in promoting microfinance; it has actively directed commercial banks, especially the Vietnam Bank for Agriculture and Rural Development, to provide credit to farm households and other poor members of society. The SBV has also gradually formulated the legal framework for pro-poor credit targeted programs, coming up with a Draft Decree on Microfinance that provides NGOs with a legal basis for engaging in microfinance operations. Nongovernmental organizations (NGOs) involved in microfinance do not receive financial support "as the law still does not recognize their right to provide microfinance" (Chu 2005, in this volume). The government, in coordination with donors interested in microfinance, has prepared a Draft Decree on Microfinance Institutions, a law that, if passed, will recognize NGOs as legitimate microfinance providers.

The government of Pakistan established the Pakistan Poverty Alleviation Fund (PPAF) in 1997 as an apex institution to help the poor through NGOs. The government has established four endowment funds at the State Bank of Pakistan to support microfinance: the Microfinance Social Development Fund, the Community Investment Fund, Risk Mitigation Fund, and the Deposit Protection Fund. Under the Microfinance Sector Development Program, developed with assistance from the Asian Development Bank, the government plans to design and establish the legal, supervisory, and regulatory architecture that will address the following issues, among others: definition and categorization of MFIs and their licensing procedures; corresponding supervision and regulation standards and systems; disclosure and reporting requirements; and appropriate adjustments for entry threshold prescribed under the banking laws.

Rapid economic growth, which began in the 1980s and continued through the 1990s and up to the present time, has enabled Malaysia to experience dramatic reductions in poverty. However, there are still pockets of poverty in the rapidly developing country. The first micro-credit scheme was initiated in September 1987, through Amanah Ikhtiar Malaysia (AIM), the first nongovernmental organization aimed at poverty alleviation in the country. Specifically, AIM was established "for the sole purpose of assisting very poor households to lift themselves out of poverty." Microfinancing is an important instrument for poverty alleviation. Micro-credit programs are seen as complementing the government's efforts in reducing poverty. Thus, the government provided loan capital to Amanah Ikhtia Malaysia (AIM), an NGO, in the form of grants as well as interest-free loans to be distributed to the poor. The Malaysian government announced the Package of New Strategies in May 2003, which established a MYR1 billion new fund for micro-credit schemes for small businesses and enterprises to be lent by two financial institutions.

Since Japan is a developed country, it presents a different case for microfinancing. The country has a Small and Medium Enterprise Basic Law (enacted in 1963 and revised in 1999) to provide funding for small-scale and medium enterprises. The SSEs include micro-businesses such as private taxis, small restaurants, and retail shops that are operated by only one or two persons or by the owners themselves. Japan is a mature economy where access to finance services is not seen as a major problem for micro-businesses and households. An indication of the maturity of its financial system is reflected in the laws creating financial intermediaries and in basic laws such as the Civil Code, Commercial Code, and others, enacted many, many years ago, which govern the rules of the game and the basic legal infrastructure for both financial institutions and clients. These laws ensure ease in loan contracting, providing and getting guarantees, collecting loans, and registering lands and other properties for securing the loans. Japan has also created specialized financial institutions such as the National Life Finance Corporation and a host of other institutions to channel credit to sectors, companies, micro-businesses, and other target clientele.

THE REGULATORY AND SUPERVISORY ENVIRONMENT FOR MFIS

As mentioned above, microfinance cannot be simply viewed as one of the traditional credit products, like commercial, consumer, or mortgage credit. It is a loan product that has been developed first by NGOs in response to the failure of traditional banking methods to deal with the problem of lack of access to credit for small-scale borrowers, chiefly poor households and microenterprises that used to depend on informal lenders for their liquidity requirements. Further experimentation with microfinance technologies indicates the potential to provide commercially-priced finance products and services to a vast array of microenterprises and poor households hitherto dismissed by urban-based commercial lenders as horrendous credit risks or too destitute to have financial savings. Over the last decade, pioneering efforts of NGOs and others across the developing countries have shown that the poor, particularly women, can successfully use small loans to earn income and are prompt and reliable loan repayers (Christian AID Reports 1997). The experience seems to indicate that the traditional collateral may be unnecessary, that lending procedures can be designed to ensure that credit extension is practical and cost-effective, and that lending to the poor is financially sustainable (Llanto 2005).

As shown in Table 2, the characteristics of microfinance gleaned from the literature[7] are different from the conventional credit provided by traditional financial institution, which fuel the quest for an appropriate regulatory treatment and architecture.

These characteristics create a specific risk profile for MFIs that has to be properly understood by the regulatory authorities in order to arrive at appropriate regulation and supervision. Fitzgerald and others (1998), in a study of barriers to lending in the Philippines prior to the reforms instituted by the National Credit Council and the Bangko Sentral (Philippine central bank), found that the traditional regulation and supervisory practices of the central bank have prohibitive effects on banks engaged in microfinance. In this respect, Staschen (1999) carefully notes that the risk categories (credit risk, interest rate risk, liquidity risk, management risk, ownership and governance risk, new industry and subsidy dependence) risk differ signi-

[7] Table 2 is a modification of a table developed by Staschen (1999) from Berenbach and Churchill (1997), Jansson and Wenner (1997), and Rock (1997).

Table 2. Distinctive Features of Microfinance

Characteristic	Description
Type of client	Low-income Employed in the informal sector or self-employed Lack of physical collateral Interlinked household and microenterprise activities
Lending technology	Group or individual loans Simple and minimal documentation Cash flow- and character-based Collateral substitutes, e.g., group guarantee, peer pressure, joint liability Repeat loans provided, short-term maturities
Interest rates	Generally market, allowing MFI to cover costs and a margin of profit
Loan portfolio	Working capital, short-term loans, repeat loans Few longer-term loans Clients mostly women
Provider	NGOs Banks, adopting microfinance lending technology In some areas, cooperatives In others, government banks/ministries
Institutional structure	Decentralized If MFI is NGO, insufficient external control, dependent on quasi-equity capital (grants and soft loans) If MFI is bank or co-op, regulated
Regulation/supervision method	Limited to a subgroup of MFIs (banks, for example) Second-tier institutions are commissioned Traditional vs. risk-based supervision NGOs left unregulated vs. plan for comprehensive regulation and supervision of all types of MFIs

ficantly in the case of NGOs from those attaching to traditional financial institutions. The different risks that visit non-conventional lending operations may increase the "solvency and liquidity risks" of a MFI overall, which triggers a different regulatory and supervision approach. Minimum capital requirements, capital adequacy ratios, loan loss provisioning, and placing limits on the amount of certain risk assets that the MFI can take are some of the common regulatory instruments imposed on microfinance institutions (Table 1). These are typically risk mitigation and risk avoidance instruments, which are in the traditional regulatory toolbox. However, because of the characteristics of microfinance, regulators have had to develop more creative risk management instruments. Traditional bank regulation and supervision cannot be imposed on microfinance in a straightforward manner. Vogel and others (2000) suggest that with respect to microfinance institutions, "the greater their demonstrated ability to manage risk, the more tolerant a regulator should be to variation of risk, higher levels of risk and alternative approaches to managing risks." This is to say that regulators should be more concerned with the risk management techniques used by MFIs, e.g., the "methodologies used to manage risks in portfolios of microfinance" (ibid.).

Common in the survey countries is the use of onsite and offsite supervision. This is part of the traditional approach to bank supervision. For example, in the case of Lao PDR, in offsite supervision, information reported by financial institutions is reviewed in order to get a picture of the financial performance and risk profile of the institution. The Lao PDR Central

Bank conducts sample checks onsite to validate the information reported and to evaluate the professional capacity of management and staff, the efficacy of policies and procedures, and the ability to manage risk. The State Bank of Pakistan uses two major supervisory tools: offsite surveillance and onsite examination for monitoring and supervision of MFIs. The existing onsite and offsite surveillance systems employ a CAMELS rating system to rate and assess the financial health of MFIs.

This is also the practice in the other survey countries including Malaysia and the Philippines. In Malaysia, the Development Financial Institutions Act provides a comprehensive supervision framework which incorporates prudential rules, onsite and offsite supervision, reporting requirements, and disclosure standards. Related to offsite and onsite supervision is the need for an advanced management information system (MIS) for effective offsite control. It can partially replace onsite inspections (Gonzalez-Vega 1992; Staschen 1999). The Philippines uses both onsite and offsite supervision but has additionally embarked on working on a risk-based supervision approach for microfinance in lieu of traditional bank supervision. The Bangko Sentral ng Pilipinas (BSP) has issued several circulars and guidelines in this regard:

- Clear guidelines on the treatment of microfinance-oriented banks.
- Provision of a rediscounting facility for banks engaged in microfinance.
- Adoption of a risk-based supervision format that is more appropriate for microfinance operations of banks.

Traditional bank supervision is concerned with the quantification of problems and the minimization of risks in individual financial institutions, while risk-based supervision focuses more on the quality of management and risk management systems in individual institutions plus the recognition of risks to the banking system (systemic risks) caused by the environment in which the banking system operates (Vogel and others 2000). Vogel and others argue that the main difference of microfinance from traditional bank lending lies in the risk profiles, not in the set of risk factors affecting MFIs. Microfinance institutions have a different risk profile from traditional banks. Because of the small risk associated with individual transactions in MFIs, it is more appropriate to focus on systems and processes and on the use of proper risk management techniques by the MFI concerned. In contrast, the higher risk associated with relatively larger commercial loans warrants scrutiny of individual loan transactions of traditional banks. In this situation, traditional bank supervision may be proper. For MFIs, it is submitted that risk-based supervision seems more appropriate for microfinance operations than traditional forms of supervision that focus on collateral and risks of individual loans.

The Lao PDR Central Bank has established supervisory policies and procedures for the formal sector, but these are not adapted to the supervision of microfinance activities of non-regulated microfinance providers. There is yet no system for supervision of MFIs, and this still needs to be developed. Lao PDR does not have any specific regulations on the establishment, organization, and operations of associations, social funds or local NGOs. Thus, the legal status of these entities providing microfinance services remains uncertain. However, they follow their own set of management rules. Under the newly minted Microfinance Regulations, any institution intending to carry out microfinance activities including the mobilization of voluntary deposits from the general public should apply for a license to the Bank of Lao PDR. Other institutions, such as NGOs, associations, village funds, village banks, and other entities that will engage only in micro-lending excluding the mobilization of voluntary deposits, should register with the relevant government body.

The Nepal Rastra Bank, the central bank of that country, has promoted microfinance through various interventions such as targeted credit, priority sector lending, and lending to the deprived sector, which was made mandatory for commercial banks; channeling of credit to microfinance institutions like the Rural Self Reliance Fund (RSRF); and second-tier credit supply schemes within the central bank and the autonomous Rural Micro Financing Development Center (RMDC). The active involvement of the government in microfinance is characterized by the establishment of village development programs, which promote the cooperative movement throughout the country and established the Cooperative Development Bank (now Agriculture Development Company Ltd.). The licensing of NGOs for limited banking functions by Nepal Rastra Bank was a bold step in promoting microfinance.

Pakistan has issued the Microfinance Ordinance (2001) and the subsequent MFI Licensing Rules and Prudential Regulations. The State Bank of Pakistan also created a special Microfinance Division to take care of regulatory and supervisory procedures for MFIs. Pakistan's microfinance policy and legal framework provides scope for NGOs to become regulated MFIs provided they meet the requisite criteria. This is policy has been adopted to ease the transformation of NGOs, which are seeking a depository status, into regulated institutions.

The Malaysian situation is very different from those of other countries. There is currently no regulatory and supervisory framework for microfinance NGOs since these do not mobilize savings from the public but use donor grants to provide loans to targeted poor households.

Before moving to the next topic, it is important to emphasize the need to develop supervisory capacity to deal with the rapidly expanding number of microfinance institutions and the increasing volume of microfinance transactions, including most especially deposit mobilization among poor households. This is a major issue in light of the experience of some countries such as Indonesia and the Philippines, whose supervisory units are understaffed relative to the number of rural financial institutions. Limited capacities should trigger a rethinking of priorities for regulation and supervision, and the adoption of an appropriate approach, e.g. risk-based supervision, as well as recognition of the need to build regulatory capacity. A relevant point is raised by Alfred Hannig of GTZ, who observed that "effective regulation and supervision require sufficient capacity, so do not regulate what you cannot supervise" (Valenzuela and Young 1999). Speaking of priorities, regulatory agencies may focus only on deposit-taking institutions, as pointed out at the beginning of this paper. Donors and/or second-tier institutions that provide wholesale loans may take responsibility for "supervising" non-deposit-taking institutions. In other jurisdictions with scarce regulatory capacity and resources, self-regulation with strong disclosure rules and performance standards, may be the regulatory solution.

TOWARD APPROPRIATE REGULATORY FRAMEWORKS

The key challenge is not so much the construction of a legal and regulatory architecture for microfinance as finding the appropriate regulatory framework, including supervisory methods, to ensure the soundness of MFIs and the protection of deposits. It is also about building capacities to regulate. The survey countries report varying approaches to the problem of developing appropriate regulatory frameworks. In the quest for appropriate regulatory frameworks, it should be noted that microfinance has become a worldwide phenomenon because it lies outside conventional regulation, a situation that has triggered the innovative impulses of MFIs which are on the lookout for loans, deposits, and other products that are suitable to their clients, who are typically low-income, without physical collateral, but potential if not actual micro-entrepreneurs. Thus, policy makers and regulators should invest time and analytical capacity in finding the appropriate regulatory frameworks in their respective countries. The dampening impact of inappropriate regulation is emphasized by Chavez and Gonzalez-Vega (1993, 1994): "Inappropriate regulation may frequently be more dangerous than no regulation at all. What really matters are the effects of regulation, not their objectives."

Successful methods for delivering financial products and services for the poor have grown and matured outside the conventional regulatory frameworks. Great care must be taken therefore by policy makers and regulators in defining and imposing regulation and supervision methods that will not constrain or dampen those innovative impulses. This is not to say, though, that the protection of depositors, especially poor depositors, should be taken lightly. On the contrary, this objective should spur policy makers and regulators to really think hard and deeply about the need for appropriate regulatory frameworks that will balance the objective of ensuring the sustainability of MFIs and protecting depositors, on the one hand, and encouraging innovative impulses to continue to create relevant products and services for the poor and microenterprises, on the other.

Fine-tuning existing regulatory frameworks will not be sufficient and may create a sense of complacency on the part of tradition-minded regulators that all is well with microfinance once some fine tuning or retrofitting of current regulatory frameworks has been accomplished. A wider understanding of the advances of sustainable microfinance is still needed among policy makers and regulators in order to improve the policy and regulatory environment. For example, Lao PDR acknowledges this and has asked the assistance of the Asian Development Bank in developing an appropriate regulatory framework.

Van Greuning and others (1998) point out that the approaches to regulation and supervision of MFIs can range from nonexistent to full regulation, either through the existing prudential regulatory framework or by modifying the existing regulatory requirements to fit the organizational and operating characteristics of microfinance institutions. “Tiered banking” is a prime example of the modified or adaptive approach because it takes into account the different characteristics of microfinance and the range of MFIs engaged in it. In this regard, van Greuning and others recommend a regulatory approach determined by the funding sources of the financial institution.

In contrast to this approach is risk-based supervision, a relatively new approach to supervising regulated financial institutions that is the preferable approach to bank supervision (Vogel and others 2000). Under risk-based supervision, most financial products and services share a common set of risk factors but can have very different risk profiles. The difference therefore is in the risk profiles, not in the set of risk factors (Vogel and others). Thus, risk-based supervision concentrates on the MFI’s ability to manage risks and not on the collateral required to secure the loan, the number of “unsecured loans,” compliance with tedious documentation, and other factors that are the concern of typical bank supervision.

Regulation and supervision from this viewpoint means looking at microfinance as an activity rather than as a special type of institution. Treating microfinance as requiring the creation of special institutions designed to meet the demand for finance services of different types of clients and, therefore, as needing specialized regulatory treatment, will result in fragmentation and distortion of regulation. This will run against competitive neutrality; i.e., “regulation must be organized to avoid distortion of competition amongst financial intermediaries” (Staschen 1999). The aim, according to Chavez and Gonzalez-Vega (1992), is have a “level playing field.”

The survey results indicate that the “jury is still out,” so to speak, on the debate regarding the appropriate regulatory approach or framework. Hannig and Omar (1999), in their review of the African experience, note: “The debate is still guided by contemporary experimentation, and is complicated by the span of institutional types, country contexts and the variety of interests of the key actors involved.” They add that it is difficult to identify, much less replicate, a “correct” regulatory and supervisory framework—and that, considering the diversity of environments, perhaps this should not be the overarching aim. All this says is that there is no one-size-fits-all approach to regulation and supervision, but on balance the rationale and arguments for risk-based supervision seem to outweigh those favoring other approaches.

The survey reported in this volume carries two simple but powerful messages: (a) find an appropriate regulatory architecture and (b) build the capacity to handle it. As the reports show, the survey countries are on track with the first message, but there is growing interest in addressing the second message as well. The two objectives are challenging and daunting (to say the least), and it is hoped that the near future will show the realization of these twin objectives in the countries concerned. It takes time to develop the appropriate regulation and supervisory approach and practices as well as to build the requisite capacity. Designing regulatory mechanisms and building effective institutional frameworks are never easy tasks, but these can be facilitated by mutual trust that is built by constant interaction and feedback between regulators and microfinance institutions.

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Part II

National Reports

BANGLADESH

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INTRODUCTION

The main theme of this paper is to present the findings of a survey on the microfinance industry (MFI) in Bangladesh. The objectives of the survey are to establish the status and the legal and regulatory framework for microfinance; to determine the impact of the legal and regulatory framework on microfinance institutions; and to recommend measures that will improve the legal and regulatory environment so that MFI productivity may be enhanced. The paper is organized into six sections. The first section describes the poverty and unemployment situation in Bangladesh and gives an overview of the national development strategy and the government policies for poverty alleviation. It also discusses the role of the microfinance industry in alleviating poverty and generating employment. The second section discusses the structure and financial system of Bangladesh with special emphasis on the performance of formal and informal lenders in the credit market. The emergence of microfinance institutions in Bangladesh is also described in the same section. The third section describes the microfinance products and services of major microfinance NGOs (MF–NGOs) operating in Bangladesh, including micro-lending technologies or methodologies used by MFIs. The fourth section describes the government policy and legal framework supporting microfinance. The fifth section explains the regulatory and supervisory environment for banks, nonbanks, and MFIs. The last section elaborates the specific regulatory requirements and supervisory practices for MFIs in Bangladesh.

POVERTY ALLEVIATION AND EMPLOYMENT GENERATION

Poverty and Unemployment in Bangladesh

Poverty

The economy of Bangladesh, with its large and growing population and low per-capita income, is characterized by conditions of abject poverty for the majority of the people. The low level of human resources development in Bangladesh is a serious constraint to the development process of the country. About half of its population lives below the poverty line, a proportion that rises to nearly 80% in rural areas.

Absolute Poverty

The Household Income Expenditure Survey 2000 (HIES 2000) of the Bangladesh Bureau of Statistics (BBS) reveals that in 2000, 42.3% of the rural poor were below the poverty line based on daily per-capita calorie intake of 2122 kcal, and 18.7% were below the hard-core poverty line based on daily per-capita calorie intake of 1805 kcal. In 1983/84, poverty in rural areas was 61.9%; this ratio declined to 42.35 in 2000 (Table 1). Hard-core poverty in rural areas in 1983/84 was 36.7%, which declined to 18.7% in 2000. On the other hand, poverty and hard-core poverty in the urban areas in 2000 had declined only to 52.5% and 25% respectively, compared with 67.7% and 37.4% respectively, in 1983/84.

Table 1. Poverty and Hard-core Poverty on the Basis of Calorie Intake

Nature of poverty		1983/84	1985/86	1988/89	1991/92	1995/96	2000
Poverty	National	62.6	55.7	47.8	47.5	47.5	44.3
	Rural	61.9	54.7	47.8	47.6	47.1	42.3
	Urban	67.7	62.6	47.6	46.7	49.7	52.3
Hard-core poverty	National	36.8	26.9	28.4	28.0	25.1	20.0
	Rural	36.7	26.3	28.6	28.3	24.6	18.7
	Urban	37.4	30.7	26.4	26.3	27.3	25.0

Source: BBS Preliminary Report of Household Income and Expenditure, Survey 2000

A study by the Bangladesh Institute of Development Studies (BIDS) reveals that more than 50% of the people (51.7%, 1994) in rural areas are poor, of whom about 22.5% are in hard-core poverty (Table 2). The study, however, brings to light some improvements in different aspects of living standards (especially education, housing, clothing, etc.) for the rural poor.

Table 2. Changes in Poverty in Rural Areas (%), 1987–1994

Index	1987	1989/901	1994
Hard-core poverty	25.8	30.7	22.5
Poverty	31.7	28.6	29.2
Poverty and hard-core poverty	57.5	59.3	51.7
Poverty gap ratio	21.7	24.8	19.2
FGT [A]	10.9	13.5	9.6

Source: "1987–1997, Dynamics of Rural Poverty in Bangladesh," BIDS, April 1999

According to the data of the BBS, poverty has been reduced at the national level from 47% to 44.7% during the last four years. In 1999, 43.3% of the people in urban areas were below the poverty line while in rural areas this proportion was 44.9%. On the basis of absolute poverty measurements along with all other research findings, it can be concluded that there have been overall improvements in the poverty situation from the 1980s to the 1990s.

Land Distribution

The poverty situation is influenced by unequal land ownership in rural areas and inequality of income distribution in both urban and rural areas, lack of employment opportunities, and above all low economic growth rates. According to the 1995/96 HIES Survey conducted by the BBS, 6.43% of households in rural areas were landless; 12.34% of households owned 0.05 acre or less of land, and 55.23% owned up to 0.50 acre (Table 3).

Income Distribution

Disparity is evident in income distribution also. The Preliminary Report of HIES 2000 reveals that the income of the highest 5% of households at the national level was 28.66% of total national income in 2000 (this figure had been 18.30% and 23.62% respectively in 1983/84 and 1995/96. And the income of the lowest 5% households was 0.92% of the total in 2000 (compared with 1.17% in 1983/84 and 0.88% in 1995/96). The increase in income disparity is evident in both rural and urban areas: HIES 2000 reveals that inequality of income widened in both urban and rural areas during the period from 1983/84 through 2000.

Table 3. Distribution of Land Ownership by Household (%)

Ownership of land (acre)	National	Rural	Urban
Total	100	100	100
Landless	9.97	6.43	28.02
0.01–0.04	14.05	12.34	22.78
0.05–0.49	35.19	36.46	28.71
0.50–1.49	19.03	20.80	10.04
1.50–2.49	8.89	9.84	4.04
2.50–7.49	10.88	11.97	5.36
7.50 or more	1.98	2.16	1.08

Source: BBS Household Expenditure Survey, 1995–96

Unemployment Scenario

Due to extreme pressure on land, a large labor force tries to find marginal activities within the rural economy in order to survive. According to recent estimates, about 29% of the labor force were involved in marginal activities (those having low productivity) in 1981–90. There has been some improvement in economic growth in some years during the past two decades, but generally the poverty situation has deteriorated, primarily due to the rapid increase of the working age population, increasing landlessness, and slow growth in productive non-farm employment. This has been compounded further by a high incidence of underemployment, a predominance of low-productive and low-remunerative jobs, and a high dependency ratio resulting from very low participation of women in economic activities. Thus, the burden of poverty falls disproportionately on women. Women on average had a nutritional intake of only 88% that of males and earned 40% of the wages earned by males; moreover, the declining availability of home-based activities has exposed women to serious economic pressures.

Overview of National Development Strategy and Policies

State Policy

The fundamental principle of state policy is to adopt effective measures to remove social and economic inequality between individuals and ensure equitable distribution of wealth and of opportunities among citizens, in order to attain a uniform level of economic development throughout the Republic.

National Vision

The vision of Bangladesh's poverty reduction strategy is to substantially reduce poverty within the next generation. The specific target is to reduce the number of people living below the poverty line by 50% by 2015. Through adopting a comprehensive approach, the strategy visualizes that, by the year 2015, Bangladesh will achieve the following objectives: (a) attain universal primary education for all girls and boys of primary school age; (b) eliminate gender disparity in primary and secondary education; (c) reduce infant and under–5 mortality rates by 65%, and eliminate gender disparity in child mortality; (d) reduce the proportion of malnourished children under five by 50% and eliminate gender disparity in child malnutrition; (e) reduce the maternal mortality rate by 75%; and (f) ensure availability of reproductive health services to all women.

Development Strategy

The government has finalized a three-year "National Strategy for Economic Growth, Poverty Reduction and Social Development" to implement its medium-term plan. The cardinal objective of the development strategy articulated in the document will be to make sure that the poor share the benefits of growth. The strategy document lays emphasis on the following five major strategies: (a) acceleration of pro-poor growth; (b) promotion of good governance; (c) investment in human development; (d) women development; and (e) ensuring social security.

Government Programs for Poverty Alleviation and Employment Generation

Annual Development Programs

The government has attached the highest priority to poverty alleviation in all its development plans and has been implementing a number of projects aimed at poverty alleviation. The major strategy for poverty alleviation is human resource development, and the base of human resource development is education, health, nutrition, and women development.

Safety Net Programs

To supply the ultra-poor with food and create income-generating employment for them, the government provides resources from the budget every year. The bulk of resources are utilized in programs like Food for Work (FFW), Gratuitous Relief (GR), Test Relief (TR), Vulnerable Group Feeding (VGF), Vulnerable Group Development (VGD), and others. In addition to providing funds, Food for Work, Vulnerable Group Development (VGD), rural infrastructure construction and maintenance programs, and other programs also create employment; and education expansion programs such as Food for Education, special subvention and financial support, and free primary education directly reduce education expenses.

Special Programs

A number of poverty alleviation programs have been taken up on a high-priority basis under the government's Special Program. The programs included among them are: tree plantation, aquaculture, goat rearing, primary and women's education, information and communication technology, library development, children's rights, vocational and technical education, and housing for distressed people. The government is also implementing a set of new programs that would help efforts at poverty alleviation. Among these programs, two projects, the Abasan (Housing) Project, and the Poverty Alleviation and Goat Development Project, are worth special mention.

Bangladesh Rural Development Board (BRDB)

The BRDB has been working in the field of rural development, in particular, towards poverty alleviation through cooperatives and nonformal group networks, with the financial and technical support of the government of Bangladesh and foreign donors.

Palli Daridrya Bimochan Foundation (Rural Poverty Alleviation Foundation)

The government established the Rural Poverty Alleviation Foundation in 2000 with all the assets and manpower of 139 Assetless Central Cooperative Societies. Its goal is to strengthen the economic and social development of rural poor and disadvantaged people and promote gender equality.

Bangladesh Rural Development Academy (BARD)

BARD, a government agency for rural development, is implementing a project entitled "Small Farmers and Landless Laborers Development" in 30 *upzilas* of 8 districts around the country. Under the project, small farmers, landless laborers, and poor woman are being organized into nonformal groups, given skill development training, and provided with credit support for income generation and capital formation. In addition, the Academy has been implementing the Comprehensive Village Development Project (CVDP).

Rural Development Academy (RDA)

RDA, another government organization, has been implementing the Comprehensive Rural Development Project, as well as an Afforestation and Empowerment Project for poverty alleviation.

Special Credit Program

The Jatiya Mohila Sansgtha (National Women Forum) has been implementing a "Self-Employment Credit Program" to promote the self-reliance of the poor unemployed women through their district and *upzila* offices.

Palli Progati Project (Rural Development Project)

This rural development program has been launched under an agreement between the Bangladesh Krishi Bank and the Bangladesh Rural Development Board (BRDB) to provide micro-credit to the farmers who are members of 338 unions under 338 *upzilas*. No collateral security will be required to borrow up to BDT 12,000.

Abashan (Housing) Project

This housing project was launched by the government for poverty alleviation. The Abashan project aims to alleviate poverty by providing land accommodation, training, credit, education, health services, family planning, income-generating activities, pure drinking water, electricity, improved transportation systems, and facilities for tree plantation to 65,000 landless, homeless, and destitute families. Under this project, the adult members of these families will be provided training for skill development, human development, and awareness building.

Local Government Engineering Department (LGED)

This Department, under the Ministry of Local Government, Rural Development and Cooperatives, has been implementing various infrastructure construction projects, especially rural roads, bridges/culverts, growth centers, and embankments, to generate employment in rural areas.

Urban Poverty Reduction Program

The government has been implementing an Urban Infrastructure Development Program for urban poverty alleviation through the micro-credit program. To increase the family incomes of selected slum dwellers in 4 city corporations and 21 municipalities, LGED operates a revolving loan under the Slum Development Project assisted by the United Nations Children's Emergency Fund (UNICEF).

Role of the Microfinance Industry in Alleviating Poverty and Generating Employment

Group-based approach

Bangladesh has pioneered the idea of micro-credit as an effective instrument of poverty alleviation using a group-based approach. It has successfully implemented the scheme through Grameen Bank and a number of NGOs and government agencies. The commitment of the government regarding poverty alleviation through micro-credit has made a significant contribution to further strengthening and sustaining the ongoing programs of Bangladesh by augmenting the required credit fund.

Rural Employment

A large number of rural unemployed people, especially the landless, are being pushed to take up self-employment in various non-crop activities. Since these people come from very poor economic backgrounds, the major constraint they face is the shortage of funds. They often have to depend upon the local moneylenders who charge usurious rates of interest. Provision of institutional credit at reasonable rates of interest could make a significant improvement in the lives of these rural disadvantaged groups.

Women Development

Microfinance has caused a shift in values and expectations that affects women's role in society. In Bangladesh, for example, a study of experience in an International Fund for Agricultural Development (IFAD) project has found that women involved in microfinance not only change the way they manage household income; they also change their own roles and the roles of others in their families and communities.

Global Concept

More than two decades after the first loans were introduced, micro-credit has proved itself one of the most effective tools for reaching the poor and alleviating poverty. Banking for the poor through microfinance is now an international concept with varied models and is recognized by all major organizations working in the field of economic and social development. A recent World Bank study shows that micro-credit programs operating in Bangladesh over a long period have had a greater impact on extreme poverty than on moderate poverty. It is reasonable to conclude that micro-credit not only affects the welfare of participants and nonparticipants but also has an impact on the aggregate welfare at the village level (World Bank, Bangladesh Rural Finance, Agricultural and Natural Resources Division, Report No. 15484-BD, The World Bank).

Impact of Microfinance

Some findings on the impact of micro-credit in Bangladesh from the study report prepared by BIDS are presented in Table 4:

Table 4. Impacts of Microfinance (Compared to Nonparticipants)

Broad category	Indicators	Types of change	Cause of change
Economic impact	Income	+	Self-employment activities
	Food security	+	Greater access to cultivable land through the rental market
	Wage (land poor)	+	Transport and other non-agricultural activities supported by micro-credit
	Employment (land-poor)	+	Better access to the land rental market Wage employment in non-agriculture sector
	Assets (land-poor)	+	Av. lower land size than nonparticipants Larger operational holding Impact of ME (poultry, livestock, bicycles, rickshaw/van)

(continued on next page)

Social and other develop-ment impact	Fertility and contraceptive use	+	Program participation Female methods dominate
	Health and nutrition	+	Program placement effect
	Sanitation and drinking water	+	Program participation
	Literacy and school enrollment of children	+	Program participation
	Social mobility	?	Doesn't vary significantly
	Women participation and household welfare	+	Participation in a micro-credit program Increasing women's income

Source: Bangladesh Institute of Development Studies (BIDS): 2001: "Final Report on BIDS Study on PKSF's Monitoring and Evaluation (MES)," October 2001, Dhaka. The Palli Karma Sayahak Foundation (PKSF) commissioned a longitudinal Monitoring and Evaluation Study (MES) conducted by Bangladesh Institute of Development Studies (BIDS). Started in 1997, the study was completed in 2001. The study covered 3026 sample households spread over 91 villages located in 13 PKSF Partner Organizations (PO) operational areas.

Major Microfinance Service Providers

Government's Role

The government departments/agencies through nongovernmental NGO–MFIs extend financial services to the rural poor. The Nationalized Commercial Banks (NCBs) and two agriculture credit banks provide rural credit throughout the country. The government, as a part of lending policy, provides no more than 20% of rural credit through formal financial institutions. The government has been disbursing micro-credit for poverty alleviation through different Ministries/Divisions/Departments.

Grameen Bank

The Bangladesh Bank (Central Bank) in 1978 made provision for NGO intervention in micro-credit programs. Subsequently the Grameen Bank Project launched by the Bangladesh Bank became famous around the world. The Grameen Bank Project was born in Bangladesh in 1976. In 1983 it was transformed into a formal bank under a special law passed for its creation. The poor borrowers from the bank, who are mostly women, now own it. It works exclusively for them. Borrowers from Grameen Bank at present own 94% of the total equity of the bank. The government owns the remaining 6%. Grameen Bank does not require any collateral against its micro-loans. The total number of borrowers is 3.8 million; 96% of them are women. Grameen Bank has 1,277 branches. It works in 46,620 villages. The total number of staff members is 12,546.

NGO–MFIs

Several hundred NGO–MFIs in Bangladesh have extended micro-credit to millions of borrowers. The micro-loans are small, normally between one and five thousand *taka.* A small amount of money, therefore, covers a large number of borrowers, generating a noticeable socioeconomic impact. NGO–MFIs mobilize tiny savings from their borrower-members. Among others the following major NGO–MFIs are working in the country.

Bangladesh Rural Advancement Committee (BRAC)

BRAC started its first small loan programs in the mid–1970s, lending to groups of artisans and other poor villagers to finance income-generating activities. It initiated its major credit activity in 1979, and has been involved in microfinance ever since. Despite having one of the largest microfinance operations in the world, BRAC is not exclusively a microfinance providing institution (MFI). It has equally large programs in health, education, employment generation, human rights, and development of other capacities, which are part of its holistic development approach. It is now one of the largest NGOs in the world.

Proshika

It has been more than two decades since Proshika, now one of the largest NGOs in Bangladesh, took its first step. The central objective of Proshika is human development and empowerment of the poor, who gradually stand tall and achieve freedom from poverty by themselves. Since its inception, Proshika has made a significant contribution to the modest reduction of poverty already achieved in Bangladesh. Spread in 22,917 villages and 2,028 urban slums in 57 districts, Proshika now works with nearly 2.82 million men and women members drawn from rural and urban poor households, and has organized them into 148,354 primary groups of an average 19 members each.

Association for Social Advancement (ASA)

ASA began in 1978, with the aims of empowering the oppressed through "peoples' organizations" mobilized for social action against exploitation, and of fighting social injustice through legal aid. In 1984, ASA shifted its focus to the basic social unit, the family, recognizing the critical role of women in development. In the late 1980s, ASA began to incorporate management skills for income-generating projects and stressed the importance of savings in development education efforts. At this point, micro-credit delivery came as a quite natural extension of its development program for rural poor women.

Nationalized Commercial Banks (NCB)

The Bangladesh Bank issued instructions to all the Public Sector Banks in the early 1990s requesting them to establish a linkage with NGOs dispensing micro-credit and to offload their surplus funds to assist the poverty alleviation activities of the MFIs. The Nationalized Commercial Banks (NCBs) introduced rural credit throughout the country. One of the characteristic features of this mass-oriented program was that loans were to be disbursed without any collateral security.

Other Commercial Banks

A small number of local private banks provide micro-credit to poor clients. These banks include Pubali Bank, Uttara Bank, Islami Bank Bangladesh, Prime Bank, Social Investment Bank, Bangladesh Commerce Bank, The Trust Bank, and others. However, their disbursement figures are not very significant.

Palli Karma Sahayak Foundation (PKSF)

The government created PKSF as a nonprofit organization registered under the Companies Act in May 1990. The objective of the organization is to undertake and promote various activities aimed at poverty alleviation. The Foundation works as an apex financing organization for NGOs (known as POs, Partner Organizations) running micro-credit programs in rural areas. PKSF has a mandate to undertake wide-ranging activities for poverty alleviation, including capacity building of its POs. The POs of PKSF serve about one million beneficiaries. The government provides fund to PKSF, and the POs get loans from the PKSF at the interest rate of a 2% service charge. PKSF is a semi-autonomous credit wholesaling institution that provides loans on preferential terms to the semiformal sector for micro-credit.

Rural Poverty Alleviation Foundation

A new MFI, the Rural Poverty Alleviation Foundation, was established in 1999 under an Act of Parliament. As an autonomous, long-term, and self-dependent body, the Foundation started functioning in 2000. The basic mandate of the Foundation is to assist the poor and downtrodden population of rural areas.

Karma Sangsthan Bank

The Karma Sangsthan Bank was established in 1998 under an Act of Parliament. The approved capital of the bank is BDT 30,000 million, of which the government of Bangladesh (GOB)'s share is 75%; the remaining 25% is owned by the NCBs, Schedule Banks, insurance companies, and other financial institutions. The major function of the bank is to provide loan to unemployed youths for income-generating activities under the rules and regulations of the central bank.

Basic Bank

The Basic Bank was established in 1989 to provide small credit for small enterprises. The bank disbursed BDT 503 million to 1,08451 poor clients as micro-credit loans without collateral.

Ansar &VDP Bank

The Ansar & VDP Bank was established in 1995 as a specialized bank and statutory agency under an Act of Parliament. The total amount of loans disbursed by the bank, from its inception to March 2003, is BDT 2.880 billion. Of this, BDT 1.954 billion has been repaid. Loan recovery rate was 99%. The beneficiaries of the bank are the members of Ansar & VDP (Civil Defense Force), and they own a 75% share of the bank. The bank provides collateral-free micro-credit loans to members in 60 different subsectors.

Donor-assisted Projects

The World Bank has funded US$105 million to an apex facility in Bangladesh that on-lends to large and small microfinance institutions reaching very poor clients. Under a GTZ--IFAD-assisted Marginal and Small Farms System Crop Intensification Project (MSFSCIP), the nationalized commercial banks (NCBs) lend directly to grassroots beneficiaries with the collaboration of an intervening NGO. The UNDP-assisted Community Empowerment for Poverty Alleviation at the Grassroots Level (CEPA), being implemented by the Rural Development Academy (RDA), Bogra, is another example of a donor agency micro-credit operation in Bangladesh.

STRUCTURE AND PERFORMANCE OF THE FINANCIAL SYSTEM

The Financial System of Bangladesh

The financial system of Bangladesh consists of Bangladesh Bank (BB) as the central bank, nationalized commercial banks (NCB), government-owned specialized banks, domestic private banks, foreign banks, and nonbank financial institutions. The financial system also embraces insurance companies, stock exchanges, and cooperative banks.

Bangladesh Bank (BB)

Bangladesh Bank, as the central bank, has legal authority to supervise and regulate all the banks. It performs the following functions: serves the traditional central banking roles of note issuance and of being banker to the government and banks; formulates and implements monetary policy; manages foreign exchange reserves; supervises banks and nonbank financial institutions; manages prudential regulations include minimum capital requirements, limits on loan concentration and insider borrowing, and guidelines for asset classification and income recognition; imposes penalties for noncompliance and also intervenes in the management of a bank if serious problems arise; and delegates authority in issuing policy directives regarding foreign exchange.

Commercial Banks

The commercial banking system dominates Bangladesh's financial sector, with a limited role for nonbank financial institutions and the capital market. The banking sector alone accounts for a substantial share of assets of the financial system. The banking system is dominated by the 4 nationalized commercial banks (NCBs), which together controlled more than 54% of deposits and operated 3,396 branches (55% of the total) as of 30 June 2003. It represents about 49% of the total assets of the financial system.

Specialized Banks

Two of the 5 specialized banks, Bangladesh Krishi Bank and Rajshahi Krishi Unnayan Bank, were created to meet the credit needs of the agriculture sector. Two others, Bangladesh Shilpa Bank (BSB) and Bangladesh Shilpa Rin Sangtha (BSRS), extend term loans to the industry sector. The total assets of these specialized banks represent about 26% of the total assets of the financial system.

Financial Institutions (FIs)

Twenty-eight financial institutions are now operating in Bangladesh. Of these institutions, one is government owned, 15 are local (private), and the other 12 are established as joint ventures with foreign participation.

Capital Market

The capital market, an important ingredient of the financial system, plays a significant role in the economy of the country.

Regulatory Bodies

The Securities and Exchange Commission exercises powers under the Securities and Exchange Commission Act of 1993. It regulates institutions engaged in capital market activities. Bangladesh Bank exercises powers under the Financial Institutions Act of 1993 and regulates institutions engaged in financing activities, including leasing companies and venture capital companies.

Participants in the Capital Market

The SEC has issued licenses to 27 institutions to act in the capital market. Of these, 19 are Merchant Banker and Portfolio Managers while 7 are Issue Managers and one acts as Issue Manager and Underwriter.

Stock Exchanges

There are two stock exchanges, the Dhaka Stock Exchange (DSE) and the Chittagong Stock Exchange (CSE), that deal in the secondary capital market. The DSE was established as a public Limited Company in April 1954 while CSE was established in April 1995. As of 30 June 2000, the total number of enlisted securities with DSE and CSE were 239 and 169 respectively. Out of 239 securities listed with the DSE, 219 were listed companies, 10 were mutual funds, and 10 were debentures.

Investment Corporation of Bangladesh (ICB)

The Investment Corporation of Bangladesh was established in 1976 with the objective of encouraging and broadening the base of industrial investment. ICB underwrites issues of securities, provides substantial bridge financing programs, and maintains investment accounts, as well as floating and managing closed-end and open-end mutual funds and closed-end unit funds to ensure a supply of securities as well as to generate demand for securities. ICB also operates in the DSE and CSE as a dealer.

Insurance

The insurance sector is regulated under the Insurance Act of 1938 with regulatory oversight provided by the Controller of Insurance on authority under the Ministry of Commerce. Twenty-one companies provide general insurance, and life insurance is provided by six companies. The industry is dominated by the two large, state-owned companies; Shadharan Bima Corporation (SBC) for general insurance and Jibon Bima Corporation (JBC) for life insurance, which together command most of the total assets of the insurance sector.

Interest Rate Policy

Under the new interest rate policy that became effective in January 1990, all deposit rates are decontrolled. The market, except for exports, freely determines interest rates.

Capital Adequacy

In January 1996, Bangladesh Bank announced a new policy on Capital Adequacy along the lines recommended by the Basle Committee on Banking Supervision. The revised policy on capital adequacy requires scheduled banks to maintain at least 9% of off-balance sheet risk and risk in different types of assets as capital.

Loan Classification and Provisioning

Bangladesh Bank introduced a new accounting policy with respect to loan classification, provisioning, and interest suspense in 1989, with a view to attaining international standards over a period of time. A revised policy for loan classification and provisioning was introduced on 1 January 1999. The revised policy calls for an independent assessment of each loan on the basis of qualitative factors and objective criteria. Each loan is branded with the worst level of classification resulting from these independent assessments. A circular on loan provisioning scheme was issued by Bangladesh Bank on 12 December 1998, as per Table 5 below.

Table 5. Loan Provisioning Scheme of Bangladesh Bank

For micro/agriculture credit		All other credit	
Unclassified	5%	Unclassified	1%
Substandard	5%	Substandard	20%
Doubtful	5%	Doubtful	50%
Bad and loss	100%	Bad and Loss	100%

Source: Bangladesh Bank, Annual Report 2002–03

Foreign Exchange System

On 24 March 1994, the Bangladesh Taka (domestic currency) was declared convertible for current transactions under the terms of Article VII of the IMF Articles of Agreement. Consequent to this, current external settlements for trade in goods and services and for amortization payments on foreign borrowings can be made through banks authorized to deal in foreign exchange, without prior central bank authorization. However, because resident-owned capital is not freely transferable abroad (the Taka is not yet convertible on capital account), some current settlements beyond certain indicative limits are subject to bona fide checks. Direct investments of nonresidents in the industry sector and portfolio investments of nonresidents through stock exchanges are repatriable abroad, as also are capital gains and profits/dividends thereon. Investment abroad of resident-owned capital is subject to prior Bangladesh Bank approval, which is given only sparingly.

Exchange Rate Policy

The exchange rate policy of Bangladesh Bank aims at maintaining the competitiveness of Bangladeshi products in the international markets, encouraging inflow of wage earners' remittances, maintaining internal price stability, and maintaining a viable external account position.

Types of Banks and Nonbank Financial Institutions

Different Types of Banks

The banking sector in Bangladesh comprises four types of scheduled banks. There are 4 nationalized commercial banks (NCBs), 30 private commercial banks (PCBs), and 10 foreign commercial banks (FCBs). At present 49 banks with 6,236 branches are in operation in the banking sector of Bangladesh. The structure of the banking sector with breakdown by types of banks is shown below.

Nonbanking Financial Institutions

At present there are 14 nonbank financial institutions (NBFIs) in Bangladesh with a total authorized capital of Taka 7295 million and paid up capital of Taka 2880 million plus share capital of Taka 37.55 million. The interest rate for direct financing is 16.6%, on average, while the interest rate for lease financing can be as high as 19% and as low as 2.4%. The service charge is, on average, 0.15% throughout the industry. Nearly 40 private-sector NBFIs are awaiting licenses from Bangladesh Bank.

Regulatory and Supervisory Role of the Central Bank

Bank Licensing

The Bank Companies Act of 1991 empowers Bangladesh Bank to issue licenses to carry out banking business in Bangladesh. Pursuant to section 31 of the Act, before granting a license, BB needs to be satisfied that the following conditions are fulfilled: that the company is or will be in a position to pay its present or future depositors in full as their claims accrue; that the affairs of the company are not being or are not likely to be conducted in a manner detrimental to the interest of its present and future depositors; that, in the case of a company incorporated outside Bangladesh, the government or law of the country in which it is incorporated provides the same facilities to banking companies registered in Bangladesh as the government or law of Bangladesh grants to banking companies incorporated outside Bangladesh; and that the company complies with all applicable provisions of the Bank Companies Act, 1991. Licenses may be cancelled if the bank fails to comply with above provisions or ceases to carry on banking business in Bangladesh.

Regulation of Nonbank Financial Institutions (NBFIs)

Nonbank financial institutions (NBFIs) in the country are regulated by the central bank under the Financial Institutions Act, 1993, and the regulations made thereunder. The activities of the NBFIs, mainly in the sectors of industry, trade and commerce, and housing, notably expanded during the fiscal year 2002–2003. The total number of NBFIs in the country was 28 as of June 2003. Of these, 15 are under domestic private ownership, one is in the public sector, and 12 are joint ventures.

Microfinance Research and Reference Unit

Bangladesh Bank in 2000 created a "Microfinance Research and Reference Unit" to protect the interests of depositors and to ensure transparency and accountability of MF–NGOs' micro-credit operations. A Steering Committee was formed under the leadership of the Governor of Bangladesh Bank. The Committee will work as a temporary regulatory body for monitoring of the microfinance activities. The committee has no legal framework to impose penalties or take any disciplinary action against defaulting MFIs other than soft monitoring activities.

The Performance of the Banking Institutions

Assets

Industry assets continued to be dominated by the nationalized commercial banks (NCBs); these held 46.50% of total assets in 2001, which decreased (by 0.94 percentage point) to 45.56% in 2002. The government-owned specialized banks held 11.47% of industry assets in 2002 (a slight decrease from 11.77% in 2001), composed largely of loans to target sectors. The share of private commercial banks in industry assets increased (by 1.29 percentage point) from 34.87% in 2001 to 36.16% in 2002. Foreign commercial banks held 6.81% of industry assets in 2002, showing a slight increase by 0.05 percentage point over the previous year. Aggregate industry assets in 2002 registered an overall increase of 13.49% over 2001. During this period, NCBs' assets increased by 11.21% and those of PCBs rose by 17.70% (Table 6).

Table 6. Total Assets in the Banking System Structure (billion Taka)

Bank type	2001				2002			
	No. of banks	No. of branches	Total assets	% of industry assets	No. of banks	No. of branches	Total assets	% of industry assets
NCBs	4	3608	595.32	46.50	4	3496	662.08	45.56
DFIs	5	1298	150.72	11.77	5	1311	166.63	11.47
PCBs	30	1331	446.41	34.87	30	1398	525.46	36.16
FCBs	11	34	87.78	6.86	10	31	98.89	6.81
Total	50	6271	1280.31	100.00	49	6236	1453.06	100.00

Source: Bangladesh Bank, Annual Report 2002–03 (NCB: Nationalized Commercial Bank, DFI: Development Financial Institution, PCB: Private Commercial Bank, FCB: Foreign Commercial Bank)

Liabilities

The aggregated liability portfolio of the banking industry in 2002 was BDT 1453.06 billion, of which deposits constituted BDT 1023.53 billion or 70.44%. Deposits in 2001 accounted for 74.69% of aggregated liabilities. Capital and reserves of the banks were BDT 62.59 billion or 4.31% of aggregate liabilities in 2002, against BDT 53.21 billion or 4.15% in 2001.

Deposits

The total deposits with banks in 2002 rose to BDT 1023.53 billion from BDT 956.28 billion in 2001, showing an overall increase of 7.03%. The NCBs continued to dominate by holding BDT 515.06 billion or 50.32% of total industry deposits in 2002, with an increase of BDT 28.09 billion or 5.77% over the previous year. The PCBs' deposits amounted to BDT 377.08 billion, which constituted 36.84% of total industry deposits in 2002. This was an increase of BDT 28.17 billion or 8.07% over the position in 2001. Deposits of FCBs rose by

BDT 6.33 billion or 9.66% in 2002 over the previous year. The DFIs' deposits were BDT 59.53 billion in 2002 as against BDT 53.96 billion in 2001, showing an increase of 10.32% over the previous year (Table 7).

Table 7. Deposits in the Banking System Structure (billion Taka)

Bank type	2001				2002			
	No. of banks	No. of branches	Deposits	% of deposits	No. of banks	No. of branches	Deposits	% of deposits
NCBs	4	3608	486.97	50.92	4	3496	515.06	50.32
DFIs	5	1298	53.96	5.64	5	1311	59.53	5.82
PCBs	30	1331	348.91	36.49	30	1398	377.08	36.84
FCBs	11	34	65.53	6.85	10	31	71.86	7.02
Total	50	6271	956.28	100.00	49	6236	1023.53	100.0

Source: Bangladesh Bank, Annual Report 2002–03

Performance and Rating of Banks

The performance of the banking sector under the CAMEL framework (which involves analysis and evaluation of five crucial dimensions of banking operations), is discussed below.

Capital Adequacy

Banks in Bangladesh are required to adopt the Basle Minimum Capital Standard equal to 9.00% of Risk-Weighted Assets (RWA) with core capital equal to at least 4.50% of RWA. While the PCBs and the FCBs have been maintaining the required capital adequacy ratio, the NCBs and DFIs are yet to achieve the target. The aggregate capital adequacy ratio of the banking sector has showed a downward trend since 1997 and declined to 6.65% in 2001. However in 2002 the ratio rose to 7.52%, i.e., back to the 1997 level.

Asset Quality

The ratio of nonperforming loans (NPLs) to total loans of the banks shows an encouraging trend, having declined from its peak (41.11%) in 1999, although the aggregate ratio was still as high as 28.01% in December 2002. This is due to the very high level of NPLs of the NCBs and DFIs. The NCBs and DFIs continue to have very NPLs, mainly because of substantial loans provided by them on considerations other than commercial interests and under directed credit programs, especially during the 1970s and 1980s.

Loan Loss Provisioning of the Banks

The aggregate amounts of NPLs of all banks from 1997 to December 2002 along with the amounts of provision required to be maintained and the amounts actually provided by the banks. The banks have been continuously failing to maintain the required level of provisions against their NPLs. During the years 1997 to 2002, the banks could maintain 60.46% of the required provision in 2001; this declined thereafter to 55.78% in 2002. The main reason for the continuous shortfall in the provision adequacy is the inability of the NCBs and some of the PCBs (including those in the problem bank category) to make sufficient provisions due to inadequate profits. The DFIs and FCBs are notably better, in that they have been able to make adequate provisions in recent years. Although some individual PCBs could make adequate provisions, the aggregate position did not improve mainly because of the huge provision shortfall of the banks in the "problem-bank" category. When banks are placed in the problem-bank category, the central bank is motivated to bring their financial condition up to the satisfactory level, through close monitoring of the bank's management setup, as well as giving updated advisories.

Management Soundness

Sound management is most important prerequisite for the strength and growth of any financial institution. The expenditure–income (EI) ratio of the DFIs was very high at 180.37% in 1998 and 175.26% in 2000. This was mainly because the DFIs made loan loss provisions by debiting "losses" in their book. The position, however, improved after 2000, and the ratio came down to 89.05% and 95.94% in 2001 and 2002 respectively, as these losses could be easily recovered out of subsequent profits. The EI ratio of the NCBs exceeded 100% in 1990 before falling to a little over 98% by the end of 2002. The very high EI ratio of the NCBs was mainly due to high administrative and overhead expenses, suspension of income against NPLs, and profit-taking.

Earnings and Profitability

Although there are various measures of earning and profitability, the best and most widely used indicator is return on assets (ROA), which is supplemented, by return on equity (ROE) and net interest margin (NIM). Earnings as measured by return on assets (ROA) and return on equity (ROE) vary largely within the industry. Analysis reveals that the ROA of the NCBs have been very low and that of the DFIs even worse. The PCBs' displayed an inconsistent trend, and the FCBs' return on assets ratio have consistently declined, from 4.82% in 1997 to 2.36% in 2002. The NCBs' return on equity ratio rose from negative 1.08% in 1999 to 4.21% in 2002. In the case of DFIs, the ROE sharply rose from negative 68.01% in 2000 to 12.28% in 2001, though it then declined to 5.76% in 2002.

Net Interest Income

The aggregate net interest income (NII) of the industry has been positive and consistently increased from BDT 6.27 billion in 1997 to BDT 13.45 billion in 2002. However, the NII of the NCBs sharply declined, from BDT 3.11 billion in 1999 to a negative amount of BDT 1.21 billion in 2000. The trend continued, and the NCBs' interest income in 2001 was lower by BDT 1.79 billion than interest expenses; in 2002 the shortfall was BDT 1.46 billion. The DFGIs had a negative NII in 1997 and 1999, which was reversed in 2000 to BDT 0.96 billion and thereafter was positive in 2001 (BDT 2.66 billion) and 2002 (BDT 1.37 billion). Although the net interest income of the NCBs has been negative during the last three years, the overall industry NII shows a consistently upward trend. This is because the rate of increase in NII of the PCBs and FCBs has been very high over the period 1997 to 2002. This trend indicates that the PCBs and FCBs are charging interest at very high rates compared to the interest they are paying to depositors (Table 8).

Table 8. Net Interest Income by Type of Bank (billion Taka)

Bank type	1997	1998	1999	2000	2001	2002
NCBs	2.66	2.19	3.11	–1.21	–1.79	–1.46
DFIs	–0.10	0.48	–0.11	0.96	2.66	1.37
PCBs	1.73	2.28	2.97	6.11	9.21	10.17
FCBs	1.96	2.15	1.78	2.54	3.27	3.38
Total	6.27	7.12	7.75	8.39	13.35	13.45

Source: Bangladesh Bank, Annual Report 2002–03

Infrastructure and Operating Results

A comparative analysis of branch networks, population, and operating results by various types of banks during 2001 and 2002 has been conducted to indicate the recent industry trends in these areas. The operating expenses of NCBs in 2002 increased by BDT 0.4 billion from the previous year, although the number of NCBs branches was reduced to 112 and the number of employees to 1158. In the case of PCBs, operating expenses increased by BDT 2.30 billion during the same period, with an increase in the number of branches by 67 and of employees by 678. The expenses of the DFIs and FCBs were less in 2002 than in 2001, with a reduction in the number of branches and employees.

Liquidity

Commercial bank deposits are at present subject to a statutory liquidity requirement (SLR) of 20% inclusive of a 4% cash reserve requirement (CRR). The ARR is to be kept with the Bangladesh Bank and the reminder as qualifying secure assets under the SLR, either in cash or in government securities. SLR for the banks operating under the Islamic Shariah is 10%, and the specialized banks are exempted from maintaining the SLR Liquidity indicators.

CAMEL (Uniform Interagency Bank Rating System) Rating

Performance indicators of the banking industry overall depict a trend similar to that of the state-owned banks, which is understandable due to their predominant market share. Ratings on the basis of the various indicators indicate that the financial performance of the PCBs and FCBs in general has been better than that of the industry average. However, 4 of the PCBs, rated CAMEL 4 or 5, are still in the problem-bank list out of 7 put in this category in the mid–1990s. Activities of the problem banks are closely monitored by the central bank with special guidance and care. One such bank was taken off the problem bank list in June 2003 and 2 others in 2000 and 2001 because of improved performance. As of the end of 2002, the CAMEL rating of 9 banks was 1 or *Strong*; 21 banks were rated 2 or *Satisfactory*; the rating of 7 banks was 3 or *Fair*; 10 were rated 4 or *Marginal*; and 2 got a 5 or *Unsatisfactory* rating. All the 4 NCBs and 4 of the DFIs had a *Marginal* rating.

Changes in Legal Framework

Several provisions of the three Acts relating to banking—the Bangladesh Bank Order of 1972, the Bank Companies Act of 1991, and the Banks (Nationalization) Order of 1972—have been amended this year with a view to further strengthening the activities of the banking sector, bringing dynamism and extending greater autonomy to the central bank. The Money Loan Court Act of 2003 was enacted in March 2003 with a view to streamlining of the process of realization of overdue loans and advances by the banks and financial institutions. Provisions have been made in this Act for realization of the banks' dues by selling of properties held as security, without prior orders of the court. This Act intends to achieve the goal of a healthier and corruption-free financial sector by collecting long outstanding overdue debts and moving against loan defaulters as early as possible (maximum I year).

Prudential Regulations

Bangladesh Bank revised the Prudential Regulations in June 2003, and the following guidelines have been prescribed:

a. The ratio of risk-weighted assets of each bank must be not less than 9.0%, instead of 8.0%, with at least 4.5% in core capital.
b. Rescheduling of various types of loans has been prescribed by fixing the rates of down payment requirements between 15% and 50%, depending upon the type and size of loans and the amount overdue.

c. Loans classified as bad or loss for 5 years or more against which 100% provision has been made are to be written off by banks as per new guidelines.
d. An individual loan amounting to 15% of a bank's capital and reserves is defined as a large loan for that particular bank. The large lending of a bank is to be kept within a limit prescribed by the central bank.
e. Bangladesh Bank has introduced a Large Loan Restructuring Scheme for rescheduling and restructuring the large loans of the scheduled banks.
f. The bank companies will be required to disclose more information in their financial statements as per the International Accounting Standards beginning in the year 2003.
The draft guidelines have mainly stressed on the accounting procedure and monitoring system rather than any prudential regulations for the NGO–MFIs.

Products, Clientele, and Collateral

Products, clientele, and collateral for borrowing of the commercial banks, microfinance bank and financial institutions are reflected in Table 9.

Table 9. Products, Clients, and Collateral

Bank	Products	Clientele	Collateral
Commercial banks	Deposits Personal loans Auto loans Consumer products Corporate financing Foreign exchange Trade finance Investment advisory General banking service	Individuals Corporations Multinationals	Property Hypothecation Pledge Personal guarantee Savings certificate Assets
Microfinance banks	Micro-credit Deposits Remittance Housing loans Education loans	Members of groups 95% are rural poor women	No collateral, but group liabilities
Financial Institutions	Project financing	Medium to large companies and rich individuals	Mortgage of land and other assets

Performance of Nonbanking Institutions

Twenty-eight financial institutions are now operating in Bangladesh. Of these institutions, one is government-owned, 15 are local (private), and the other 12 are established under joint ventures with foreign participation. The total amount of loans and leases of these institutions is BDT 29,729 million as of 30 April 2003. Bangladesh Bank has introduced a policy for loan and lease classification and provisioning for FIs from December 2000 on a half-yearly basis.

Ansar & VDP Bank

Ansar & VDP Bank was established in 1995 as a specialized bank and statutory agency under an Act of Parliament. The total amount of loans disbursed by the bank, from its inception to March 2003, is BDT 2880 million. Out of this, BDT 1954 million has been repaid. The loan recovery rate was 99%. The beneficiaries of the bank are the members of Ansar & VDP (Civil Defense Force); they own 75% shares of the bank. The bank provides collateral-free micro-credit to members in different 60 subsectors.

Bangladesh Samabay Bank

Bangladesh Samabay Bank was established in 1971 as a specialized bank. Any cooperative society is eligible for membership in this bank, and 536 cooperative organizations have become members of the bank. The total amount of loans disbursed by the bank, from its inception to March 2003, is BDT 2246 million.

Grameen Bank

The total amount of loans disbursed by GB, since its inception, is BDT 180.21 billion (US$ 3.99 billion). Out of this, BDT 165.95 billion (US$ 3.62 billion) has been repaid. The total number of borrowers of the bank stood at 2.59 million, of whom 95% are women. A total of 1181 rural branches of GB are operating, covering 41,908 villages.

Karma Sangsthan Bank

The Karma Sangsthan Bank was established in 1998 under an Act of Parliament. The approved capital of the bank is BDT 30,000 million, out of which the GOB's share is 75% and the remaining 25% is owned by the NCBs, Schedule Banks, insurance companies, and other financial institutions. The major function of the bank is to provide loan to unemployed youths for self-income generating activities under the rules and regulations of the central bank. The total amount of loans disbursed by the bank, from its inception to March 2003, is BDT 201 million, out of which employment for about 7000 youths have been created.

Investment Corporation of Bangladesh (ICB)

The Investment Corporation of Bangladesh was established in 1976 with the objective of encouraging and broadening the base of industrial investment. The total approved capital is BDT 1000 million, and the total paid-up capital at present is BDT 466 million, which is divided into 46,60,418 shares with a value of BDT 100 each. The ICB underwrites issues of securities, provides substantial bridge financing programs, and maintains investment accounts, floats and manages closed- and open-end mutual funds and closed-end unit funds to ensure a supply of securities as well as generate demand for securities. ICB also operates in the DSE and CSE as dealers. Since its inception it has made commitments to invest BDT 2936.40 million in 372 projects.

Bangladesh House Building Finance Corporation

Bangladesh House Building Finance Corporation was established in 1973 with a view to solving the housing problem by providing credit for house building, repairing, and restructuring. The Corporation provides six categories of loans to borrowers: a) general loans for single people or jointly for husband and wife; b) group loans for flat owners; c) apartment purchase loans; d) integrated loans; e) low-cost house-building loan; and f) loans for construction of semi-pucca buildings. The rate of interest ranges from 10% to 15% in different areas of the country. The total loans and advances disbursed by the BHBFC, up to March 2003, is BDT 29,989 million.

Saudi-Bangladesh Industrial and Agricultural Investment Company Ltd.

Saudi-Bangladesh Industrial and Agricultural Investment Company Ltd. was established in 1983 under a Protocol signed between Bangladesh and Saudi Arabia. It has begun functioning as a private limited company with its headquarters at Dhaka. The objectives of the company were to further enhance economic growth in Bangladesh through investment in agro-based industries on a commercial basis. The company provides loans for balancing, modernization and rehabilitation, replacement and expansion of existing industries. From its inception to December 2002, the company disbursed BDT 2493 million for 46 projects.

Industrial Development Leasing Company

Industrial Development Leasing Company was established in 1985 as a public limited company, a joint investment of five foreign financial institutions including International Finance Corporation (IFC) and other three local banks and insurance companies. Shares of the company were offered to the public in 1992, and at present 45% of shares are owned by the five foreign financial institutions and the remaining 55% are owned by the public and 14 Bangladeshi financial institutions. The company has successfully introduced leasing facilities as an alternative source of financing in the manufacturing and service sectors. It has disbursed loans totaling BDT 3250 million during the last 20 years.

GSP Finance Company Bangladesh Ltd.

GSP Finance Company Bangladesh Ltd. was established in 1996 as a Financial Institution and was registered under the Financial Institution Act of 1993. The company provides loans for capital financing in the industry sector. It also participates in financial market activities including accepting deposits and investment. During the last 6 years it has disbursed loans totaling BDT 948 million.

Bangladesh Industrial Finance Company Bangladesh Ltd.

Bangladesh Industrial Finance Company Bangladesh Ltd. started functioning in 1996 as a public limited company under the Company Act of 1994. The major objectives of the company include providing loans for capital financing (as lease financing) in the industry sector, financing for BMRE of industrial units, establishment of SMEs, and priority financing for export-oriented and import-substitute industries. It also participates in financial market activities including accepting deposits. It has disbursed loans totaling BDT 518 million during the last 6 years.

The Role of Informal Lenders in the Credit Markets

Rural Financial Market

Bangladesh rural financial markets comprise formal and quasi-formal institutions, as well as informal lenders. Study of rural finance during the past two decades shows that formal financial markets are inefficient and the transaction cost of lending is very high. In addition, formal financial institutions are nonviable because of high default costs and the inefficient allocation of resources. About 80% of formal banks' rural branches in Bangladesh were not profitable, and effective lending interest was much lower than the nominal lending interest rate. The situation is the same for both commercial and development banks. Formal banks are inefficient and institutionally weak. The social cost of operation of formal banks is extremely high. Poor households have very little access to the formal credit market unless they come under a specific goal-oriented credit program for the poor. The production technology generally used by commercial and development banks is not appropriate for providing financial services to the poor. With the emergence of the Grameen production technology, the risk of lending to the poor is being recognized as negligible. There has been a significant change in the structure of the rural credit market. More than 1000 micro-credit NGOs (hereafter referred to as microfinance institutions or MFIs) have been providing financial services to poor households in Bangladesh.

Grameen Bank

The total amount of loans disbursed by GB, since its inception is BDT 180.21 billion (US$ 3.99 billion). Out of this, BDT 165.95 billion (US$ 3.62 billion) has been repaid. The total number of borrowers of the bank stood at 2.59 million, of whom 95% are women. A total of 1181 rural branches of GB are operating, covering 41,908 villages.

Palli Karma Shahayak Foundation (PKSF)

Palli Karma Sahayak Foundation (PKSF), established in 1990, has been providing micro credit to a targeted population of poor people (people owning up to .50 acre of land or assetless) through partner organizations (NGOs). Up to July 2002, credit of BDT 1.15 billion has been disbursed to about 3,723,667 borrowers (of whom 86.43% are women) through 187 partner organizations, and the recovery rate is 98.12%.

Bangladesh Rural Development Board (BRDB)

BRDB has been working in the field of rural development, especially towards poverty alleviation through cooperatives and non-formal group networks throughout the country, with the financial and technical support of the government of Bangladesh and development partners. The target groups of the program are small farmers (holding up to .50 acre of land), and assetless women and men. Family planning, health, and education programs are also included in the credit and training activities. During the period of 1990/91 to December 2001/2002, 1.46 million members under 54,204 societies in 449 *upzilas* borrowed BDT 20.59 billion, of which BDT 16.97 billion has been recovered.

Palli Daridrya Bimochan Foundation

The Palli Daridrya Bimochan Foundation was established on 30 April 2000, with all the assets and manpower of 139 Thana (assetless central cooperative societies) under the "Rural Development 12" Project. Its goal is to strengthen the economic and social development of the rural poor and of disadvantaged people and to promote gender equality. Up to December 2001 assetless people have received amounts of BDT 8 billion 80.4 million, of which BDT 7 billion 661.2 million is recoverable. The actual amount of recovery is BDT 7 billion 361.4 million (a recovery rate of 96%) during the same period. The assetless members of the foundation have generated BDT 408.4 million as savings. A total of 15,462 societies and 420,168 beneficiaries belong to the foundation.

Bangladesh Rural Development Academy (BARD)

BARD, Comilla, has been implementing a project entitled "Small Farmers and Landless Laborers Development" in 30 *upzilas* of 8 districts in the country. Under the project, small farmers, landless laborers, and poor women are being organized into non-formal groups, given skill development training, and provided credit support for income generation and capital formation. In addition to the aforesaid project, the Academy has implemented a Comprehensive Village Development Project (CVDP). A sum of about BDT 702 million has been disbursed up to December 2001 to more than 76,000 beneficiaries. The rate of recovery is 91.27%.

Rural Development Academy (RDA)

RDA, Bogra, has been implementing a Comprehensive Rural Development Project and a primary Afforestation and Empowerment Project for poverty alleviation. The cumulative disbursement and recovery of credit under these projects are BDT 66.1 million and 63.5 million, respectively.

Swanirvar Bangladesh

Established in 1975, this organization has been operating in the field of family planning and mother child-care activities alongside its micro-credit program. At present, its activities have been expanded to 13,000 villages and 168 *upzilas*. Up to December 2001, a total of BDT 2.54 billion had been disbursed to 752,000 borrowers, of whom about 560,000 (75%) are women. The rate of recovery is 85.27%.

MF–NGOs

As of June 2002, out of 681 microfinance NGOs, the top 40 are almost invariably stabilizing their positions in terms of the number of members, distribution of loans, outstanding and overdue loans, and so on.

Active Members

The total number of active members of 681 MF–NGOs was 12,696,574 (in the last issue of these statistics, in December 2001, it was 12,447,623). On the other hand, a comparison of 470 common MF–NGOs shows that the number of active members decreased by 0.20% during the same period.

Outstanding Borrowers

The total number of outstanding borrowers from 681 MF–NGOs was 9,266,119 (compared with 8,864,42 in the last issue, as of December 2001). If we consider the common set of 470 MF–NGOs, we see that the number of outstanding borrowers increased 4.45% during the six months from December 2001 to June 2002. During the same six-month period, the amount of cumulative disbursement increased by 14.25%, outstanding loans by 13.27%, and net savings by 11.98% for 470 common MF–NGOs.

Sources of Revolving Loan Funds (RLF)

As of June 2002, 681 MF–NGOs received BDT 37 billion 347.43 million from external and internal source for their revolving loan funds (RLF). The major external sources include foreign donations at 17.04% (international NGOs 0.55% and international donors 16.49%), members' savings (25.49%), and PKSF (23.64%). However, a major portion of the fund (16.59%) was also generated from service charges. The contribution of local banks and international donors to the RLF is seemingly decreasing, while the share contributed from members' savings, PKSF, and own funds is increasing. The detailed sources of funds are presented in Table 15 below.

The Performance of Formal and Informal Lenders in the Credit Market

Financial Services Industry

The financial services industry consists of three broadly fragmented sectors; formal, semiformal, and informal. The formal sector includes all regulated institutions including banks, nonbank financial institutions, and insurance companies. The semiformal sector includes institutions that are otherwise regulated but which fall outside the formal oversight function of the central bank, insurance department, or Securities and Exchange Commission. This sector is mostly occupied by nongovernmental organizations (NGOs) and discrete government programs. The informal sector includes private intermediaries who are completely unregulated. These include friends and relatives, shopkeepers, moneylenders, spontaneously formed Rotating Savings and Credit Associations and building societies, mutual fund operators, and traders and dealers in the agricultural market.

Performance of the Industry

In overall terms, it is difficult to determine the market share of all the sectors accurately, given restricted information disclosure (in the formal sector) or simply the absence of reliable information (in the informal sector and to some extent the semiformal sector). Despite the difficulties, the following observations can be made:

Advances

Several studies suggest the market share of the informal sector in the small and microloans to be between 50% and 70%. The formal sector has about 20%–35% of market share, although this sector has steadily lost market share over the last decade. The lost share has gone to the semiformal sector, which has registered exponential growth in disbursement of small loans to the poor over the last decade. The interesting aspect is not only the high market share being captured by the semiformal sector, but also the study increase in the total size of the micro-loan market as a whole. Micro-credit programs of Grameen Bank, BRAC, and other MF–NGOs have clearly improved poor households' access to institutional credit. One study shows that the rural non-farm sector receives 60% of its financing from non-formal microfinance institutions. In contrast, formal financial institutions allocated only 48% and informal lenders only 28% of their funds to this sector.

Savings and Deposits

Aggregate deposit mobilization from small services in the formal banking sector amounted to almost BDT 23.378 billion by 1996. The comparable figure for the semiformal sector was BDT 18.481 billion. Data on deposits held in the informal sector are not available. While anecdotal evidence suggests that poor people have strong willingness and high propensity to save, much of their savings is in the form of non-money-denominated assets. This would tend to suggest that the current market for savings and deposits is almost exclusively controlled by the formal banking and semiformal sectors, whose market shares amount to 55% and 45% respectively.

Insurance

Insurance services are hardly available at all for the poor. Virtually all insurance is based on reciprocal arrangements. The formal sector does provide limited access in the form of crop insurance, but this rarely used by the poor. The semiformal market claims to provide insurance, but most schemes are not designed using strict actuarial principles and are implicitly used as a strategy for augmenting the sector's lendable capital.

Outreach

It is estimated that 13 million poor families are living in Bangladesh. Data show that both formal banks and semiformal financial institutions cumulatively disbursed BDT 67.97 billion in advances to approximately 10.4 million clients (individuals) up to 1997. But this estimation contains around 20% overlaps or documentation duplication. Experts believe that the number of poor people receiving microfinance support does not exceed 8 million (individuals). Assuming one loan per family, both the formal and semiformal sectors provided loans to over 60% of poor families up until 1997.

Distribution and Market Fragmentation

A World Bank survey on rural finance found that almost 70% of poor borrowers turned to the informal sector for loans, while the formal banking sector and the semiformal sector each extended loans to 19% of the poor. Among low-income groups, the majority loans were from the informal sector—some 57%, while the formal banking sector provided loans to 49% of the borrowers—with the balance provided by semiformal sector (NGO–MFIs). The formal sector does not lend to low-income families, but concentrates on the poor. There does appear to be some overlap across the sectors, but this is very small. As few as 8% of borrowers take loans from the formal banking sector and from informal intermediaries simultaneously, and only 1.7% borrow from informal intermediaries and the semiformal sector at the same time.

Linkage of Informal Credit Markets with Formal Credit Markets

NCB and MFI Linkage

The commonest linkage between MFIs and the formal banks is where banks bulk-lend to MFIs who make onward disbursement (retail) to their grassroots members. The linkage between the BRDB-sponsored two-tier cooperatives and the Sonali Bank may be considered the oldest of this kind. The latest of such linkages is the ASA–Agrani, PAGE–Janata linkage. In both cases the MFIs had to offer collateral security. The rural credit market in Bangladesh is highly segmented. Formal lenders, such as commercial and agricultural development banks, are guided by the rules and regulations of the central bank. Informal lenders (professional moneylenders, input dealers, friends, and relatives) are virtually outside the control of the government. Between these two types of lenders, micro-credit programs and institutions, such as Grameen Bank and BRAC; government cooperative structures; and NGOs are involved in financial transactions with minimum financial regulation from the government. Formal credit plays an even smaller role in crop production than in non-crop and non-farm production. Rural production is largely self-financed. Microfinance seems to have played a larger role than formal finance in agriculture in Bangladesh, and its role is growing. Micro-credit programs are supporting more landless households and women and financing more rural production than formal financing institutions. The landless poor and women received more than 80% of the loans disbursed by microfinance institutions.

Emergence of Microfinance Institutions in Bangladesh

Growth-oriented Strategy

Bangladesh, like many other countries, pursued growth-oriented development strategies in the 1960s. It was thought that the trickle-down effect would resolve these issues. The basic thrust of the growth-oriented development strategy was that economic growth could be achieved through modernization in both agriculture and industry. However, Bangladesh's experience of the Green Revolution strategy failed to deliver the goods. While the agricultural growth strategy increased crop production markedly, it failed to make the rural poor productive and self-supporting. As the subsidized inputs had encouraged capital-intensive methods of agricultural production, it discouraged a demand-induced growth strategy.

Targeted Wage-employment Approach

A targeted wage-employment approach was introduced in the 1970s through Food for Works (FFW), the Rural Works Program (RWP), and the Vulnerable Group Development (VGD) program. These programs were taken up as direct government anti-poverty schemes. Experience has shown that the impact of these programs on the target group (the poor) was limited because of their short duration and seasonal nature. Further, even as their impact on income, land, and employment was negligible, the potential risk of malpractice and substandard work was high.

Non-credit Basic Need Approach

The targeted non-credit scheme of the NGOs appeared as an alternative approach for reducing poverty by providing needed goods and services to the poor. It was soon apparent, however, that poverty has to be confronted on a sustained basis and that human capital services such as adult literacy, skills training, and primary health care were not enough to sustain poverty reduction among the rural poor. It was felt that in order to promote human development, the productive capacity of the poor had to be increased through physical means—i.e., physical capital with credit.

Targeted Credit Approach

Targeted credit programs for the poor were not tried until 1976 when Professor Muhammad Yunus introduced an experimental project to test whether the poor were creditworthy and to see how credit could be provided without physical collateral. Yunus designed a delivery model specifically for channeling credit to the poor. The central hypothesis of the targeted credit approach is that lack of access to credit is the biggest constraint of the rural poor.

Yunus believed that with appropriate support, the poor can be productively employed in income-generating activities. After almost seven years of experimentation in different places with a variety of group-based mechanisms, Yunus's idea of banking for the poor came into being as a bank with its own charter. With government backing, Grameen Bank (GB) was established in 1983 to work exclusively for the poor.

Grameen Bank's Approach

Grameen Bank's group-based lending approach is the guiding principle for more than 750 NGOs operating small-scale micro-credit programs in Bangladesh. The Bangladesh Rural Advancement Committee (BRAC), an NGO, is one of the major micro-credit providers, with 3.9 million members. Bangladesh Rural Development Board (BRDB), a government organization, provides micro-credit to 0.5 million members. All the major NGOs follow the Grameen Bank's group-based lending approach to a great extent. There are some differences in their product and services, as Table 10 shows.

Table 10. Micro-credit Programs: Features of Selected NGO–MFIs

Program feature	Grameen Bank	BRAC	BRDB	ASA
Membership criteria	Maximum land-holding of half an acre of land	Maximum land-holding of half an acre of land	Maximum land-holding of half an acre of land	Maximum land-holding of half an acre of land
Group features	Five members form a group. Separate groups for men and women. Weekly meetings of the groups	30–40 members form a village organization. Separate groups for men and women. Weekly meetings of the groups	15–35 members form a primary cooperative. Separate groups for men and women. Weekly meetings of the groups	20 members form a unit. Separate groups for men and women. Weekly meetings of the groups
Savings mobilization	BDT 1 per week. 5% of each loan goes to group fund	BDT 2 per week. 4% of each loan goes to group fund	BDT 2 per week. 5% of each loan goes to group fund	Minimum BDT 10–25 per week
Credit delivery mechanism	No collateral but group liability	No collateral but group liability	No collateral but primary cooperative liability	No collateral but group liability

Source: Shahidur R. Khandker, *Fighting Poverty with Micro-credit Experience in Bangladesh*, The University Press Limited, Dhaka, 1998

MF–NGOs

Information collected by the Credit Development Fund (CDF) reveals that 363 microfinance NGOs have extended credit services to about 6.6 million borrowers. All the organizations follow the group-based credit approach to the targeted women and the poor. However, the GB's success in removing poverty and reaching the poor has attracted worldwide attention. The GB's group-based approach to lending has been replicated in more than 80 countries including the United States of America. Donors like USAID, IFAD, NORAD, and SIDA are playing very important role in promoting micro-credit programs for poverty alleviation in Bangladesh.

MICROFINANCE PRODUCTS AND SERVICES

Products and Services of Major MF–NGOs

Grameen Bank

Grameen Bank provides three types of loans:

a. Income-generating loans with an interest rate of 20%.
b. Housing loans with an interest rate of 8%.
c. Higher education loans for the children of Grameen families with an interest rate of 5%.

All interest is simple interest, calculated on the declining balance method.

Grameen Bank has provided loans to about 30,000 women borrowers to buy mobile phones and offers telecommunication services in nearly half of the villages of Bangladesh where this service never existed before. Each year families of deceased borrowers from GB receive a total of BDT 8 to 10 million in life insurance benefits. Each family receives up to a maximum of BDT 2000. Borrowers are not required to pay any premium for this life insurance. Borrowers come under this insurance coverage by being a shareholder of the bank.

BRAC

The services provided by BRAC under its Rural Development Program are:

a. Savings and credit: (a) mandatory and current savings options; (b) income-generating and housing loans; and (c) life insurance.
b. Sector programs and technical assistance for income and employment generation: (a) poultry and livestock; (b) fisheries; (c) sericulture and silk development; (d) social forestry; (e) horticulture and vegetables; and (f) program support enterprises.
c. Social development: (a) essential health care; and (b) human rights and legal education.

Proshika

Proshika provides the following products and services to its clients:

Employment and Income-generating Program (EIGP)

The implementation of the EIGP revolves around initial organizational building among rural landless laborers, marginal peasants, fisherfolk, weavers, urban slum dwellers, and women of these socioeconomic categories.

Credit Program Out of Revolving Loan Fund (RLF)

Proshika has a relatively large proportion of male group members in its total population of members. Unlike other MFIs/NGOs (where groups are almost 100% women), Proshika's male group members account for 45% of the total disbursement.

Savings and Insurance Scheme

The scheme has been developed based on certain principles, e.g., security of savings, life insurance, risk coverage for damaged houses caused by natural disasters, and accessibility.

ASA

There are two types of loans in ASA operations for two different categories of target people, namely:

a. Micro-credit for general members.
b. Micro-enterprise credit for micro-enterprise members.
c. Disaster loans for members of all categories in case of disasters.
d. Life insurance for the borrowers.
e. Donations in case of borrowers' deaths.

Micro-lending Technologies and Methodologies Used by MFIs

Features of Micro-credit Programs

The characteristic features of the micro-credit programs of the microfinance Institutions/ NGOs are:

a. Collateral-free credit with simplified documentation and flexible terms and conditions.
b. High rate of recovery of credit ensured through close supervision of end-use; the recovery percentage of the loans disbursed by these agencies ranges between 95% and 100%.
c. Provision of strict group exercises (weekly meetings, savings mobilization, repayment of weekly installments, etc.) and awareness-raising training on various aspects of social discrimination and human development; sometimes on functional literacy is taught preceding and following issuing of credit.
d. Most of the members/borrowers (about 80–85%) are women; amount of loan varies from BDT 2000 to BDT 10,000.
e. Interest ranges around 15% on a flat-rate (some with declining-rate) basis—the effective rate being almost double.
f. Finances mostly non-farm instant income-generating activities (IGAs).
g. Target is poor men or women owning less than 0.50 acre of cultivable land or having total assets of the value of less than one acre of land in the locality.
h. Short-term loans, repayable within one year in weekly installments.
i. Focus on cohesive groups in contrast to bank's individual approach; peer pressure—the main theme of the group approach—acts as a driving force in ensuring timely repayment of credit.
j. Credit preceded by skill development training, where necessary, and followed by marketing support for the entrepreneurs, in contrast to the banks which have no such forward and backward linkage provisions.
k. Forced savings by members with a view to generating own investible funds for the members and gradually lessening dependence on credit.
l. Simultaneous intervention in other areas like health, sanitation, and community development in order to improve overall living conditions of the group members.

Self-targeting Approach

A micro-credit program targeting the poor faces two problems: moral hazard of lending and identification of the poor. The question arises whether it is possible to introduce a self-targeting mechanism within financial institutions. In order to be financially viable, a financial institution must have a client group that is creditworthy and has an incentive to repay loans. Targeting this type of clientele is difficult in a rural setting characterized by asymmetric information and imperfect incentives, which produce the moral hazard problem of lending. Financial institutions try to select clients who are willing to repay loans on time and will abide by the rules and regulations established by the institutions. Borrowers may fail to abide by the rules, because they lack either the incentive or the ability to do so. Incentive problems arise if there are no mechanisms forcing borrowers to repay their loans. This problem is particularly acute in many developing countries, where governments often write off institutional loans for political reasons. Micro-credit programs have adopted innovative ways of tackling these problems. Like traditional moneylenders, micro-credit programs deal informally with borrowers, so they know much about their clients. In contrast, commercial banks or other financial institutions lend on the basis of asset ownership to avoid adverse selection of borrowers. Group-based lending requires potential borrowers to self-select into groups whose members live in the same community and are thus in a position to enforce the eligibility criterion of owning less than half an acre of land. For effective functioning of groups, the group method has to create social collateral that imposes certain disciplinary actions on group members.

Different Types of Collateral for Microfinancing

Many micro-credit programs rely on group-based lending and other methods to resolve the problems of imperfect information and imperfect enforcement of lending. By relying on peer pressure to monitor and enforce contracts, group-based lending provides an incentive for borrowers to repay and helps avoid adverse selection of borrowers, thereby improving loan recovery rates. While group-based lending does not always improve loan recovery, it constitutes a powerful incentive for repayment when it helps create "social collateral" that works against loan default. In Bangladesh most micro-credit programs have separate programs for men and women, in accordance with the socio-cultural norms. Membership is strictly limited to people who own less than half an acre of land, are not members of the same household as another program member, have similar economic resources, and live in same village. Table 11 shows the different methods of credit delivery and savings mechanisms of MFIs.

Table 11. Credit Delivery and Savings Mechanism of MFIs

	Credit delivery	Savings mobilization
Grameen Bank	No collateral, but group liabilities. 50–week installment of loan. Interest at the end of loan cycle. 20% interest rate for general loan, 8% for housing loan. Maximum loan BDT 10,000.	BDT 1.00 per week. 5% of each loan (nonrefundable) goes to group fund. 0.5% of each loan used for group insurance. Option to buy share worth BDT 100 per member.
BRAC	No collateral, but group liabilities. 50–week installment of loan. Interest at the end of loan cycle. 20% interest rate for production loan. Maximum loan BDT 10,000.	BDT 2.00 per week. 4% of each loan (nonrefundable) goes to group fund. 01% of each loan used for group insurance.
Proshika	No collateral, but group liabilities. Clients need to have some savings (5%). 18% interest rate on a simple basis. Loan duration 6 months to 2 years.	BDT 120 per month for economic and social security programs that covers house construction, medical expense, education of children, legal expense, life insurance.

(continued on next page)

ASA	Initial loan size is BDT 5000 for rural areas and BDT 6000 for urban areas per member with a BDT 1,000–2,000 annual increase. Maximum loan size is BDT 9000 (US$ 184). Micro-enterprise credit: Initial loan size is BDT 10,000 to 12,000 with annual increase. Maximum loan size is BDT 40,000. Disaster loan: BDT 1000 per member for all categories. Loan for one-year term and payable on equally weekly installments Interest rate 12.5% flat per annum up to BDT 9000 and 15% from BDT 10,000.	Weekly at a minimum rate of BDT 10–25 per member. Interest on savings is 6% to 8%.
RD-12	No collateral, but primary cooperative liabilities. 50–week installment of loan. Interest at the end of loan cycle. 16% interest rate for production loans. Maximum loan BDT 10,000	BDT 2.00 per week. 5% of each loan (nonrefundable) goes to group fund. Mandatory purchase of cooperative share of BDT 10.00 per member per year.

GOVERNMENT POLICY AND LEGAL FRAMEWORK

Government Policies and Laws Supporting Microfinance

Poverty Reduction Strategy

The government acknowledged in its document "Interim Poverty Reduction Strategy Paper 2003" that micro-credit would play an important role in the country's poverty reduction strategy. It observed that Bangladesh has achieved impressive success in extending micro-credit to assetless poor households that were earlier considered "non-bankable" under the traditional collateral-based financial practices. The government recognized that the success of the credit model in providing credit access to the poor, as pioneered by the Grameen Bank, has been widely acknowledged in the world.

Existing Legal Framework

Generally, NGOs are registered under one or more Acts of Parliament or ordinances. These provisions apply to NGOs in general, and the laws do not categorically address those with microfinance activities. To be registered under any of the acts, the NGOs need to fulfil certain conditions and requirements, which are quite simple and flexible. Most of the NGOs in Bangladesh have microfinance programs, which are exempted from oversight by the central bank or any other regulatory agency. At present, the only microfinance institution (MFI) in Bangladesh being regulated by the central bank is the Grameen Bank. MF–NGOs in general derive their legal basis from the country's constitutional guarantee of freedom of association of citizens. MFIs may be registered under specific laws, but many small MF–NGOs prefer to remain unregistered and work informally. However, without registration under Foreign Donations (Voluntary Activities) Regulation Ordinance of 1978 no NGO can receive any funds from foreign donors. Similarly, no NGO can take any facility from the government or from autonomous government bodies like PKSF without registration under any act.

So most of the NGOs are now registered. MFIs that prefer to register have several options. The major acts under which they can be registered are: (i) Societies Registration Act (1860); (ii) Companies Act (1913); (iii) Cooperative Societies Act (1984); (iv) Charitable and Religious Trust Act (1920); (v) Trust Act (1882); and (vi) Foreign Donations (Voluntary Activities) Regulation Ordinance (1978).

MFI that wish to receive foreign donations must be registered with the NGO Affairs Bureau under the Foreign Donations (Voluntary Activities) Regulation Ordinance 1978. (This is one advantage of registration.) Most NGOs/MFIs are registered with the Social Welfare Department under the Ministry of Social Welfare under the Societies Registration Act of 1860. Over 16,000 NGOs have been registered under this act. Under the Companies Act of 1913, NGOs are registered as nonprofit organizations. Organizations registered with the Cooperative Societies Act of 1984 are formal cooperatives, distinct from NGOs/MFIs. Those registered under the Trust Act of 1882 and the Charitable and Religious Act of 1920 are characteristically distinct from other NGOs. Most MF–NGOs are registered under the Societies Registration Act, and some of these are also registered under the Foreign Donations (Voluntary Activities) Registration Ordinance of 1978.

Microfinance Programs Supported by the Government

Government's Role in Providing Funding to MFIs

The government has created a number of institutions and has implemented different development projects for operating micro-credit programs. Duplication of approaches is noticed among the agencies, but the target groups are distinctively different. Grameen Bank addresses the landless poor, particularly rural women, and provides them collateral-free loans. BRDB provides loans mainly to cooperative societies. PKSF provides funds to NGOs for micro-credit programs. Karmasangsthan Bank provides loans to unemployed youths. There are some other similar types of organizations and programs in the government sector. However, all these institutions follow a group-based approach. In terms of scope, it would have much more difficult for a single organization to provide micro-credit products to a huge number of clients in Bangladesh. The government has taken steps to coordinate all these agencies. The commitment of the government regarding poverty alleviation through micro-credit has made a significant contribution to further strengthening and sustaining the ongoing programs of Bangladesh by augmenting the required credit funds. The government has been disbursing micro-credit for poverty alleviation through different administrative Ministries/Divisions/Departments.

Grameen Bank

The amount of BDT 180.21 billion had been disbursed as credit by June 2003 to about 2.78 million members of Grameen Bank in 390 *upzilas* of 60 districts through 1,182 branches. The amount of recovery was BDT 165.96 billion during this period. The bank's operation reached 42,611 villages around the country. Grameen Bank members had saved more than BDT 84.38 million in their savings accounts.

Palli Karma Sahayak Foundation (PKSF)

Established by the government in 1990, this institution has been providing micro-credit to targeted poor people. Up to June 2003, PKSF had disbursed credits of BDT 15.07 billion to about 41.7 million borrowers through its 213 partner organizations which include small organizations as well as big organizations like BRAC, ASA, Proshika, and Ansar &VDP Bank.

Bangladesh Rural Development Board (BRDB)

The target groups of BRDB include small farmers (holding up to 0.50 acre of land), and assetless women and men. Family planning, health and education programs are also included in BRDB's credit and training activities.

Rural Poverty Alleviation Foundation

The basic mandate of the Foundation is to assist the poor and downtrodden population of the rural areas. Because of the successful execution of two rural development projects, a substantial amount of funds have been accumulated and transferred as the assets of the Foundation.

Table 12. Microfinance Involvement of Different Departments of GOB (as of June 2002)

SL No.	Name of the government department	Total no. of beneficiaries		Cumulative disbursement	Total outstanding	Recovery rate
		Male	Female			
1	PKSF	455,945	3,113,620	11,488,885,000	7,804,304,000	98.30%
2	Dept. of Youth	339,978	226,652	4,713,268,000	864,845,000	89.30%
3	BRDB	2,636,265	1,004,857	26,500,478,000	5,001,884,000	87.00%
4	BARD	1,777	1,128	15,592,000	2,257,000	86.00%
5	Women Education Project under BARD	Nil	538	5,664,000	382,000	98.00%
6	Small Farmers Development Project	26,359	27,872	713,177,000	163,456,000	89.34%
7	Palli Daridra Bimochon Foundation	33,641	320,211	9,158,178,110	1,100,228,540	95.00%
8	Women Entrepreneurship Development Program	Nil	129,863	823,842,000	177,698,000	94.00%
Grand total		3,493,965	4,824,741	53,419,084,110	15,115,054,540	92.12%

Source: Credit and Development Forum (CDF)

Karma Sangsthan Bank (Employment Bank)

The Karma Sangsthan Bank was established in 1998 under an Act of Parliament. The approved capital of the bank is BDT 300 billion, out of which the GOB's share is 75% and the remaining 25% is owned by the NCBs, Schedule Banks, insurance companies, and other financial institutions. The major function of the bank is to provide loans to unemployed youths for income-generating activities under the rules and regulations of the central bank.

Micro-credit Programs of NCBs

Commercial banks have also been participating in poverty alleviation programs and providing credit support to landless and small farmers. Besides their own programs, they also provide credit to different organizations including NGOs. Up to December 2002, cumulative credit disbursement and recovery stands at BDT 84 billion and BDT 78 billion respectively. The number of beneficiaries is 12.23 million, and the recovery rate is 93.20%.

Micro-credit Programs of Other Commercial and Specialized Banks

The micro-credit programs of other commercial and private banks are also in operation. Up to June 2002 the total number of beneficiaries was 2,33,370 and cumulative disbursement was BDT 2.9 billion.

Table 13. Microfinance Involvement of NCBs and Specialized Banks (as of June 2002)

SL No.	Name of bank	Total no. of beneficiaries		Cumulative disbursement	Total outstanding	Recov-ery rate
		Male	Female			
1	Rupali Bank	1,886	210	16,766,000	9,414,000	88.00%
2	Janata Bank	301,891	196,748	16,240,400,000	5,800,800,000	79.00%
3	Social Investment Bank	1,300	4,700	162,052,000	55,540,000	94.00%
4	National Bank	1,900	50	75,548,000	17,310,000	95.00%
5	Bangladesh Krishi Bank	614,485	639,566	8,346,000,000	3,113,100,000	85.00%
6	Islami Bank Bangladesh	7,379	98,041	1,670,240,000	415,180,000	99.00%
7	The Trust Bank	20,000	0	508,500,000	508,500,000	95.00%
8	BASIC Bank	40,000	60,000	574,100,000	193,901,000	99.00%
9	Agrani Bank	460,936	50,788	19,188,400,000	7,015,600,000	81.00%
10	Grameen Bank	116,601	2,251,040	161,411,200,000	12,218,700,000	98.29%
Grand total		1,566,378	3,301,143	208,193,206,000	29,348,045,000	91.30%

Source: Credit and Development Forum (CDF)

Policy Guidelines for Micro-credit Programs

The government has recently formulated some policy guidelines in order to streamline micro credit program operated by the different government agencies. The objectives of the policy are: (a) to ensure good administration of revolving funds; (b) to eliminate discrimination in operational activities; (c) to bring more transparency in fund distribution; (d) to expand effective micro-credit programs; (e) to protect the interests of borrowers and MFIs in fixing rates of interest; (f) to supervise the overall activities of MFIs; (g) to rationalize internal and external auditing; and (h) to continuously evaluate microfinance activities.

Main Features of the Policy Guidelines

1. No funding shall be allocated to the revolving loan fund of any development project; rather, special loans shall be allocated to different government implementing agencies for micro-credit operations on the basis of their operating efficiency, satisfactory audit reports, and realistic requirements.

2. In cases of foreign-funded projects, provision for revolving loan funds may be made as per agreement, and micro-credit operation will be administered according to the relevant project document.
3. A second loan shall be provided to any agency only after complete repayment of the first loan. However, no second loan will be provided to any borrower for the purpose of repaying the first loan.
4. No new personnel recruitment shall be allowed for the purpose of micro-credit operation by any government agency; rather, existing manpower will be deployed for its operation.
5. Any ministry or government agency, having received a revolving loan fund, may depute any competent NGO, bank, or financial institution for the operation of micro-credit. In that case, the ministry will be responsible for observation, evaluation, monitoring, and auditing of the concerned agency's operational activities.
6. If a micro-credit project is completed successfully, it may be transformed into a separate agency, free from control of the ministry, and will operate like an NGO. The government may include any successful micro-credit program in the root functions of any ministry or government agency operating under a revenue budget.
7. The government shall extend all administrative assistance and support to successful micro-credit users for promotion of small-scale enterprises. Special emphasis shall be given to greater mutual understanding and cooperation among the government agencies, nationalized commercial and specialized banks, and NGO–MFIs. The government shall provide insurance facilities and loan to micro-credit providers for disaster mitigation.

Since the different government organizations have been operating micro-credit programs under different approaches and procedures, it was essential to rationalize all the programs. The government has rightly formulated a set of unified policy guidelines, and this will obviously help to streamline the micro-credit programs that are part of its development strategy.

Protection for Borrowers

The Artha Rin Adalat Ain (Money Loan Court Act) of 2003 was enacted in March 2003 with a view to streamlining of the process of managing overdue loans and advances by banks and financial institutions. Provisions have been made in this act for collecting banks' dues by selling properties held as security, without prior orders of the court. The Bankruptcy Act of 1997 was enacted to decide all questions arising out of bankruptcy, whether of title or priority or of any nature whatsoever. The Act provided the assignment of a District Court to deal with and dispose of proceedings under this Act. However, data are not available how many of the bankruptcies are because of business failures.

THE REGULATORY AND SUPERVISORY ENVIRONMENT FOR MFIS

Regulatory and Supervisory Infrastructure for Banks, Nonbanks, and MFIs

Central Bank

Bangladesh Bank, the central bank of Bangladesh was established under the Bangladesh Bank Order of 1972. The objectives of the BB are to stabilize domestic monetary value and maintain a competitive external par value of the Bangladesh Taka with the aim of fostering growth and development of the country's productive resources in the best national interest.

Nationalized Commercial Banks (NCB)

In pursuance of the Proclamation of Independence of Bangladesh, for taking over the running of certain banks of the former East Pakistan in Bangladesh, the Bangladesh Banks

(Nationalization) Order was promulgated in 1972. Under this act 11 commercial banks of the former East Pakistan were nationalized and reconstituted into 6 commercial banks.

Private Commercial Banks (PCB)

All private banks, local and foreign, were established under the Bank Company Act of 1991. The Act is applicable to all banks. Bangladesh Bank's responsibility is to monitor financial intermediation, control the money market, and protect the interest of depositors as per the Bangladesh Bank Act. A bank needs to obtain a license from the BB, but MFIs do not have such licenses.

Financial Institutions (FIs)

The Financial Institution Act of 1993 and the Financial Institution Regulations of 1994 were adapted to issue licenses to financial institutions, as well as to regulate, control, and administer them. All investment companies, building societies, merchant banks, mutual associations, mutual companies, and leasing companies function under the Act and its subsequent regulations.

Microfinance Institutions (MFIs)

Grameen Bank was established under the Grameen Bank Ordinance (1983) to provide facilities and other services to landless persons in rural areas and to provide for matters connected therewith. Grameen Bank operates as an MFI under Grameen Bank Act. As it is a special MFI, the Banking Companies Act is not applicable to Grameen Bank. Some special types of banks/microfinance institutions were established under a certain Act of Parliament, for example, the Ansar & VDP Bank and the Cooperative Bank.

MF–NGOs

Most of the NGOs in Bangladesh have microfinance programs, which are exempt from overseeing by the central bank or any other regulatory agency. At present, the only microfinance institution (MFI) in Bangladesh being regulated by the central bank is the Grameen Bank. In microfinance NGOs, a distinction is usually made between members and non-members. Those who are covered within the target group are called non-members. In fact, however, there is no legal basis at present for making such a distinction. Grameen Bank can mobilize deposits because it is a formal bank. NGOs cannot take deposits because NGO law does not allow them to do it. Micro-credit can be funded locally at the village level, provided a legal framework is created to allow micro-credit programs to accept public deposits. It was suggested by the Steering Committee of the Microfinance Research and Reference Unit of Bangladesh Bank that the MFIs that have already collected a substantial amount of savings (more than BDT 10 million) be instructed to obtain mandatory licenses from Bangladesh Bank to operate as financial institutions. The government has accepted the suggestion, and it will be implemented soon. However, it has also been decided recently by the government that no organizations except banks should be allowed to take deposits from the public.

Types of Laws

MFIs that prefer to register have several options. The major Acts under which they can be registered are shown in Table 14.

Table 14. Types of Financial Institutions and Their Regulating Laws

Type of financial institution	Regulating laws	Remarks
Central Bank	Bangladesh Bank Order, 1972	Bangladesh Bank was established under this Act.
Nationalized Commercial Banks	Bangladesh Banks (Nationalization) Order, 1972	Six Nationalized Banks were established under this Act. Subsequently two banks were handed over to the private sector.
Private Commercial Banks	Bank Company Act, 1991	All local and foreign private commercial banks were established under this Act.
Financial Institutions	Financial Institutions Act, 1993 Financial Institutions Regulations, 1994 Securities and Exchange Commission Act, 1993	All financial institutions other than banks were established under this Act.
MFI (GB)	The Grameen Bank Ordinance, 1983	Grameen Bank, the pioneer microfinance institution (MFI), was established under this Act.
MF–NGO	Societies Registration Act 1860 Companies Act, 1913 Cooperative Societies Act, 1984 Charitable & Religious Trust Act, 1920 Trust Act, 1882 Foreign Donations (Voluntary Activities) Registration Ordinance, 1978	NGOs and MF–NGOs were registered under this Act.

The Central Bank's Regulatory Authority

Limitations of the Central Bank

The central bank in Bangladesh is an important and illuminating exception to central bankers' entrenched obsession with regulating and supervising all financial institutions. The Bangladesh Bank has the vision and understanding to be extremely reticent about getting into regulation/supervision of the MFIs. The Bangladesh Bank has recognized three important issues that prohibit it (and indeed most) central banks from getting involved in the regulation/supervision of MFIs:

a. The poor state of the formal financial sector and the role the Bangladesh Bank is playing in the reform process leave little institutional capacity free to support this rapidly growing sector.
b. Microfinance is radically different from the financial sector which Bangladesh Bank supervises, and considerable resources would be required to devise a supervisory framework.

c. The sheer size of the microfinance sector in terms of number of institutions poses logistical problems for supervision.

In short, Bangladesh Bank wants to focus on its central mandate and strengthen the formal financial sector—no small task. In terms of institutional capacity, especially logistical constraints, it is realistically difficult for Bangladesh Bank to take on the burden of regulating and monitoring the activities of NGO–MFIs.

Microfinance Research and Reference Unit

Bangladesh Bank (BB) set up a Microfinance Research and Reference Unit to protect the interests of depositors and ensure the transparency and accountability of the MF–NGOs' micro-credit operations in 2000. A Steering Committee was constituted under the leadership of the Governor of Bangladesh Bank to promote smooth functioning of the unit for two years.

The Steering Committee of the "Microfinance Research and Reference Unit" of BB has begun functioning with the following Terms of Reference:

1. To formulate a policy framework to regulate the NGOs and MFIs involved in the micro-credit and financial business and to determine the best practice of performance, with a view to improve the activities of these organizations to the desired level.
2. To evolve a generic accounting procedure for ensuring transparency and accountability of these organizations.
3. To monitor the activities of these NGOs and MFIs operating micro-credit and financial transactions as per the policies and procedures established by the committee.
4. To recommend a legal framework for the Microfinance Research and Reference Unit of BB or a suitable regulatory authority for microfinance management. The Committee seems to be a recommending body without any resources or adequate lawful authority to regulate the MF–NGOs. However, the Committee suggested that they be given the authority to work not as a permanent regulatory agency, but as an interim body that will lead to the establishment of a formal regulatory organization.

Recommendations of the Steering Committee

The Steering Committee of the Microfinance Research and Reference Unit of Bangladesh Bank submitted its Report to the government with the following recommendations; and the government, on 7 April 2004, approved it:

1. To take measures for prohibiting collection of savings from non-borrowers of the MFIs.
2. To take appropriate steps against the MFIs that already collected a substantial amount of savings (BDT 10 million) and require them to obtain mandatory licenses from Bangladesh bank to operate as financial institutions.
3. To ensure mandatory execution of the guidelines and best practices developed by the Steering Committee.
4. To collect updated information and data regarding the MF–NGOs operating micro-credit in the country.
5. To establish a regulatory body as quickly as possible. However, as it will take time to constitute the proposed body, it is suggested that this committee be given a mandate to work as a regulatory authority for an interim period. Accordingly, the Committee recommended extending its duration for two years. As there is no regulatory body, the committee recommended that it be given the authority to regulate. However, this proposal was not accepted by the government. Rather, the committee was assigned to work for the formation of a regulatory body.

6. The Committee, in its extended period, will perform the duties recommended in paragraphs 1, 2, and 3. It will work to frame regulatory legal infrastructures for the MFIs. The Committee will also issue licenses/registrations to the MFIs.
7. The Committee observed that most MF–NGOs working in Bangladesh are charging 15% or less as service charges/interest rate for micro-credit business. The Committee decided not to make any recommendation for a ceiling any rate in this regard. However, considering the importance and sensitivity of this matter, the Committee suggested that it should be monitored and observed regularly by the Committee and declared that it would suggest to the government, if necessary, that a ceiling be set for the rate interest/service charges.
8. The Committee recommended that the fund provided by the World Bank for the PKSF to implement the Second Poverty Alleviation Microfinance (MF-II) measure be allocated for framing regulations for MFIs.

The Steering Committee was constituted of representatives from the major MF–NGOs like Professor Yunus of Grameeen Bank, Fazle Hasan Abed of BRAC, the Managing Director of PKSF, and others. It is expected that the MF–NGOs will accept the proposed role of the Bangladesh Bank and the Steering Committee.

Second-tier Bodies Functioning as "Regulators" for MFIs

Palli Karma Sahayak Foundation (PKSF)

The government established Palli Karma Sahayak Foundation (PKSF) as a nonprofit organization registered under the Companies Act in May 1990. The PKSF has emerged as a second-tier institution to provide funds to NGOs. The major objectives of PKSF are:

a. To give various types of financial help and assistance to non-government, semi-government, and government organizations, voluntary agencies and groups, societies, and local government bodies, so that NGOs, or partner organizations (POs), consistent with the PKSF's image and objectives, can undertake activities with a view to generating income and employment opportunities among the economically most disadvantaged groups in the society.
b. To assist in strengthening the institutional capacity of POs, so that they can manage their programs in a sustainable manner.

PKSF does not directly lend money to the landless and to assetless people; rather reaches its target groups through its POs, the designated delivery mechanism for reaching the poor. It provides greater thrust to institutional development. It favors no particular model; instead, innovations and different approaches based on experience are encouraged. Legally PKSF is a "company limited by guarantee," meaning "company not for profit," and is registered under the Companies Act of 1913/1994 with the Registrar of Joint Stock Companies. The legal structure of PKSF allows flexibility, authority, and power to take programs and implement them throughout the country while managing its affairs as an independent organization. PKSF's mandate authorizes its management to mobilize funds in the forms of grants, loans, and contributions from a wide variety of sources that include GOB, private individuals and organizations, foreign governments, international donors and lending agencies, and capital markets. So far PKSF has received funds from the GOB, the IDA/World Bank, USAID, and the Asian Development Bank. In order to achieve its objectives PKSF performs the following major functions:

a. Provision of micro-credit funds to the POs.
b. Developing the best practices for the micro-credit sector.
c. Institution/capacity-building support for POs.
d. Advocacy for appropriate policies and regulations useful for the micro-credit sector.

NGO Foundation

On 7 April 2004, the government created the NGO Foundation under a new Act of Parliament, with a mandate to accept funds from the government and donors for disbursement to small NGOs. The government initially donated BDT1 billion to the Foundation**.** PKSF was created under the Companies Act as an autonomous body. On the other hand, the NGO Foundation was established under an Act of Parliament. However, the objectives of both organizations seem to be the same.

Working Relationship Between Second-tier Bodies and the MFIs

The objective of the organization is to undertake and promote various activities aimed at poverty alleviation. The Foundation works as an apex financing organization for NGOs (known as POs, Partner Organizations) running micro-credit programs in rural areas. PKSF has a mandate to undertake wide-ranging activities for poverty alleviation, including capacity building of its POs). The POs of PKSF serve about one million beneficiaries and are classified into two categories based on their area coverage and the focus/dimension of their activities. The large ones are classified as BIPOOL (Big Partner Organizations Operating in Large Areas) and the small ones as OOSA (Organizations Operating in Small Areas). Out of the total 164 POs, three are BIPOOL while the remaining 161 are OOSA. The Foundation's program is spread over about 21,000 villages in 1728 unions under 313 *thanas* of 58 districts. PKSF's coverage is, however, poor in comparison with the large-scale demand for funds for poverty alleviation.

There is no relationship between central bank and PKSF in terms of regulating MFIs. However, PKSF is an important member of the Steering Committee of the Microfinance Research and Reference Unit of Bangladesh Bank, which is working to prepare a regulatory framework for the country's micro-credit sector.

Self-regulation Practices of MFIs

Policy Guidelines and Standards of PKSF

PKSF, in the last decade, has developed a number of policy guidelines and standards for its POs and for the micro-credit sector involving the practitioners of PKSF, POs, and others concerned. Major policy guidelines and standards prepared by PKSF are:

1. Statement of policy guidelines for selection of POs and borrowers among the rural and urban hard-core poor.
2. Guidelines for accountants.
3. Policy for loan classification and debt management reserve.
4. Guidelines for accountants
5. Guidelines for managing savings.
6. Guidelines for managing service charge earnings.
7. Guidelines for avoiding overlapping.
8. Management of information systems.
9. Guidelines for performance standards and categorization of POs.
10. Financial rationing analysis.
11. Policy for the utilization of disaster management funds.
12. Guidelines for indicators for an early warning system.
13. Business planning for POs.
14. Guidelines for managing audits of POs by PKSF.
15. Guidelines for internal audits of POs by PKSF.
16. Guidelines for external auditor of PKSF.
17. Guidelines for external auditor of PKSF for auditing its POs.

18. Guidelines for auditors appointed by POs.
19. Policy for loans for institutional development.

Policy Guidelines and Standards of BB

The Steering Committee of the Microfinance Research and Reference Unit of Bangladesh Bank suggests some self-regulatory guidelines to be followed by the MF–NGOs. The guidelines are:

1. The governing bodies of MF–NGOs should include members from among the credit receivers.
2. Governing Body meetings and an Annual General Meeting should be held regularly and effectively.
3. MF–NGOs should publish Annual Reports and Audit Reports regularly and submit them to the concerned government authorities (or to the proposed regulatory body).
4. MF–NGOs should have written Service Rules that contain personnel policies such as recruitment, promotion, and wage and salary structure.
5. MF–NGOs should practice standard and generally acceptable accounting.
6. To ensure reliability, MF–NGOs should have their own audit departments for internal audits.
7. The governing bodies of MF–NGOs should include representatives from either the government/Bangladesh Bank or the (proposed) regulatory body.

SPECIFIC REGULATORY REQUIREMENTS AND SUPERVISORY PRACTICES

Regulatory Requirements

Special Law for an MFI to Be Registered and Obtain a License to Operate

The central bank of Bangladesh provides licenses to financial institutions under the Financial Institutions Act (1993) and regulates them under the Financial Institutions Regulations (1994). The Directorate of Social Welfare deals with the registration of NGOs involved in certain voluntary social welfare activities under the Voluntary Social Welfare Agencies (Registration and Control) Ordinance of 1961. The Office of the Registrar of Joint Stock Companies, an office attached to the Ministry of Commerce, is responsible for registration of organizations under the Societies Registration Act 1860. The same office also provides registration certificates to NGOs as nonprofit companies under (Section 26/28 of) the Companies Act 1913/1994. The Office of the District Registrar or Sub-Registrar under the Ministry of Justice, Law and Parliamentary Affairs deals with the NGOs as trusts under the Charitable and Religious Trust Act (1920) and the Trust Act 1882. The Registrar of Cooperative Societies, a department of the Ministry of Local Government, Rural Development and Cooperatives, is responsible for registration of cooperative organizations under the Cooperative Societies Ordinance of 1984. The NGO Affairs Bureau is responsible for all matters falling within the terms of the Foreign Donations (Voluntary Activities) Registration Ordinance of 1978 and the Foreign Contributions (Registration) Ordinance of 1982.

Requirements for Registration and Licensing

The governmental bodies follow different procedure for registration and licensing of MF–NGOs. To register with the NGO Affairs Bureau a letter of intent from a foreign donor stating the amount and purpose of the donation in favor of the NGO is required. The Social Welfare Department requires a Memorandum of Association and Bylaws of the NGO for registration. Similarly a Memorandum of Association and Bylaws of the NGO are needed for registration under the Companies Act, the Charitable and Religious Trust Act of 1920 and the

Trust Act of 1882. There is no specific time frame for registration with any department. However, in most cases it takes a long time to complete the process and obtain the registration.

Minimum Capital Requirements and Other Major Conditions for MFIs

There is no specific regulation regarding the minimum capital requirement of MFIs. However, it was suggested by the Steering Committee of the Microfinance Research and Reference Unit of Bangladesh Bank that MFIs which have already collected a substantial amount of savings (BDT 10 million or more) be instructed to get mandatory licenses from Bangladesh Bank as financial institutions. The government has accepted the suggestion, and it will be implemented soon.

Ownership of MFIs

There is no hard and fast concept of ownership; rather, ownership is relative to the nature and activities of the organization. In Bangladesh it is commonly believed that microfinance organizations are organizations of the people. The mission of such organizations is also to the address the immediate needs of the people, such as poverty alleviation and employment. Thus these organizations made a point of include the people and make space for them: the whole arrangement of such organizations is meant to including the people as part of management. As the very basis of these MF–NGOs is nonprofit distributing, there are no shareholders of the organization to have a stake in the organization. So there is no visible owner of an MF–NGO, as nobody invested money to build the equity of the organization. Many such organizations started their operations with donor money, so donors might have a stake in the organization. The donor might, for example, want to see that more clients are covered. The general members of the organization do not have any stake in the organization in monetary terms; however, they may feel a social responsibility to devote their time and effort to the wellbeing of the poor and to be engaged in the running of the organization. There may be some feeling of social ownership among the people. They wish to see the people in the community receiving the services of the organization they are involved in. In this respect the clients could feel some sort of ownership, as they are the heart of any microfinance program. But the MF–NGOs consider their clients as "*samity*" (association) members, not as organizational members. So there is little scope for the clients to feel ownership of the MF–NGOs. For effective governance, the ownership of the clients may be ensured by incorporating representatives of the clients both in the governing body and in the executive committee.

Foreign Donor Agencies and the Capitalization of MFIs

External donors are one of the major sources of fund for the MFIs. NGO activities in Bangladesh mostly developed from a welfare- and relief-oriented missionary attitude, backed by grants from external donors. Parts of these grant funds and/or other surplus income has been used as revolving fund to allow income-generating activities to be undertaken by the grass-root members of microfinance institutions. This fund still constitutes the major portion of MFI lending funds. Sponsors' equity and reinvested earnings also form a significant part of the lending fund. A publication of the Credit and Development Forum (CDF), a network of MFIs, shows a breakdown of the sources of funding for 351 MFIs on 31 December 1996 (Table 15).

Table 15. Sources of MF–NGOs' Funding

Sources of funds	Taka (in millions)	% of share
Member savings	1656	20.41%
Loans from PKSF and banks	961	11.83%
Foreign donations	3888	47.90%
Sponsors' equity and reinvested income	1612	19.86%
Total	8117	100%

PKSF has also received funds from the IDA/World Bank, USAID, and ADB. Other CDF studies show a variety of sources of revolving funds for MFIs.

Interest Rate Policy

There has been no regulation of interest rates until recently. The Steering Committee of the Microfinance Research and Reference Unit of the Bangladesh Bank observed that most MF–NGOs working in Bangladesh have been charging around 15% in service charges/interest for their micro-credit business. The Committee decided not to make any recommendation for a ceiling any rate at this stage. However, considering the importance and sensitivity of the issue, the Committee suggested that the matter would be monitored and observed regularly by the Committee and that, if necessary, it would suggest that the government set a ceiling for the rate of interest/service charges that can be levied. The service charges on loans have been found to vary from 5% to 25% in the flat rate method and 11% to 35% in the declining balance method. A CDF study shows that out of 681 organizations, 95.74% (652 organizations) practice the flat method and only 2.64% (18 organizations) practice the declining method. Moreover, 1.62% (11 organizations) practice both methods for calculating service charges. Table 16 gives a clear picture of the interest rates /service charges of MF–NGOs:

Table 16. Interest Rates/Service Charges on Loans Practiced by MF–NGOs

Charge (%)	Flat method (out of 663)		Declining method (out of 29)	
	No. of MF–NGOs	% of MF–NGOs	No. of MF–NGOs	% of MF–NGOs
>=10	20	3.02	0	0.00
11–12	29	4.37	2	6.90
12.50	13	1.69	0	0.00
13–14	8	1.21	0	0.00
15	523	78.88	10	34.48
16–17	25	3.77	4	13.79
18–19	11	1.66	1	3.45
20–21	33	4.98	2	6.90
22–23	0	0.00	0	0.00
24–25	1	0.15	5	17.24
26–30	0	0.00	2	6.90
31–35	0	0.00	1	3.45
36	0	0.00	1	3.45
Total	663	100.00	29	100.00

Rates of Interest/Service Charges

The rates of interest/service charges of the leading MFIs are listed below:

1. Government-sponsored micro-credit programs charge different rates of interest that range from 5% to 17%.
2. Karma Sangsthan Bank, a government-owned specialized bank for employment generation, charges only 14% with 3% rebate for in time repayment.
3. Grameen Bank charges 20% interest for general loans and 8% for housing loans.
4. BRAC's present rate of interest/service charge is 20% for production loans.
5. A service charge of 18% is levied on the Proshika loan. It is calculated on a simple basis, on declining loan balances.
6. RD-12 charges a 16% rate of interest for production loans. Some observe that the MFIs are charging higher rates of interest to poorer clients.
7. ASA charges a 12.5% flat interest rate per annum for loans up to BDT 9000 and 15% flat per annum for loans greater than BDT 10,000.

Interest Rates on Savings

It appears from the CDF study that the interest rate on savings offered by MF–NGOs is not very conducive to mobilizing more savings, as government and commercial banks have been offering even higher rates of interest. Some MF–NGOs have already begun offering different term deposits with higher interest rates, which is encouraging saving in rural areas.

Proshika

Under the Proshika Savings Scheme the group members are paid 5% interest on the savings fund. In addition, compensation for destruction or damage of homestead and houses by natural disasters like river erosion, cyclones, or tornados is payable to the members at twice the amount of the savings deposit of the member concerned. In this situation the savings deposit will remain intact against their name, and they will have the same right to their deposit as other members. In case of the death of a member, the amount of compensation is calculated by multiplying the savings of the deceased group member by the number of years of savings being kept by his or her group.

ASA

For micro-credit and microenterprise members' savings, BRAC charges interest at a compound rate of 6% or 8% per annum; i.e., those who use savings withdrawal facilities will receive interest at 6%, and non-withdrawal savers are entitled to receive interest at 8%. For associate members' savings interest is given at a compound rate of 6% or 7% per annum; i.e., those who use savings withdrawal facilities will receive interest at 6% and non-withdrawal savers are entitled to receive interest at 7%.

BRAC

The interest rate BRAC's compulsory members' saving is 6%. Its Current Account Savings bears no interest but allows the group members to make unlimited withdrawals.

Method of Supervision for MFIs

Self-regulations Prescribed by MMRU

The Steering Committee of the Microfinance Research and Reference Unit of Bangladesh Bank suggests some self-regulation measures to be followed by the MF–NGOs. The suggestions are:

1. The governing body of MF–NGOs should recruit members from among the credit receivers.
2. Governing Body meetings and an Annual General Meeting should be held regularly.
3. MF–NGOs should publish Annual Reports and Audit Reports regularly and submit them to the appropriate government authorities (or to the proposed regulatory body).
4. MF–NGOs should have written Service Rules that contain personnel policies that affect recruitment, promotion, wage and salary structure, and so on.
5. MF–NGOs should practice standard and generally acceptable accounting.
6. To ensure reliability, MF–NGOs should have their own Audit Departments for internal audit.
7. The governing bodies of MF–NGOs should include representatives from either the government/Bangladesh Bank or from the (proposed) regulatory body.

Responsibilities of the Regulatory Authorities

The Steering Committee of the Microfinance Research and Reference Unit of Bangladesh Bank suggests that the Unit may be made responsible to supervise the MF–NGOs for the following undertakings:

1. Registering the organizations that would like to operate microfinance programs in Bangladesh.
2. Monitoring MF–NGO activities.
3. Receiving quarterly reports in a prescribed format.
4. Taking actions in response to any unlawful operation by MF–NGOs.
5. Receiving Annual Reports, Audit Reports, and Proceedings of Annual General Meetings and follow up on them.
6. Developing policies and guidelines for microfinance operation and disseminate them.
7. Informing the government and the microfinance operation about MF–NGOs activities.
8. Developing appropriate policies for depositing savings from clients and thus allowing them to utilize the fund.
9. Developing guidelines on the ownership pattern of MF–NGOs in Bangladesh, as the existing laws do not have any specific directions about the ownership of MF–NGOs.

Banking Regulations for MF–NGOs to Mobilize Savings

There are 1000+ MF–NGOs in Bangladesh that have micro-credit programs. Interestingly, there is hardly any provision in the existing statues that gives them permission to operate micro-credit programs. In other words, MF–NGOs are operating microfinance rather illegally. However, it is fact that there is also no bar in any statute to operating microfinance programs. Moreover, most MF–NGOs carry out financial intermediation by mobilizing savings and extending micro-credit to their members. Financial intermediation, in effect, amounts to banking under the Banking Companies Act and Bangladesh Bank Act. Any organization carrying out financial intermediation needs to obtain a license from the central bank. Yet MF–NGOs do not hold any such license, arguing that their financial intermediation is informal and limited to their members. In this sense members are seen as distinct clusters of people, among the general masses, whom the MF–NGOs nurture and develop. Recently it has been decided by the government that MFIs that have already collected a substantial amount of savings (a minimum of BDT 10 million) shall have to obtain mandatory licenses from Bangladesh bank and operate as financial institutions.

Regulations Governing the Transformation of NGOs into Formal Institutions

The Steering Committee of the Microfinance Research and Reference Unit of Bangladesh Bank suggested that the government should take measures to prohibit collection of savings from non-borrowers of the MFIs. It has been decided that the MFIs that have already collected a substantial amount of savings (BDT 10 million or more) shall have to obtain mandatory licenses from Bangladesh Bank.

All private banks, local and foreign, were established under the Bank Companies Act, 1991. The Act is applicable to all banks. A bank needs to obtain a license, but MFIs do not have such licenses. The Financial Institution Act of 1993 and The Financial Institution Regulations of 1994 were adapted to issue licenses to financial institution, as well as regulate and administer them. Grameen Bank was established under the Grameen Bank Ordinance. If any MF–NGO decides to transform itself into a bank, it has to obtain a license from the Bangladesh Bank under the Bank Company Act (1991).

Understanding the Nature of Microfinance Loans by the Authorities

No regulatory body has yet been constituted by the government for regulation and supervision of MF–NGO micro-credit programs. However, a Steering Committee of the Microfinance Research and Reference Unit (MRRU) of Bangladesh Bank has been established, with the Governor of Bangladesh Bank as its convenor. The Committee submitted a report on MF–NGOs' microfinance operation and submitted it to the government with a set of recommendations for a regulatory framework. The government has already approved the recommendations. It was decided that this Steering Committee would work as the regulatory body for MF–NGOs initially for two years. The members of the Steering Committee included representatives of the PKSF, BRAC, Grameen Bank, and government officials. So it is expected that the new regulatory authority is quite competent to understand the nature of microfinance loans and the related credit procedures in micro-lending.

Some Other Regulatory Issues

Capital Adequacy

There is no regulation governing capital adequacy, or a procedure for the MFIs to follow for ensuring capital adequacy.

Loan-loss Provisioning

There is no regulation governing loan loss provisioning or any procedure for the MFIs to follow so that they will be able to absorb loan delinquencies. No regulatory authority has until now been responsible for assessing the credit quality of microfinance loan portfolios.

Collateral/Risks of Microfinance

There is no regulation and supervision method to give priority to documentation of traditional collateral over loan repayment history in assessing credit quality. It has been recognized in the MF–NGO tradition that group guarantee is a legitimate form of security for microfinance. It also recognizes other nontraditional collateral, such as joint liability, peer pressure, and third-party guarantees, as legitimate forms of security. However, the existing Bank Companies Act does not recognize microfinance loans as legitimate loans.

Regulations to Govern Micro-insurance

There are no prudential regulations covering insurance products, such as capitalization requirements, ownership ceilings, investment areas or instruments, cross-ownership by MFI banks, etc. MF–NGOs follow their own practices for micro-insurance products.

Training Needs

PKSF has developed 22 training modules, of which 7 are for PKSF's staff and 15 are for the POs' staff members. The modules have been prepared based on a Training Need Assessment (TNA) study that can be followed by the regulators and supervisors.

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JAPAN

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INTRODUCTION

In general, microfinancing in Japan is not for poverty alleviation. The government states that it is support to incubate and grow small businesses, because a wide range of independent small businesses will lead to a more competitive and better economy. If we define microfinance institutions (MFIs) as institutions only for poverty alleviation, there are few MFIs in Japan, except for some forms of governmental aid or NGOs.

However, Japan has many types of financial institutions that provide loans for small companies or individuals who have their own small/microbusinesses. They provide auto loans for private taxi drivers or start-up money for a bakery owned by a woman, for example. Practically, such loan types and lending methods appear similar to what we expect of MFIs in developing countries.

In Japan, private-sector enterprises, especially local banks, credit associations, credit cooperatives, or agricultural cooperatives that provide lending and saving services both for business and household needs, have worked for small/microbusinesses for a long time. However, the private sector did not have sufficient funds for lending several decades ago. Currently, although the shortfall of funds has almost disappeared and many private-sector institutions that were in poor financial shape because of accumulating nonperforming loans in the 1990s are recovering, the total amount of loans for small businesses has decreased, although the rate of decrease appeared to slow in 2004.

Therefore the government has also supported microbusinesses by providing microloans depending on the era. However, the total volume of loans has not been very great and stands at around 10% of SME loans currently. The National Life Finance Corporation (NLFC) is one of the players on the governmental side, which has been making loans to microbusinesses since its establishment in 1949 as the People's Finance Corporation. There also are semi-governmental credit guarantee systems. Both the private and governmental sectors have helped to create and grow microbusinesses and as a result, such support has reduced poverty.

SMALL/MICROBUSINESSES IN JAPAN

There is no clear definition of a microbusiness in Japan; however, the government defines "small and medium enterprises (SMEs)" and "small-scale enterprises (SSEs)" under the Small and Medium Enterprise Basic Law (Table 1). The law was enacted in 1963 and the latest revision was in 1999, when the definition of SSEs was added. SSEs include very small businesses such as private taxis, small restaurants, and retail shops that are operated by only one or two persons, or without employees. The law targets "developing and growing a wide range of independent SMEs for a greater economy." It does not mention poverty alleviation, but includes rectification of the disadvantages of SMEs. The government enacts other special laws or modifies old laws as needed.

Statistics show that microbusinesses are still significant in the economy, although many huge companies exist in Japan. There are approximately 4.7 million enterprises in Japan, 99.7% of which are SMEs, and 87.2% of all SMEs are SSEs (Table 2). In terms of number of workers, defined as the number of regular employees of companies plus the total number of workers as sole proprietors, 70.2% are employed by SMEs, and 25.3% by SSEs (Table 3). The real estate, construction, and food service sectors have an especially high proportion of workers employed by SSEs.

Table 1. Definition of SWEs and SSEs in Japan

	Industry	Number of employees	Capital (million ¥)
SWEs	Manufacturing and others	300 or less	300 or less
	Wholesale	100 or less	100 or less
	Retail	50 or less	50 or less
	Service	100 or less	50 or less
SSEs	Manufacturing and others	20 or less	
	Wholesale	5 or less	
	Retail	5 or less	
	Service	5 or less	

Source: Small and Medium Enterprise Law (1999)
Note: SWEs are "Small and Medium Enterprises" and SSEs are "Small-Scale Enterprises." SWEs need to satisfy one or both of two criteria: number of employees and capital. There is no capital criteria for SSEs.

Table 2. Number of Enterprises

Industry	SMEs				Large enterprises		Total
			SSEs				
		% of total		% of total		% of total	
Mining	2,618	99.7	2,276	86.6	9	0.3	2,627
Construction	543,397	99.9	516,405	95.0	363	0.1	543,760
Manufacturing	554,431	99.6	493,942	88.7	2,150	0.4	556,581
Electricity, gas, heat, water supply	510	94.8	266	49.4	28	5.2	538
Transport, communications	100,459	99.7	80,462	79.8	343	0.3	100,802
Wholesaling, retailing, food services	1,999,435	99.7	1,707,214	85.1	6,394	0.3	2,005,829
Wholesaling	255,587	99.1	176,374	68.4	2,394	0.9	257,981
Retailing	1,054,397	99.7	915,668	86.6	3,544	0.3	1,057,941
Food services	689,451	99.9	615,172	89.2	456	0.1	689,907
Finance, insurance	34,282	99.1	33,126	95.8	312	0.9	34,594
Real estate	262,654	100.0	20,025	99.0	89	0.0	262,743
Services	1,191,823	99.7	1,008,453	84.3	3,742	0.3	1,195,585
Non-primary industry total	4,689,609	99.7	4,102,169	87.2	13,430	0.3	4,703,039

Source: Statistics Bureau, Ministry of Public Management, Home Affairs, Post, and Telecommunications, "Establishment and Enterprise Census of Japan (2001)"
Note: "Number of Enterprises": number of companies + sole proprietor establishments (independent establishments and head offices).

Table 3. Number of Workers

Industry	SMEs				Large enterprises		Total
			SSEs				
		% of total		% of total		% of total	
Mining	30,478	84.8	14,285	39.8	5,443	15.2	35,921
Construction	3,516,530	87.7	2,159,911	53.9	493,131	12.3	4,009,661
Manufacturing	6,635,481	61.7	2,134,914	19.9	4,119,197	38.3	10,754,678
Electricity, gas, heat, water supply	26,962	12.4	2,236	1.0	190,678	87.6	217,640
Transport, communications	2,058,631	67.9	354,136	11.7	974,096	32.1	3,032,727
Wholesaling, retailing, food services	10,145,170	72.6	3,617,709	25.9	3,828,549	27.4	13,973,719
Wholesaling	2,467,928	67.8	388,725	10.7	1,170,471	32.2	3,638,399
Retailing	4,909,837	68.7	1,861,774	26.1	2,234,118	31.1	7,143,955
Food services	2,767,405	86.7	1,367,210	42.8	423,960	13.3	3,191,365
Finance, insurance	182,164	15.6	76,491	6.5	987,079	84.4	1,169,243
Real estate	643,253	87.9	439,757	60.1	88,892	12.1	732,145
Services	6,724,696	77.0	1,993,791	22.8	2,005,533	23.0	8,730,229
Non-primary industry total	29,963,365	70.2	10,793,230	25.3	12,692,598	29.8	42,655,963

Source: Statistic Bureau, Ministry of Public Management, Home Affairs, Post and Telecommunications, "Establishment and Enterprise Census of Japan (2001)"
Note: Number of enterprises = number of companies + sole proprietor establishments (independent establishments and head offices).

Although many studies, for example, the Asian Development Bank's *Finance for the Poor: Microfinance Development Strategy* (2000), have focused on microfinancing as a tool for poverty alleviation, this paper considers SSEs or SMEs to be microbusinesses and treats financing for them as microfinancing. This is because the recipeints of small business loans in Japan are similar to the microfinance borrowers in developing countries. In Japan, the poverty problem is not as critical compared with that in developing countries, and limiting the topic to financing only for poverty alleviation would be too restrictive to explain the small business loan system in Japan. It would also be useful for developing countries to gain knowledge of Japan's experience in providing small business loans, e.g., how lenders are assessed or evaluated, what instruments are used to secure loans, how lending institutions manage the risk of lending to small businesses, which government policies are helpful in convincing private lenders to lend to small-scale borrowers, etc.

There are some special forms of government aid for poverty reduction, or NGOs, for women entrepreneurs; however, those loan amounts are very limited. There are pensions for the elderly and jobless benefits for jobseekers. For other forms of poverty, public assistance at the subsistence level is available. In 2001, 1.1 million citizens, or about 1% of the population, procured subsidies. The government also provides "microbusiness assistance (subsidy)" up to ¥45,000 (US$400; hereinafter, the exchange rate is US$1 = ¥110), but only 183 people claimed it in 2001. Or, for example, the Women Citizens' Bank, legally a nonbank established in 1998 to provide loans to women members, collects funds from 493 members and had disbursed loans of ¥338 million (US$3.1 million) to a total of 70 individuals (¥4.8 million or US$44,000 per person) as of January 2005. Outstanding loans amounted to ¥126 million (US$1.1 million) at that time. Those loans, however, are very small in volume and very few in number compared with small business loans provided by the private and public sectors in Japan.

MICROBUSINESS LOANS

Private Banks and Cooperatives

There are several types of banks and financial institutions that provide loans for small businesses in Japan (Table 4). According to the statistics of the Bank of Japan, total outstanding loans to SMEs amounted to ¥260 trillion (US$2.4 trillion) at the end of 2003, and ¥254 trillion (US$2.3 trillion) at the end of 2004. These figures include not only microbusinesses, but also larger SMEs. However, there are no other reliable statistics on the amount of loans only to small businesses.

Table 4. Outstanding SME Loans of Financial Institutions

Type of financial institution	Number of institutions	Number of branches in Japan	Loans outstanding (billion ¥)	Share (%)	Loan per branch (billion ¥)
Private financial institutions	607	23,897	233,183	89.7	9.8
Banks					
City banks	7	2,457	79,168	30.4	32.2
Regional banks	115	11,082	90,546	34.8	8.2
Others	29	340	12,384	4.8	36.4
Financial institutions for SMEs					
Credit associations	275	8,063	41,847	16.1	5.2
Credit cooperatives	181	1,955	9,238	3.6	4.7
Government financial institutions for SMEs	3	312	26,843	10.3	86.0
National Life Finance Corporation (NLFC)	1	152	9,238	3.6	60.8
Japan Finance Corporation for Small Business	1	61	7,618	2.9	124.9
Shoko Chukin Bank	1	99	9,987	3.8	100.9
Total	610	24,209	260,026	100.0	10.7

Source: Kinyu Journal (December 2004), Kinyu Journal Co.; *Nikkei Kiuyu Nenpo* (2004), Nikkei Shinbun Newspaper; Bank of Japan, "Monthly Financial and Economic Statistics"
Notes: "Outstanding loans": loans for SMEs, excluding other types of loans, e.g., loans for large companies or consumers. "Others": long-term credit banks and trust banks. "Loans outstanding": as of December 2003. "Number of institutions" and "Number of branches in Japan" as of March 2004.

City banks have been one of the main players in Japan's financial system. They mainly make loans to large companies and large SMEs, gathering deposits from branches in large city areas, and provide 30.4% of SME loans. Other big lenders to SMEs are regional banks, which have a 34.8% share of SME loans in Japan. They make loans to regional SMEs through over 11,000 branches all over Japan. There are 115 regional banks, most of which are prefecture based. These two types of bank are established under the Banking Code, which regulates the management and accounting of banks, mergers, or types of business they can/cannot do.

Historically, the modern banking system in Japan started with the enactment of the National Bank Regulations in 1872. Subsequently, many bank laws were enacted such as Deposit Bank Regulations (1890), Banking Regulations (1890), and Banking Code (1928).

There were 1,867 banks in 1901, in addition to credit cooperatives. However, as they were very small, the government encouraged them to merge, and the number was reduced to 61 in 1945. After Word War II, mutual financial banks were established under the Mutual Financial Bank Code (1951). They were rather small in size and their status changed to that of regular banks during 1988 to 1990.

Table 5. Types of Cooperatives in Japan

Types	Basic laws	Members
Agricultural co-ops	Agri. Co-op Law, Nov. 1947	Farmers, farmers groups, and residents in the area (associate)
Fishery co-ops	Fishery Co-op Law, Dec. 1948	Fishermen and fishermen's groups (associate)
Fisher productive association		Fishermen only
Marine products processing co-ops		Processors of fishery products
Forestry co-ops	Forestry Co-op Law, May 1978	Forest owners, forest operators, and employees in forestry (associate)
Credit associations	Credit Association Law, June 1951	Individuals, small- and medium-scale business managers
Credit co-ops	Small and Medium Scale Enterprise Cooperative Law, June 1949	Small business management
Common facility co-ops		Small entrepreneurs
Petty common facility co-ops		Small entrepreneurs, 1958
Mutual fire insurance co-ops		Small entrepreneurs, 1958
Joint enterprise co-ops		Petty entrepreneurs
Consumers' co-ops	Consumers' Co-op Law, July 1948	Individual
Labor credit associations	Labor Credit Association Law, Aug. 1953	Groups of laborers (labor unions, consumers' co-ops, etc.)

Source: Nohrin Chukin Research Institute website: www.nochuri.co.jp/tokei/pdf/chart12.pdf

Credit associations (275 associations with 8,063 branches) and credit cooperatives (181 cooperatives with 1,955 branches) are also important for SME financing, especially for small business financing. They are a type of bank established by small entrepreneurs and provide loans mainly to their own members, including business, real estate, and education loans. Credit associations are established based on the Credit Association Law (1951), and Credit Cooperatives fall under the Small and Medium Scale Enterprise Cooperative Law (1949) (Table 5). For credit cooperatives, the law requires "300 or more members and capital of ¥10 million (US$91,000), although ¥20 million (US$182,000) is required in big cities." Government officials examine whether directors of cooperatives are eligible to operate financial services and whether the business plan is appropriate. Some credit associations and credit cooperatives originated from the early 1900s, when the first Credit Corporation Act was enacted in Japan. As shown in Table 5, there also are agricultural cooperatives or labor credit associations, but the target recipients are limited. For example, agricultural cooperatives provide business loans mainly to farmers. The Financial Service Agency (FSA) supervises these financial institutions by law. The FSA regulates the capital adequacy of banks, and according to BIS regulations the risk asset-to-capital ratio is 8% for international banks and 4%

for domestic banks. The Bank of Japan (BOJ) conducts onsite examinations and offsite monitoring of client financial institutions that have current accounts with the BOJ on contract. The Deposit Insurance Corporation of Japan, a semigovernmental body, also investigates financial institutions with deposits. In general, from the perspective of protecting investors or depositors, the government is cautious in granting licenses for new financial institutions.

The legal requirement for new banks is to mobilize capital of ¥2 billion (US$18 million), have financial know-how, and generate revenue within three years; a detailed investigation to determine whether the plan is appropriate is added by the officials. The term of a license depends on the bank. Sony started preparations for the establishment of the Sony Bank in December 1999, started negotiations with the FSA in March 2000, and received a license in April 2001.

Table 6. Government Financial Institutions for SMEs (as of March 2004)

	National Life Finance Corporation (NLFC)	Japan Finance Corporation for Small and Medium Enterprise (JASME)	Shoko Chukin Bank
Established	1949	1953	1936
Capital (million ¥)	347,981 (100% government)	449,715 (100% government)	514,265 (78.8% government, 21.2% private)
Source of funds	Capital, bonds, Fiscal Investment and Loan Program (FILP)	Capital, bonds, Fiscal Investment and Loan Program (FILP)	Capital, bonds, deposits
Borrowers	Mainly small businesses	Mainly medium businesses	SME cooperatives and their members
Employees	Approx. 4,800	Approx. 1,700	Approx. 5,000
Branches	152	61	102
Loans outstanding to SMEs (billion ¥)	8,908	7,557	9,811
Maximum loan amount (million ¥)	48	480	20,000 (cooperatives) 2,000 (members)
Use of funds	Working fund, equipment fund	Working fund, equipment fund	Working fund, equipment fund
Repayment period	Working: 5 years, equipment: 10 years	Working: 5 years, equipment: 10 years	Working: 5 years, equipment: 10 years
Grace period	Working: 1 year, equipment: 2 years	1 year	1 year
Interest rate	Long-term prime rate (fixed rate)	Long-term prime rate (fixed rate)	Based on the firm's credibility, etc.

Source: Websites of each institution
Note: In July 2004 JASME merged with the SME Credit Insurance Section, which was one of the sections of Japan Small and Medium Enterprise Corporation (JASMEC). The section had a capital of ¥918,114 billion and 400 employees.

There is no limitation on the ownership of banks, although in credit cooperatives one investor cannot invest more than 10% of its capital. For example, Sony has an 84.2% share in Sony Bank, and only two other investors hold the remainder of the stock (as of July 2004), although many Japanese banks are public. Members of NGOs can invest in banks and co-operativess. Foreigners also can invest in banks. The US investor Cerberus Capital Management, L.P. procured 60% of the stock of the Aozora Bank in June 2003. Furthermore, there are many credit cooperatives established mainly by Korean residents in Japan.

Public Sector

Although 89.7% of SME loans in Japan are provided by the private sector, public financial institutions are also important for SME financing, especially for small business financing. There are three governmental institutions for SME financing: the Japan Finance Corporation for Small and Medium Enterprise (JASME), Shoko Chukin Bank (SCB), and National Life Finance Corporation (NLFC) (Table 6). The first two institutions provide loans to larger SMEs, while the NLFC concentrates on small or microbusinesses. The average loan size of the NLFC is approximately ¥6 million (US$55,000), which is much smaller than that of the SCB or other private financial institutions (Table 7). The institution utilization rate of the NLFC by SMEs is 31.8%, which is the highest among all types of financial institution. The Ministry of Finance and Ministry of Health, Labor and Welfare supervise the NLFC, and the FSA and Board of Audit of the government investigate them as well.

Table 7. Average SME Loan per Customer

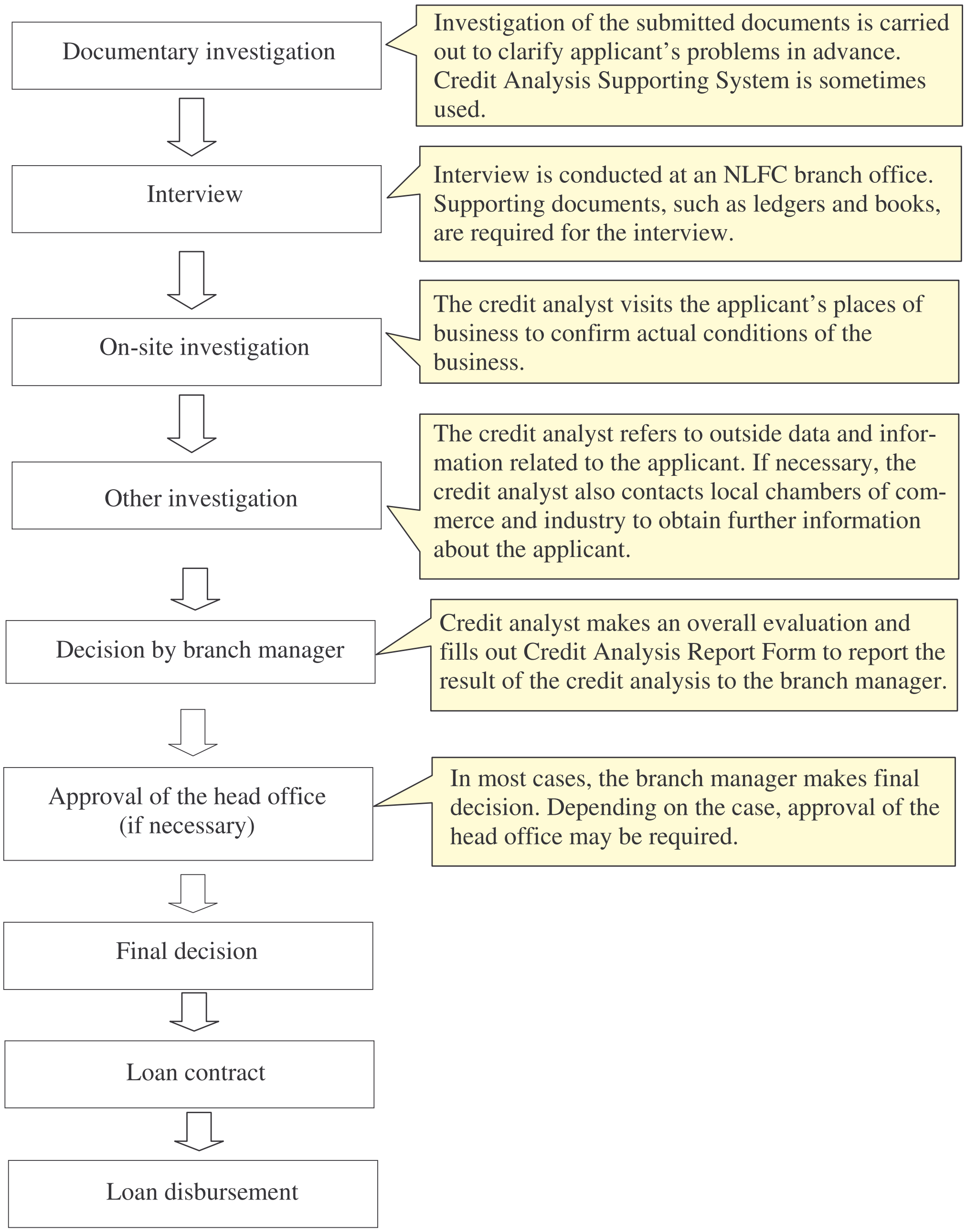
Type of financial institution		Number of customers	Share (%)	Average loan outstanding/ customer
Private financial institutions	City banks	62,000	13.2	¥144 million
	Regional banks	191,000	40.7	¥48 million
	Credit associations	139,000	29.6	¥30 million
Government financial institutions for SMEs	National Life Finance Corporation (NLFC)	149,000	31.8	¥6 million
	JASME	19,000	4.0	¥40 million
Number of small businesses (reference)		469,000	100.00	–

Source: National Life Finance Corporation, "Annual Report 2003" (in Japanese)
Note: There is a double count of the numbers of customers of private banks. For example, if a firm receives loans from three city banks, that firm is counted three times. Hence the banks' actual shares are much less than shown above.

Some local governments also offer similar loans, although the amounts are not large. However, the Tokyo Metropolitan Government established the New Bank of Tokyo with prefecture governmental funds starting in April 2005. Its outstanding SME loans are scheduled to amount to ¥930 billion (US$8.5 billion) by 2008.

The National Life Finance Corporation

The NLFC is a governmental finance institution that provides loans to very small businesses in Japan. It also offers consumer loans such as education loans. Its outstanding business loans total ¥9,238 billion (US$84 billion), which is 3.6% of all SME loans, but the NLFC concentrates on the smallest category of SMEs compared with other banks and governmental institutions. Its average loan amount is about ¥6 million (US$55,000), and the average term is approximately five years. Among its customers, 95% are SMEs with fewer than 20 workers, and 65% of those have fewer than five workers.



Source: Prepared by the author

Fig. 1 Methodology of Loans by NLFC

Founded in 1949 to promote small/microbusinesses in postwar Japan, the NLFC has been providing loans. Many large companies used those loans in their early stages decades ago. Now the NLFC employs 4,800 staff at 152 branches nationwide. The government funded all of its capital of ¥348 billion (US$3.2 billion). The NLFC borrows most of its needed cash flow from government funds, which are originally mainly from the postal savings system. The corporation also acquires subsidies from the government for special-aid low-interest loans such as for environmental investment. It does not offer deposit services. For the promotion of small businesses, most NLFC loans are provided at the fixed long-term prime rate.

Methodology of NLFC Lending

The NLFC has accumulated know-how in microlending during its long history. A summary of the loan procedure is shown in Fig. 1. NLFC staff not only carry out document reviews and interviews, but also onsite investigations or other inquiries if needed. The headquarters supports branch officers in making decisions. Such combined investigations resulted in a low default rate of 3.9% as of March 2004.

In addition to the low default rate, loans by the NLFC to individuals or small companies usually have guarantors, who are usually individuals related to the business or business owners, e.g., executives of firms, family members, relatives, friends, and/or persons with business relationships. The NLFC, like other banks and financial institutions, also investigates guarantors' private assets, income, and other information so that the institution can collect money in case of default. The guarantor(s) is asked to sign the loan contract with the borrower to make the guarantee contract valid. About 80% of loans are granted without collateral but with guarantors, including family members and third parties. The guarantee system softens credit risks for two reasons: First, borrowers will have a bad reputation among guarantors or local society if they refuse to repay. Second, repayment from guarantors can be collected if borrowers cannot repay loans. However, exerting peer pressure without a contract is illegal. Moreover, 7% of NLFC loans are made with no collateral and no guarantees, which are called smaller business loans (SBLs).

Table 8. Scheme of a Small Business Loan

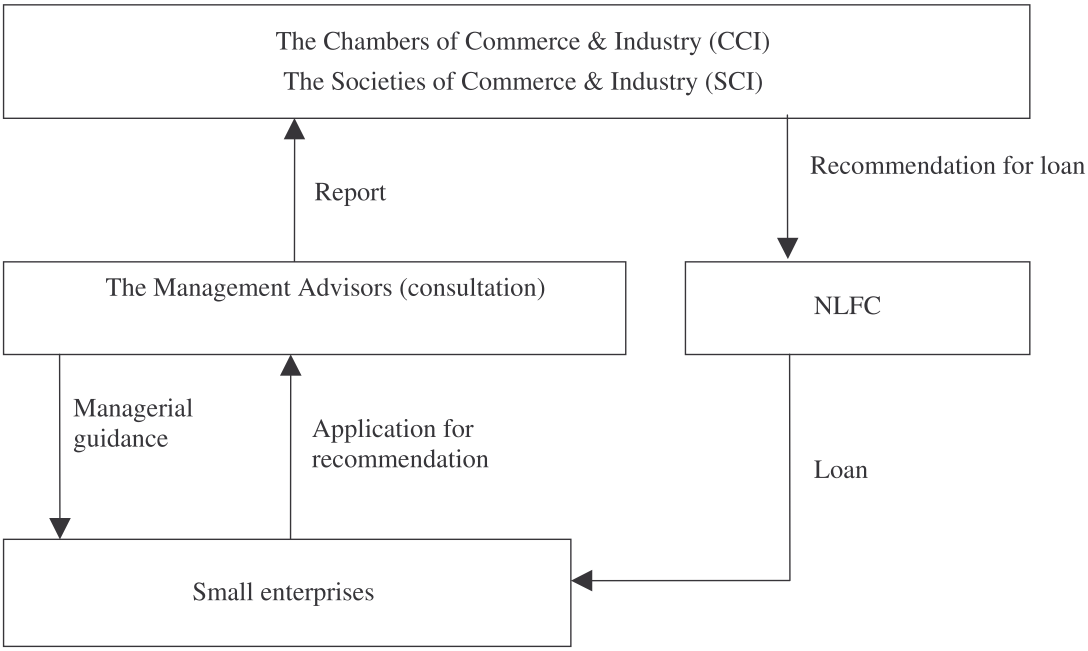
Object of loan	Commerce and service businesses with 5 or fewer employees; manufacturing and other businesses with 20 or fewer
Recommendation of CCI or SCI	All applications are required to obtain recommendation of CCI or SCI
Requirements for the recommendation	6 months managerial guidance; more than 1 year business in the same area; taxes paid up
Terms and conditions	
Maximum amount	¥5.5 million (xtra loan limits: $ 4.5 million)
Period	Equipment fund: 7 years or less; operation fund: 5 yrs or less
Interest rate per annum	1.3%
Remarks	No guarantor or collateral necessary

Source: National Life Finance Corporation, "Annual Report" 2003 and 2004
Note: Interest rate may change according to the market rate. It is 1.35% as of March 2005.

As the NLFC does not have deposit services, it only checks monthly repayments from customers, without additional interviews or documents. When customers fail to pay, officers call on them and ask why they failed to make a payment. If many payments are missed, officers visit borrowers' shops or factories to investigate. Some customers visit the NLFC to request rescheduling of loan payments. The NLFC occasionally changes the monthly repayment schedule after reinvestigation, so that customers can survive a tough financial situation. Currently, 6.5% of the outstanding loan amount of the NLFC is rescheduled. These methods are the least costly ways for the NLFC to control huge numbers of loans in a large area.

Smaller Business Loans: Cooperation with Chambers/Societies of Commerce and Industry

SBLs are a special type of loan for small/microbusinesses that are members of Chambers of Commerce and Industry (CCIs) or Societies of Commerce and Industry (SCIs) (Table 8). The target customers are SSEs as defined under the law (Table 1). The NLFC provides these loans without collateral and guarantors, according to the recommendations of CCIs or SCIs (Fig. 2).



Source: Prepared by the author

Fig. 2. Scheme of Small Business Loans

Under this scheme, SSEs can procure no-collateral, no-guarantor loans with the requirement for managerial guidance by advisors. SBL amounts are limited, although sufficient for many microbusinesses. For the financial institution, this system reduces credit risk, because a CCI or SCI has a close relationship with borrowers and better information than NLFC branches. Based in the same community, they monitor microbusinesses and give the NLFC information on customers if they fail to repay. Although CCIs or SCIs are not obligated to pay back money or pay penalties, SBLs give borrowers a high incentive to repay.

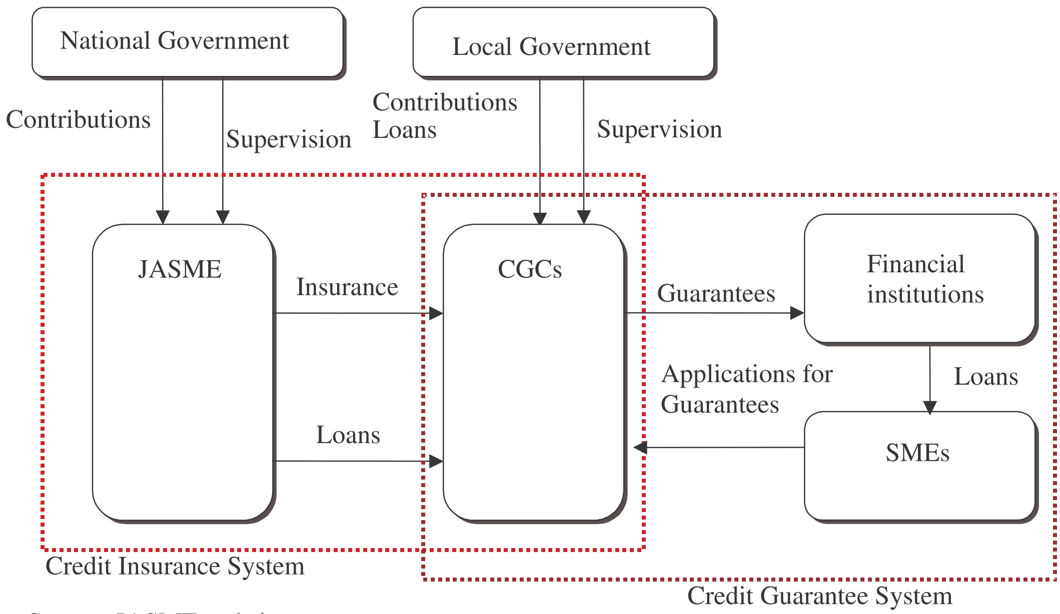
LOAN GUARANTEE SYSTEMS

There are semigovernmental credit guarantee systems in Japan. Fifty-two Credit Guarantee Corporations (CGCs) with 5,944 staff help private banks to provide microloans and offer credit guarantees to banks and cooperatives for SMEs (Table 9 and Fig. 3). The Japan Small and Medium Enterprise Corporation (JASMEC), which is a governmental institution, offers reinsurance for CGCs. These corporations operate under the Small Business Credit Insurance Law (1950) and Credit Guarantee Corporation Law (1953).

Table 9. Credit Guarantee Institutions

Credit Guarantee Corporation (CGCs)	52 independent CGCs throughout the country
	Capital contributed by local governments and financial institutions
	Operating funds from local governments and JASME
	100% coverage
Japan Finance Corporation for Small and Medium Enterprise (JASME)	Reinsurance of the guarantee liabilities of CGCs
	70%–80% coverage
	Reserve funds supplied by the national government

Source: JASME website



Source: JASME website

Fig. 3. Small Business Credit Guarantee and Insurance Systems in Japan

Eligible companies or individual business bodies that receive CGC guarantees are SMEs as defined under the law. The Annual Report of the National Federation of CGCs stated that the outstanding loan guarantee liability of CGCs amounted to ¥33,189 billion (US$302 million) as of March 2003, which is approximately 12% of SME loans in Japan. The ceiling for a general guarantee for SMEs is ¥200 million (US$1.8 million), and thus many larger

SMEs can receive CGC guarantees. Of the 2 million companies using CGC guarantees, about 40% are SMEs. This means that many microbusinesses also use them.

The first CGC, the CGC of Tokyo, was established in 1937, and most were already in existence by the late 1950s. Since then, CGCs have been supporting microbusinesses and facilitating microcredit through guarantees.

OTHER MICROFINANCING INSTITUTIONS

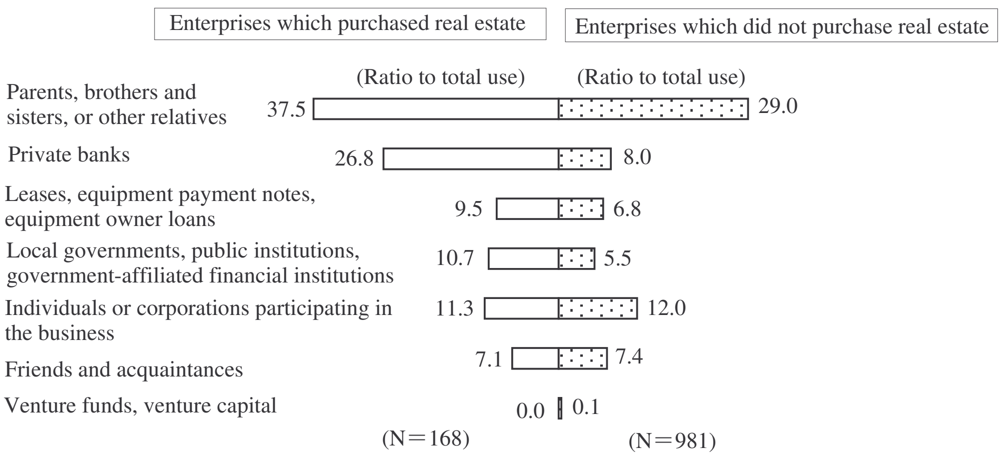
Nonbanks

In addition to the private and governmental financial institutions explained above, there are several lenders for small/microbusinesses. Financial companies that are nonbanks, including leasing companies, had ¥24.5 trillion (US$223 billion) in businesses loans as of March 2001, which is almost 10% of all small business loans. Those loans include loans for larger medium-sized businesses, although they are also important lenders for microbusinesses.

According to a survey of small businesses (most had fewer than 20 employees) by the NLFC in 1998, 5.4% used auto loans, 2.9% business credit cards, and 2.4% nonbank business loan providers. Those loans were both collateralized and noncollateralized. The latter type usually require guarantors. Nonbank interest rates are usually around 20% to 25% per annum. The respondents stated that the overall advantage of using such lenders is speedy approval, although interest rates are rather high.

Informal Lenders

The 1998 survey by the NLFC referred to above showed that 8.8% of small business financing is provided by agents other than financial institutions. However, most are considered to be loans to founders of small companies from their families or relatives. NLFC research on business start-ups showed that 37.5% of enterprises that did not purchase real



Source: National Life Finance Corporation Research Institute "Survey on Business Startups" (2002)

Note: Since this survey targents enterprises receiving funding from NLFC, the category of "Local governments, public institutions, government-affiliated financial institutions" excludes NLFC.

Fig. 4. Sources of Capital Procurement Used in Startup (Multiple Response, %)

estate procured funds from “parents, brothers, and sisters or other relatives” and 7.4% from “friends and acquaintances” (Fig. 4).

Historically, informal financing systems called *kou* or *mujin* existed, which were a kind of mutual financial aid system among villages or towns. The first document mentioning *kou* was written in 1275; in 1911, farm households relied on informal sources for 69% of their financial loans. About 300,000 *kou* still existed in 1934. Such informal financing has almost disappeared because of the emergence of formal financial institutions, although some became the parent bodies of cooperatives or mutual banks. The existence of sound banks and cooperatives in which people could deposit their money also reduced investment in informal lending. *Kou* have almost disappeared in Japan, except in Okinawa, where 11% of financing was offered by *kou* in 1979 and many still existed in 1991.

There are two types of illegal lenders: those who make loans without licenses and licensed nonbanks that make illegal loans. Their customers are usually consumers, but people also use the loans for business. The amount of loans and users of loans are not clear, as the practice is illegal. Interest rates on illegal loans are very high, and repayments are sometimes collected by illegal means. The Japan Federation of Bar Associations appealed for a special law against illegal lenders on 22 November 2002. In its statement, it noted that some illegal loans had interest of more than 1,000% per annum.

LEGAL INFRASTRUCTURE FOR MICROFINANCING

Various laws such as the Civil Code, Commercial Code, and Code of Civil Procedure ease the activities of microbusinesses and microfinancing, in addition to laws concerning banks and cooperatives. The Civil Code was enacted in 1896, influenced by the European Civil Codes. It contains the following sectons: 1) General Provisions, 2) Real Property, 3) Obligations, 4) Family, and 5) Succession (rules of inheritance). Business actions are controlled especially by the first three sections. The General Provisions cover personal rights, corporations, statute of limitations, etc. The Real Property section sets rules for proprietary rights, mortgages, etc. The Obligations section covers the basics of financial borrowing/lending contracts, joint obligations, or guarantors’ rights and obligations. Under this code, financial institutions cannot demand repayment of loans from peers, families, or other relatives who are not loan guarantors.

The Commercial Code, enacted in 1899, covers business registration, accounting, and how to operate companies. The Code of Civil Procedure sets out legal procedures for the collection of loans, including enforced auction of real estate or other assets. Because of these codes and other laws, at Legal Affairs Bureaus and their branches, people can register companies or real estate including mortgage information, and the public can view the documents at bureau offices. Official real estate files are now available on the Internet through a contract with bureaus. For land registration, maps drawn in the 19th century had been used for a long time, which contained many errors. Under the Land Survey Law (1951), a nationwide mapping survey was started. However, as there are many land units and owners, the procedure was very slow. In March 2001, the survey was finished and new maps drawn, but they covered only 43% of land and 17% of city areas. The government is accelerating the procedure using cheaper and easier systems such as the global positioning system.

The codes have been revised many times based on the social situation and need. For example, the Civil Code revision in 1947 noted legal equality between men and women, and first and second child, and changed the rules of inheritance. The latest revision of the Civil Code in 2005 will feature unlimited guarantees.

Under the Bankruptcy Code of 1923, bankruptcy is authorized by local courts, and bankrupt people usually are from exempted from repaying their debts after giving up all assets. The law protects debtors from illegal loan collection methods such as threats, gives debtors a chance to recover from too many loans, and maintains equality among creditors. The revision in 2005 increased the rights of bankrupt people. However, when a business is small, debtors and creditors prefer nonlegal liquidation, because official bankruptcy procedures authorized by law are lengthy.

Loan interest rates are regulated by two laws: the Law Concerning the Regulation of Receiving of Capital Subscription, Deposits, and Interest on Deposits and the Interest Rate Restriction Law. The first limits interest rates to 29.2% per annum. Violators are punished with penal servitude for not more than three years or a fine of not more than ¥3 million, or both. The second restricts the interest rate to 15% per annum when the principal is ¥1 million or more, although there is no penalty for violators. Bank interest rates are usually less than 15%. However, many nonbanks make loans at interest rates in the gray zone, between 15% and 29.2%.

The government once stopped regulating deposit interest rates in 1994 under its deregulation policy, but in 2002, when a banking system crisis occurred, it began again. Currently, interest rates for ordinary deposits are at the same rates as those for one-year time deposits, with some exceptions. Checking accounts bear no interest. There is no limit on interest for time deposits.

OTHER FINANCIAL SERVICES

Microdeposits

Banks and cooperatives provide almost all services including business and consumer loans, deposits, checking, transfer payments, foreign exchange, and remittance services (Table 10). They provide services for large and small companies and individuals. There are bank or cooperative branches in most towns throughout Japan, although some areas are isolated from bank branches and have difficulty accessing private financial institutions. Instead, Japan Post provides savings accounts, money orders, and insurance in addition to postal services, but does not make loans to companies or individuals, through a branch network denser than that of any other financial institution. Japan Post is a public corporation established on 1 April 2003, which took over from the governmental postal service. Currently, pro-

Table 10. Deposit Financial Institutions (as of March 2004)

Type of institution	Number of institutions	Number of branches in Japan	Deposits (billion ¥)	Share (%)	Deposit per branch (billion ¥)
Private financial institutions	607	37,032	757,980	76.9	20.5
Banks					
City banks	7	2,365	263,778	26.8	111.5
Long-term credit banks	2	49	5,321	0.5	108.6
Trust banks	27	291	36,798	3.7	126.5
Regional banks	115	11,082	241,509	24.5	21.8
Co-ops					
Credit associations	275	8,063	105,506	10.7	13.1
Credit cooperatives	181	1,955	15,253	1.5	7.8
Labor credit unions	22	685	13,830	1.4	20.2
Agricultural unions	1,092	12,542	75,976	7.7	6.1
Japan Post	1	24,715	227,372	23.1	9.2
Total	608	61,747	985,352	100.0	16.0

Source: Kinyu Journal, December 2004

cedures for privatizing government corporations are a critical political issue. To monitor the business or financial situation of borrowers, banks and cooperatives can check the movement of savings or checking accounts, which show the cash flows of their customers clearly.

Micro-insurance

There are three main types of insurance in Japan: private, cooperative, and postal. Insurance providers have licenses under the law, but there are a number of nonlicensed cooperative insurance providers. Private banks are basically prohibited from selling insurance except for limited pension insurance and house fire insurance. The government is considering allowing them to sell more types of insurance within several years. Both licensed and unlicensed insurance institutions are regulated by the Law Concerning the Regulation of Receiving of Capital Subscription, Deposits, and Interest on Deposits.

According to the Japan Cooperative Insurance Association, the market share of life insurance funds in terms of the amount insured for is: private life insurance companies, 67.2%; cooperative insurance, 22.4%; and postal insurance, 10.4%. Measured by the number of insurance policies, the share of private life insurance companies is 47.5%, cooperative insurance 20.2%, and postal insurance 32.3%. For nonlife insurance in terms of the amount insured for, the market share is private nonlife insurance companies 83.2% and cooperative insurance 16.8%; for the number of policies, it is private nonlife insurance companies 61.3% and cooperative insurance 38.7%. These data suggest that postal insurance and cooperative insurance are less widespread than private insurance policies. The average annual fee for cooperative insurance is ¥46,000 (US$420) and average claim is ¥7.6 million (US$69,000).

The largest private life insurance company, Nihon Life Insurance, has assets of ¥32.4 trillion (US$295 billion), an independent branch system, and numerous salespersons throughout Japan. Japan Post has provided postal life insurance since 1916 at every post office (about 24,000), and its assets outstanding amounted to ¥122.6 trillion (US$1.1 trillion) in March 2000. Hence, private insurance companies claim that postal life insurance has become too large.

Cooperative insurance amounted to ¥41.6 trillion (US$380 billion) in assets, most of which was in agricultural cooperative insurance. The National Mutual Insurance Federation of Agricultural Cooperatives also provides life insurance through agricultural cooperatives (about 14,000 branches) with total assets of ¥37.3 trillion (US$340 billion) including life, home, and car insurance.

CONCLUSIONS: MICROFINANCE FOR ECONOMIC GROWTH

Microfinancing in Japan is not for poverty alleviation. However, the government realizes the importance of supporting microbusiness growth. Japan has many types of microfinance institutions (Fig. 5). The system appears complex, but each institution has its own attributes. Both private and public financial institutions have contributed to fostering microbusinesses, and many have grown into medium-sized businesses or large companies.

Japan's banking system has been beleaguered since the collapse of the bubble economy in the early 1990s because of the accumulation of nonperforming loans and capital shortfalls. Many banks including some major ones have been bankrupted. Banks are now reluctant to make new loans, especially for small or microbusinesses. Loans outstanding to SMEs have been decreasing since 1996, yet the decrease appeared to halt in 2004. The government injected public funds into 32 banks under the Financial Function Early Strengthening Law while banks submit rehabilitation plans to the FSA. Twenty-one banks in 1998 and 15 banks in 1999 received such governmental funds. However, many could not achieve solvency and received business improvement orders from the FSA. Only 11 of 32 banks were in the black

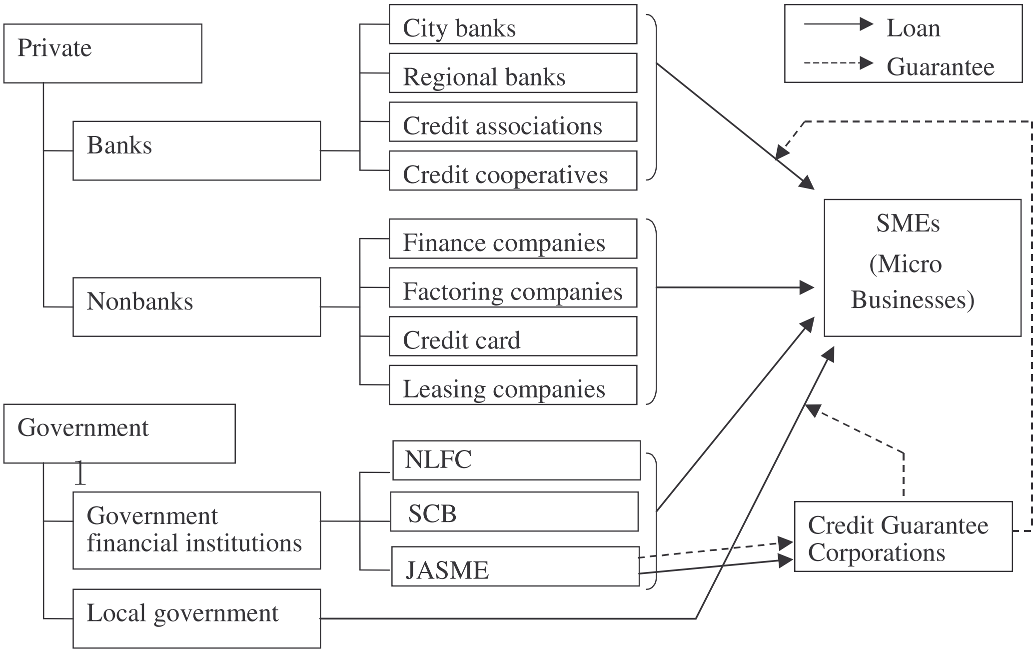


Fig. 5 SME Financing System in Japan

in March 2003. Furthermore, the Resona Group received an extra ¥1.96 trillion (US$18 billion) in public funds for rehabilitation in June 2003 and was nominally nationalized. On the other hand, the government is planning to restructure the public financing system.

However, the importance of microfinancing has not changed. Research by the NLFC showed that 64.5% of small businesses had some difficulty in financing all the cash they needed. The government provides a certain amount of budget for public microfinancing institutions. The bad loans were not originally microbusiness loans, but from the failure of investments in real estate. Japan is now struggling to recover, and the microfinance system could be modified based the needs of current microbusinesses. In addition, the microfinancing system in Japan started with informal lending, which is now common in many other Asian countries. However, Japan has constructed a legal framework for financing and established private banks, credit associations, and credit cooperatives. Many informal lenders were transformed into such formal finance institutions. Hence, all or part of the Japanese microfinancing system could be applicable in other countries.

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LAO PEOPLE'S DEMOCRATIC REPUBLIC

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INTRODUCTION

The Country's Development Strategy and the Role of Microfinance

Lao PDR is a landlocked country located in Southeast Asia, sharing borders with Thailand to the west, Vietnam to the east, China and Myanmar to the north, and Cambodia to the south. In 2004, Lao PDR had an estimated population of about 5.67 million, with an annual growth rate of 2.5%, and a land area of 236.800 square kilometers. Lao PDR is endowed with abundant natural resources such as forestry, minerals and hydroelectric power. Agriculture remains the major sector of the economy, contributing around 53% of GDP and employing over 80% of the labor force. The industrial and service sectors account for 23% and 26% respectively. Gross Domestic Product (GDP) per capita was estimated at US$ 356 in 2003.[1] Real GDP growth was 5.3% in 2002/03, compared to the authorities' estimate of 5.9%. The estimated unemployment rate was 5.7% in 2000. The country's fiscal position remains weak, with a budget deficit (excluding grants) amounting to 5.7% of GDP in 2002/03.

Lao PDR is categorized by the World Bank and other international organizations as a "least developed country" (LDC). Nearly 77% of its population live on less than US$ 2 a day and 39% (in 1977/98) below the national poverty line of US$ 1.5 a day[2] (Appendix, Table 4). Eighty percent of the Lao people live in rural areas, where poverty is most concentrated. The number of poor households is estimated to be 252,449,[3] which accounts for 28% of the total number of households in the country.

However, it is estimated that only 7% of poor households have access to rural finance and microfinance services. Access to basic financial services, such as a safe place to deposit savings and to borrow money at affordable rates, is an important tool for people who hope to be able to increase their incomes, build their businesses, and manage the events of their life cycles. Therefore, the Lao PDR government intends to promote the development of the rural finance and microfinance sector in order to increase the outreach to meet the unmet demand of people who do not have access to the banking system's services. Substantial and sustainable development of the sector can significantly contribute to the implementation of the government's policy for poverty reduction, as stimulated in the Millennium Development Goals and the National Poverty Eradication Paper (NPEP).

The National Development Strategy and Policies

In 1986, the government of Lao PDR began to transform its centrally planned economy towards a market-oriented economy under the "New Economic Mechanism" (NEM). Gradually, price controls were removed, farmer were allowed to work on their plots, the exchange rate system was unified, the government's monopoly on trade was removed, the number of state enterprises was reduced, and private enterprises were allowed to be formed. As a result, the Lao economy posted an average growth of 7% during the period 1988–1996. Beginning in mid–1996, however, a slowdown in reform efforts had a negative impact on the economic situation. Also, since Laos depends heavily on Thailand for its trade, its economy was further

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[1] Social-Economic Development Plan Report for 2002–2003 and Social Economic Development Plan for 2003–2004.

[2] World Bank, "Lao PDR." *Economic Monitor,* October 2003.

[3] Lao PDR, Macroeconomic Policy and Reform Framework discussion paper prepared for the policy dialogue meeting in the context of the roundtable process 2000-2002. Vientiane, August 2000, pp. 51-52.

affected by the Asian financial crisis in 1997. Successful stabilization began in 2000, and structural reform picked up momentum in 2001.

Laos's economic base remains agricultural, with agriculture accounting for 55% of GDP and providing 80% of total employment. Despite gains in economic growth in the 1990s, the national budget deficit remains high, and is primarily financed through external assistance. While Laos is rich in natural resources, their efficient and sustainable exploitation is constrained by an underdeveloped infrastructure, a dearth of technical and managerial skills, and limited domestic capital. As a landlocked country, Laos has no railroads, a rudimentary road system, and limited internal and external telecommunications. Two-thirds of its population is still engaged in subsistence agriculture. Hence, the transformation of household economic bases to more sustainable income-generating activities through diversification and encouragement of secondary income are key components of the government's strategy for poverty alleviation.[4]

In April 2002, the government of Lao PDR finalized an Interim Poverty Reduction Strategy Paper.

In the Lao PDR, most public investment is directly or indirectly linked to poverty eradication, be it short-, medium-, or long-term. Throughout the National Poverty Eradication Program (NPEP), the government stresses the role of all economic sectors including the private sector as the main engine for growth, and insists on the enhancement of a favorable business environment as one of the four pillars of macroeconomic stability and growth. Private sector development, including foreign direct investment (FDI), will provide part of the needed resources for national development.

The fiscal year 2003–2004 was a year of transition and consolidation to prepare for the full implementation of the NPEP. Decisions taken by the government regarding the legal framework, capacity building, and the strengthening of conditions, policies, and measures which are necessary for the enhancement of the macroeconomic environment and private sector development require sufficient lead time to become effective. For the purpose of the NPEP, the government has chosen to favor an intermediate, medium-term approach while simultaneously preparing for an in-depth, long-term approach to the funding of priority areas. This will be done within the context of an annually adjusted medium-term framework and a three-year time horizon leading to a rolling set of investment priorities for the Public Investment Program (PIP) and the NPEP. The investment priorities are linked to the programs' dual objectives:

1. Enhance the conditions for sustainable growth and development and the continuous building up of the country.
2. Eradicate poverty.

The government's vision for the financial sector reflects these poverty reduction goals, as well as the objective of meeting international standards. The financial sector will be supportive of broad-based sustainable economic growth and of the reduction of poverty. The financial sector will help enable the government to achieve its goal of graduating from the "least developed country" (LDC) status by 2020. Therefore, the financial system will have the depth needed for economic growth and development and will promote macroeconomic stability. There will be strong bank and nonbank institutions that efficiently allocate the country's resources to the most productive investments and income-generating activities of the people nationwide. The sector will be diversified and will provide wide access to financial services and extensive market reach.

[4] The National Meeting for Poverty Reduction 1, 2003.

The specific national development targets that the government of Lao PDR is currently finalizing in its National Poverty Eradication Program (NPEP) and expects to further develop are shown in Table 1.

Table 1. Government Development Targets to 2020

Indicator	Recent	2005	2010	2020
Annual GDP per capita (US$)	350 (2000)	500–550	700–750	1200–1500
Average annual GDP growth (%)	5.2 (1999)	7.0–7.5	7.0	7.0
Total population (millions)	5.3 (2001)	5.9	6.7	8.3
Annual population growth (%)	2.8 (2000)	NA	2.4	2.2
Life expectancy at birth (years)	59 (2000)	63	67	70
Infant mortality (deaths/1,000 live births)	82 (2000)	62	40	20
Maternal mortality (deaths/ 100,000 live births)	530 (2000)	350	250	130
Access to clean water (% of population)	56 (2000)	57	100	100
Adult literacy (%)	73 (1999)	78	84	90

Source: "United Nations Development Assistance Framework 2002–2006, The Lao PDR," United Nations, 2002

MICROFINANCE AND ITS ROLE IN ALLEVIATING POVERTY AND GENERATING EMPLOYMENT

As mentioned above**,** Lao PDR is categorized by the World Bank and other international organizations as a "least developed country" (LDC). Eighty percent of the Lao people live in rural areas, where poverty is most concentrated. The number of poor households is estimated at 252,449,[5] which accounts for 28.08% of the total number of household in the country. Only 7% of poor households have access to formal banking services. If targeted properly, microfinance can be an effective tool to fight poverty in the country.[6] Access to basic financial services such as safe places to deposit savings and to borrow money at affordable rates is an important tool for people who want to increase their incomes, build their businesses, and manage the events of their life cycles. Therefore, the Lao government intends to promote the development of the rural and microfinance sector in order to increase outreach so that people who do not have access to the banking system's service can satisfy their financial needs. Substantial and sustainable development of the sector can significantly contribute to the implementation of the government's policy for poverty reduction, as codified in the Millennium Development Goals and the National Poverty Eradication Paper.

However, a large demand for microfinance services, and in particular for savings, remains low, due to the fact that the Lao population in rural areas is highly dispersed, and limited infrastructure adds to the cost of financial intermediation and inhibits information flows for lenders and borrowers. These factors, combined with poor geographical conditions and the small-scale nature of transactions, pose serious challenges for developing the rural and microfinance sectors. It is estimated that 20% of households (about 160,000) live in such

[5] Lao PDR, Macroeconomic policy and reform framework discussion paper prepared for the policy dialogue meeting in the context of the round table process 2000-2002. Vientiane, August 2000, pp. 51-52.

[6] Asian Development Bank, *Finance for the Poor: Microfinance Development Strategy* (Manila: ADB, 2000). S. Charitoenko and S.M. Rahman, *Commercialization of Microfinance* (Manila: ADB, 2002). See also CGPA publications at www.cgpa.org.

remote areas that it may be difficult to develop even microfinance operations.[7] Estimates show that only 25% of potential microfinance borrowers and potential microfinance depositors have access to microfinance services (Appendix, Table 1).

In Lao PDR, a microfinance industry has only started to develop in the last four years, and it is still limited compare to other countries in the region such as Cambodia, Indonesia, and the Philippines. Microfinance was first introduced by a United National Development Capital Fund (NDCF)/United Nations Development Programme (UNDP)-funded project. There are currently more than 20 donor- and NGO-funded projects that include microfinance as a project component. However, it can be said that a certain form of microfinance for rural farmers had been undertaken prior to that time through policy lending. Microfinance was created in the Agriculture Promotion Bank (APB) by the government in 1993 to meet unfilled needs for agriculture and rural finance. However, at present the microfinance sector in the Lao PDR is still in its infancy stage, with five different types of suppliers. The first is the Agriculture Promotion Bank (APB) and the government-owned policy bank, which focus on the agricultural sector: APB promotes specific subsectors and lends at subsidized rates. Second, the Lao Development Bank (LDB), a state-owned commercial bank (SOCB), started microlending recently, with a focus on micro-traders. The third type of supplier is the Village Revolving Fund (VRF): there are approximately 1600 VRFs, mostly donor-funded and with limited outreach. Fourth, there are three microfinance initiatives: Cooperative de Crédit de Soutien aux Petites Unités de Production, or Credit Cooperative for Promotion of Small Producers (CCSP), Microfinance Project (MFP), and Project Development Rural du District de Phongsaly, or Phongsaly Disctrict Development Project (PDDP), with no more than 2,500 active borrowers each. Finally, there are numerous moneylenders who offer loans at usurious rates. (A comparison among the different types of microfinance providers is shown in the Appendix, Table 3.)

Despite this situation, there was until recently no overall strategy to develop the rural/microfinance sectors. As a part of poverty reduction, the government's policy to support access to rural/microfinance has been implemented primarily by the Agriculture Promotion Bank (APB), whose operations are subsidized with interest rates determined by the government. The APB's outreach is limited because it depends on the limited funding available from the government and donors. Until now the APB has carried out both financial and nonfinancial activities (e.g., distributing fertilizer and equipment), reflecting its mixed mandate as a financial institution and a development organ of the state.

The Major Service Providers

The Formal Sector

The formal banking system in Lao PDR comprises the Central Bank (BOL); three state-owned banks: Banque pour le Commerce Exterieur Lao (BCEL), Lao Development Bank (LDB), and Agriculture Promotion Bank (APB); three joint venture banks (JVBs); seven foreign commercial banks with branch offices; and one foreign commercial bank (FCB) with a representative office. All banks have their headquarters in Vientiane. APB has established the largest branch network in Lao PDR, with a head office in Vientiane, 18 branches in the 17 provincial capitals and Vientiane municipality, and 55 subservice units at the district level. LDB has a head office in Vientiane and 17 branches, one in each province. BCEL has three branches. The Lao–Viet bank has a branch In Champasak. The other JVBs and FCBs have no branches and hence no provincial outreach other than into the area around Vientiane municipality.

[7] These households effectively have no road access at any time of year.

The Semiformal Sector

The semiformal sector in Lao PDR is poorly developed. Three initiatives were begun in 1996 or 1997: the Microfinance Project, Cooperative de Crédit de Soutien aux Petites Unités de Production (CCSP), and Project Development Rural du District de Phongsaly (PDDP). More recent initiatives are the Rural Development Cooperative (RDC), begun in 2001, and the piloting of three credit unions with APB support, which commenced in early 2003. There are no significant domestic NGOs, but since the early 1990s many international NGO operations have been established. About 35 international NGOs have established projects that manage about 1600 village revolving funds (VRFs), mostly using the Lao Women's Union (LWU) for implementation. The methodologies used in these schemes are not those of the mainstream successful microfinance organizations (MFIs). While using mass organizations has certain advantages because they are community-based and can effectively target the poor.

A brief outline of each product offered by the main providers is given in Table 2.

Table 2. Brief Outline of Products Offered by Main Providers

Provider	Methodologies
APB	• Individual loan but to a group guarantee of 7 families (3–12 members in a group). The solidarity groups may collectively borrow from a bank and then distribute the proceeds of the loan among themselves • Loan maturities are 6 months, 1 year • Individual loans are usually very small (US$ 50)
MFP	• Individual loan but to a solidarity group of 20–40 people. The Solidarity groups may collectively borrow from a bank and then distribute the proceeds of the loan among themselves • Loan maturities are usually short at the beginning • Individual loans are usually very small (US$ 50) • Individual saving is use to build up group insurance against default • Monthly repayment
CCSP	• Individual loan but to a solidarity group of 3–12 members on their own initiative; the group chooses one member as group leader. Group members are generally trusted neighbors who are ready to jointly accept a loan and then distribute the proceeds of the loan among themselves • Individual loans up to a current loan ceiling of LAK 10 million (US$ 1,053) • Standard loan duration of 6 months • Monthly interest payments and repayment of principal at maturity date • Apart from the group liability, the following additional loan security is required: *original land title, *declaration that the heirs assume debts in the case of borrower's death, and *guarantee from persons outside the solidarity group if necessary
PDDP	• Joint guarantee from solidarity group of 5 families • Decentralized credit system serves as village banks for farmers (loan for cash crops, livestock, handicrafts, and petty trade) • One scheme per village; each village scheme is autonomous and self-managed by the villagers, who elect a credit committee once a year; farmers are free to participate and free to leave the scheme when they desire • Scheme members get loans for a one-year cycle, at the end of the cycle, the member repays money to the scheme

Performance of the Microfinance Initiative in Lao PDR

The Microfinance Project

In cooperation with the government, the United Nations Capital Development Fund (UNCDF) and the United Nations Development Program (UNDP) launched a microfinance project in late 1997. The project had two components. The first was a national component aimed at creating optimal conditions for the emergence of an enabling environment for the development of microfinance by supporting a Microfinance Task Force to sensitize senior policy makers and other stakeholders to the sustainable microfinance provision mechanisms that needed to be established, such as financially viable microfinance institutions (MFIs), microfinance funds, savings and credit unions, and the establishment of a Microfinance Training Centre. Second, the project established three microfinance services units. Two rural/microfinance services units were established (as government agencies) in Oudomxay and Sayabury Provinces, using group lending methods. A third initiative in Vientiane aimed to consolidate the experience of the Sihom Project Savings and Credit scheme (SIPSACRES), an urban credit and savings cooperative founded under an earlier UNDP Project in 1995. UNDP and UNCDF support for the project ended in June 2002, and the project is currently managed by the government. It serves about 3000 clients in total, and the interest rate is 4% per month.

Cooperative de Crédit de Soutien aux Petites Unités de Production (CCSP)

The CCSP (Credit Cooperative for Promotion of Small Producers) was founded in 1996 on the initiative of a group of Lao entrepreneurs; it is the only cooperative that is registered with the Central Bank. It currently comprises nine member-owned cooperatives. It provides microfinance for agriculture, handicrafts, small industry, and services in the vicinity of Vientiane. It accepts members' saving and makes loans to member secured by group guarantee and compulsory savings. In September 2002, it had about 1000 active savers and about 650 active borrowers. The interest rate on loans is 3% per month[7] (Appendix, Table 6).

Projet de Dévelopment Rural du District de Phongsaly (PDDP)

The PDDP (Rural Development Project of Phongsaly District) was founded in 1997. It operates village banks for farmers in 57 villages in Phongsaly District and is sponsored by the Agence Française de Développement (AFD). It accepts compulsory members' savings and leverages these with AFD funds. In March 2003, PDDP provided credit to about 2350 borrowers. PDDP makes loans for cash crops, livestock, handicrafts, and petty trade, and uses a joint liability system to guarantee loans. PDDP charges interest at a rate based on three components: a 3% management charge, a 15% contribution to operating costs, and a third, variable amount to cover inflation and the change in the price of a selected commodity over the period of the loan.

Rural Development Cooperative

The RDC operates in thirty villages of Vientiane municipality. It began its operations in August 2001 with funding from the Vientiane Municipal Development Fund. Loans are made for agriculture, handicrafts, and trade against physical collateral and a 20% savings deposit. RDC has between 400 and 500 borrowers. RDC lending rates are 4 to 5% a month for handicrafts and agriculture, and 5 to 7% per month for trade.

Credit Union Pilot Project

The Credit Union Pilot Project [entitled Asian Development Bank TA Cluster 3413 LAO: Rural Finance Development] comprises several related subprojects. Its immediate objectives are: (i) to increase the outreach of rural financial services so that greater numbers of clients have access; (ii) to increase the market orientation of rural financial institutions, including an expansion of lending to the poor; (iii) to increase the range of financial services offered; and (iv) to increase institutional diversity by such means as the development of savings and credit unions (SCUs) on a pilot basis. Work commenced in March 2003 on the establishment of three member-owned, market-driven SCUs in Vientiane, Savannakhet, and Luangprabang Provinces. Licensing of the three pilot credit unions is a condition of the current ADB Banking Sector Reform Programme Loan (BSRPL). The pilot SCU project has yet to begin lending operations. Pilot SCUs will charge the full market rates of interest necessary for them to achieve financial self-sustainability.

International NGO Initiatives

International Nongovernmental Organizations (INGOs) and Rural Finance in the Lao PDR

INGOs have largely provided rural financial services through village revolving funds (VRFs) and tend to operate in areas not reached by banks (even the Agriculture Promotion Band), representing, in many places, the only available option for credit apart form friends, family members, and moneylenders.

Approximately 35 INGOs as well as a few bilateral and multilateral agencies are supporting rural development projects in the Lao PDR. Many of these projects have set up cash or in-kind funds that support but are not central to the project's main activities. Most rely on subsidized credit that ends when the project ends, with little or no reliance on local resource mobilization. Few of them practice microfinance in a sustainable manner.

A key intermediary for INGO rural financial projects is the Lao Women's Union (LWU). Established in 1955, the LWU is a mass organization with a reported membership of approximately 650,000. There are district, provincial, and national levels of the LWU. LWU operates in every village in the Lao PDR and is active in a significant share of INGO projects as an intermediary, as an organizer, and as the Lao government's partner. Because of its reach into the village, LWU has frequently been the implementing agent or partner for INGO- supported projects.

Most INGOs began their credit or credit-in-kind activities between 1994 and 1996. Although exceptions can be found, most INGO projects have lacked a sustainable approach. On aggregate, interest rates have been about 1.5% per month (Appendix, Table 2).

The following are illustrative but not exhaustive examples of NGO participation and experience in microfinance in the Lao PDR.

CARE, Lao PDR

Originally operating in the Kingdom of Laos from 1954 to 1957, CARE resumed direct project operations in the Lao PDR in 1992. Its funding comes from bilateral and multilateral sources, Following its mission to provide the means for sustainable self-help in communities, CARE works through community-based projects implemented by government agencies and mass organizations, and seeks to strengthen these in the process. Between 1994 and 1996, CARE supported rice banks for food security in a total of more than 650 villages. The rice banks were owned by the villages, and their supervision was the responsibility of the district agriculture and forestry services office.

CONSORTIUM

CONSORTIUM, formed in 1979, combines the expertise and services of three US-based international voluntary agencies: World Learning, Inc.; World Education, and Save the Children USA. In October 1992, CONSORTIUM established a presence in the Lao PDR as an implementing partner with the UHHCR for refugee repatriation activities in community development. In 1995 CONSORTIUM began implementing other rural development projects. The focus of its activities is now on long-term social and economic development; main programs include a drug program, upgrading medical emergency services in provincial hospitals, and unexploded ordinance (UXO) awareness building. In the past, fairly substantive microfinance component of projects formed a part of its portfolio in Lao PDR. However, microfinance does not feature in its current portfolio, except in relation to sericulture projects, where credit and income generation are not ends in themselves.

CUSO, Lao PDR

In line with the mission of its parent Canadian organization to support global alliances for social justice, and its own focus in Asia on sustainable rural development, the CUSO Lao program places special emphasis on human resource development, training, information sharing, and institution strengthening. CUSO has provided loans to support activities promoted by its Sustainable Upland Agriculture Project. However, CUSO has experienced high loan default rates, and generally does not regard microfinance as part of its operations.

Mennonite Central Committee (MCC)

MCC is the umbrella agency for relief and development programs for Mennonite Churches in North America. MCC has been working in the Lao PDR since 1975. Since 1993 MCC's involvement has mainly been to provide assistance to integrated development projects in one district each in Phongsaly and Houaphanh provinces. Small revolving funds play a role in each of the four components of MCC's integrated rural development projects: health, primary education, agriculture for food security, and women's income-generation activities. Revolving funds take the form of rice banks, small loans for poultry and/or pig husbandry, loans in kind (fruit tree seedlings), a drug fund (basic medicine), and loans for women (for raising crops and weaving). MCC considers that its rice banks and women's income-generating activities have been successful. However, loan funds for animal husbandry have not been sustainable, due to inflation, epidemics, and the difficulty of motivating of farmers to vaccinate their animals.

Save the Children Australia (SCA), Lao PDR

SCA is secular organization committed to addressing the needs of children and women through development strategies and programs with direct impact on their communities. SCA has focused its development assistance program in the Lao PDR on health and village development, in partnership with the Ministry of Health and LWU. Income generation and credit is one of five components of SCA's Integrated Village Development Project (IVDP), which is carried out in six districts of Sayabory and Bolikhamxay provinces.

Aside from the Village Revolving Funds, the informal sector consisted of 1) rotating group funds, which were more prevalent in urban than in rural areas; 2) household-to-household loans, which represented more than 50% of all recorded house debts, a powerful direct indicator of latent demand for credit not filled by conventional lending; 3) money-lenders (numbering about 1000 in rural areas), and 4) suppliers (not a major source). The following are salient findings for the informal microfinance sector: VRFs cover 15% of all villages; there is lack of coordination between donors with respect to terms, conditions, and methods of disbursement that vary widely between and within donor or NGO-supported projects; there is very limited sustainability; and donor- or NGO-supported VRFs often lack the capacity or experience for the financial intermediation necessary to expand the scale of their operations.

The Demand for Rural and Microfinance Services

The demand for rural and microfinance services in Lao PDR is significant. It includes a high demand for credit to support agriculture production, livestock husbandry, and non-farm income-generating activities, and for secure savings facilities. However, the financial sector in the Lao PDR has to date achieved a low level of outreach in rural areas.

- **In the formal sector,** it is estimated that about 120,000 (or 15%) of the estimated 800,000 households in Lao PDR have access to credit and savings services from the Agriculture Promotion Bank (APB) and a further 2000 small savers and borrower (or 0.25% of household) use the service from Lane Xang Development Bank (LDB).
- **In the semiformal sector**, the four types of microfinance initiatives appear to have about 7000 savers and 6500 borrowers, for 0.9% and 0.8% of household respectively, though for the most part the savings are compulsory deposits. One estimate suggests that a further 8000 household (or 1%) have access to Village Revolving Funds (VRFs) mainly for loans.[8]

The Role of the Government and the Stance Taken by the Regulatory Authorities

The government's vision is that the financial sector will have the depth to support broad-based sustainable economic growth. To ensure the implementation of the sustainable rural and microfinance policy framework, and recognizing the importance of rural and microfinance, the Lao government has established a Rural and Microfinance Committee (RMFC) to promote activities in the sector. RMFC has carried out an assessment of the sector and formulated a vision for its expansion with diversity, security, and future sustainability.[9] It is envisaged that a diversity of autonomous MFIs with private and public ownership will be encouraged through the new legal and regulatory framework, with appropriate protection for depositors. Such MFIs will be required to operate in financially self-sustainable ways. Moving in this direction, in 2005, the government issued the Microfinance Regulation that comprehensively govern the operations of private MFIs and the development of financially viable and commercial microfinance institutions.

The final version of the policy statement and action plan on rural and microfinance was endorsed by the Governor of the Bank of Laos after a long process of consultation in the provinces, including a major workshop of the provincial Deputy Governors. The policy statement and action plan have been submitted to the Prime Minister's Office (PMO), and approval is expected. In the meantime, the Rural and Microfinance Committee has formulated a strategy and detailed plans to implement the strategy to promote and support the development of microfinance. All of the strategies translate into specific action and have been structured in three phases:

1. Short-term, to 2006: " Getting the Framework Right."
2. Medium-term, from 2007 to 2009: "The Transition to Sustainability."
3. Long-term, from 2010 to 2015: "Extending Access to All."

The Role of the Donors' Community

The donors' community has provide assistance to the government in developing strategies and policies concerning real GDP, inflation targets, savings, revenue targets, and investment figures. To promote rural development and microfinance it is important to permit donors and NGOs to operate and foster innovation, while at the same time discouraging subsidies that undermine the financial sector as it works to deepen sustainable approaches that rely on good governance, scalability, and professional support for microfinance; governments accepting assistance must ensure that evolving best-practice principles are include in project designs, and an agreed code of practice for microfinance project design is desirable. Performance standards that cover the organization, operations, and reporting of MFIs strengthen the

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[8] First Initiative/Lao PDR, "Development of a Rural and Microfinance Strategy and Legal and Regulatory Framework/Toward a Strategy to Promote Rural and Microfinance," June 2003, p. 11. This estimate is based on the findings of the UNDP/UNCDF 1997 Microfinance Profile assuming about 5 active borrowers per VRF.

[9] RMFC, BOL, "Policy Statement for the Development of Sustainable Rural and Microfinance Sector," 2003 (second draft).

industry and make it more attractive to investors. In addition, the BOL can lend to the APB some funds which are provided by donor agencies (e.g., ADB, IDA, IFAD, and EU), and expects the APB to charge low rates of interest or rates that are considered sufficient to cover costs and loan loss provision.

The Situation in Lao PDR

The activities of most development projects (government-owned development projects/ bilateral projects/INGO projects) are implemented directly through different local-level government agencies with the central level line ministry (with the exception of the APB). At the district level government organizations such as LWU, Lao Youth Union, district finance officers, village chiefs and APB branches are the key microfinance project implementing agencies or practitioners in Lao PDR. They mainly work side by side with the INGOs or with different development projects initiated by the government or donor agencies.

The main characteristics of INGO projects reviewed by UNDP/UNCDF[10] have been found to be: 1) widely varying interest rates between similar projects, within projects, and between cash, asset, and production loan projects; 2) a frequent lack of savings components; 3) difficulties in ascertaining loan performance (repayment rates); 4) difficulties in monitoring on the large physical scale of many project areas, impeding the derivation of lessons and ability to plan for sustainability; and 5) a need for basic training (at village, intermediary, and district levels) in the theory and in the implementation of small-loan schemes and in key financial concepts.)

STRUCTURE AND PERFORMANCE OF THE FINANCIAL SYSTEM

The Structure of the Financial System

The Lao banking system is small and undiversified, with a limited number of different institutions, dominated by public commercial banks with only a few nonbank financial institutions including microfinance institutions (MFIs). The Lao banking sector is small in absolute terms, with total assets in the system amounting to approximately US$ 408 million. Furthermore, the Lao banking sector is also relatively small when compared to the size of the Lao economy: the ratio of total assets of the banking system to GDP is about one-fourth. This is particularly low for an economy with a non-diversified financial system (i.e., with no alternative but banks to supply loans), and it is evidence of a system in an early stage of development.

In the first phase of reforms, in the late 1990s, Lao moved away from a mono-bank system, separating central banking from commercial banking and permitting joint venture and foreign banks to operate in the country. In the mid–1990s, state-owned commercial banks (SCBs) had to be restructured and rehabilitated. However, the SCBs accumulated significant nonperforming loans. Thus, restructuring state-owned commercial banks, improving regulation and supervision, and opening up the banking system were made key pieces of the current round of banking reforms initiated in 2001.

At present the banking system in Lao PDR comprises the Central Bank (BOL); three state-owned banks: Banque pour le Commerce Exterieur Lao (BCEL), Lao Development Bank (LDB), and Agriculture Promotion Bank (APB); three joint venture banks (JVBs); seven foreign commercial banks with branch offices; and one Foreign Commercial Bank with a representative office (FCBs). These banks are commercial banks except for APB, a policy bank primarily geared towards development banking for agriculture and rural development but also performing commercial banking operations.

[10] Slover et al. 1997.

Table 3. Market Share of Banking Institutions as of December 1999

Types of Institutions	Number	Assets (US$ million)	Assets in % of total
State-owned banks	3	289	70.7
Foreign branches	7	85.5	20.9
Joint venture banks	3	34.0	8.3
Representative office	1	NA	NA
Total	15	408.4	100.0

Note: APB's assets account for about 5% of total assets in the banking system.

Nonbanking Financial Institutions

There are only a few nonbank financial institutions (NBFI) in Lao PDR, evidencing a narrow—i.e., undiversified—financial system where there are still only limited alternatives to banks for access to financial services. The microfinance system is emerging; there is only one insurance company; and the social security system is still in its early state, with little or no accumulated financial surpluses. Institutions such as leasing companies, which base their lending on future cash flow of a rented asset, rather than on past performance and collateral, are missing. Life insurance institutions providing long-term capital are also lacking. There is no capital market or arrangements for providing equity or debt or standardized debt contracts.

Regulatory and Supervisory Role of the Central Bank of Lao PDR

The Lao government has made progressive efforts to improve the regulatory framework through Decree Law No. 2 of March 2000 on Commercial Banks and through BOL regulations; these cover capital adequacy, lending to large borrowers, foreign currency exposure, loan classification and provisioning, and other issues. Six prudential regulations were issued in 1996. In 1997, a new chart of accounts for banks was adopted. In 1998, a new regulation on asset classification and provisioning was introduced. However, in the recent review of Decree Law No. 2 on Commercial Banks indicated that certain articles in the Decree needed to be improved to bring the prudential framework into line with the Bale Committee's core principles for effective banking supervision.[11] Amendments to the Decree were revised in 2003. As mentioned earlier, the government issued the Microfinance Regulation in 2005, aiming at developing financially viable microfinance institutions and expanding outreach to response to the unmet demand for financial services to isolated and poor populations.

The Central Bank of Lao PDR is a financial institution of the government with equivalent status to a Ministry, reporting to the government, which has regulatory role over the monetary and banking system of financial and credit institutions in Laos. In June 1990, Law No. 4 formally created the bank and gave it the formal name "The Bank of The Lao PDR." This law gives the central bank the right and duty to achieve two main objectives: 1) to promote and maintain internal and external monetary stability, an efficient payments mechanism, and liquidity, solvency, and proper functioning of soundly based monetary, credit, and financial institutions in Lao PDR; and 2) to foster conditions conductive to orderly, balanced, and sustained economic growth for the prosperity of the Lao PDR (Article 3 of Law No. 4). This was follow by a series of banking decrees such as Decree 53 of September 1990 on the Management of Foreign Exchange and Precious Metals and Decree 3 of January 1992 on the Management and Operations of Commercial Banks and Other Financial Institutions. Furthermore, "BOL shall perform other tasks as provided by law or as assigned by the government";

[11] Bank of Lao PDR, World Bank, and ADB, 2002.

this provision leaves the door open to almost anything, consistent with the mission "to serve the plan" (Articles 5 and 3).[12]

At Bank of Lao, the Financial and Banking Supervision Department is responsible for inspection of all formal financial institutions, including APB, but there is no delegated supervision in the semi formal sector. Bank of Lao carries out onsite inspection and off site supervision. Each year, it prepares an overall inspection plan, and all institutions are inspected the same way. All institutions must be inspected onsite at least yearly. For offsite supervision, banks send reports to the Bank of Lao monthly; these include the balance sheet, profit and loss accounts, and a loan portfolio report.

Bank of Lao has a supervisory policies and procedures for the formal sector. However, its policies and procedures are not yet well developed to the supervision of microfinance activities. Accordingly, there is not yet a system for supervision of MFIs, and this still needs to be developed.

PERFORMANCE OF BANKING INSTITUTIONS IN LAO PDR

The banking and financial industry in Lao PDR is dominated by three State-owned Commercial Banks (SCBs)—Banque pour le Commerce Exterieur Lao (BCEL), Lao Development Bank (LDB), and Agriculture Promotion Bank (APB); three joint venture banks (JVBs); seven foreign commercial banks with branch offices, and one foreign commercial bank with a representative office (FCB). The financial system performs five functions: a) mobilizing saving; b) researching and allocating capital; c) exercising corporate control; d) facilitate trading of goods, services, and financial contracts; and e) facilitating trading, hedging, and pooling of risks. State-owned commercial banks (SCBs) dominate the market with more than two-thirds of the total assets. The three largest banks (BCEL, LDB, and APB) are fully owned by the government.

Restructuring and Improvement of SCBs

Lao banking has had problems in common with other countries in the region: the SCBs accumulated significant nonperforming loans (NPLs) and were characterized by poor management. Beyond the priority of stopping loss-making activity and resolving NPLs, the SCBs have been restructured and rehabilitated to improve regulation and supervision; in addition, opening up the banking system was made a key piece of the current round of banking reforms which began in 2001. The challenge of getting SCBs to run on more commercial principles, improve their lending decisions, and improve their risk management was met by merging two SCBs into a new one called Lao Development Bank (LDB); in addition, various changes in regulations were issued in 2001 and 2002.

For BCEL and LDB specifically, under the framework of restructuring in order to develop and implement better credit policies/procedures, new organization and committee structures and operating guidelines were adopted; under the World Bank's Financial Management Adjustment Credit (FMAC) program, steps have been taken to curtail new lending, centralize credit decision-making, require future lending to be subject to commercial criteria, delegate appointment powers from the Ministry of Finance so the banks are able to appoint their own managements, allow the banks to set their own deposit and lending interest rates, approve performance-based recapitalization plans, undertake external audits, and begin resolution of NPL portfolios. The functions of these banks center on foreign trade finance and services, such as letter of credit issuance and import and export settlements.

[12] Bank of Lao PDR, World Bank, and ADB, "The Banking and Financial Sector in Lao PDR-Financial Sector" (15 July 2002), p. 14.

Financial Services and Products

Overall the system is dominated by the state-owned banks, with BCEL accounting for about half of deposits and 40% of loans in the banking system. However, as of 31 December 2001, outstanding loans for agriculture (including agribusiness) in all banks totalled about LAK 286.6 billion, of which 281.1 billion was outstanding from the SCBs and APB (including about 190 billion from APB), 5.4 billion was outstanding from JVBs, and 0.1 billion was outstanding from FCBs. All FCBs with lending operations in Lao PDR have significant nonperforming loan (NPL) burdens and are risk-averse. The state-owned banks including APB also have significant NPLs, and are currently undergoing restructuring.

Attitudes toward rural finance vary among the banks. APB is mandated to focus on the rural sector, and its portfolio is predominantly in agriculture and agribusiness. LDB has strategic interests in building its small and medium-scale enterprise financing across all sectors including rural enterprises. BCEL is focused on foreign trade finance and has little interest in rural lending, regarding the rural sector as high-risk and difficult to manage because of its lack of branch networks. In practice, APB is currently the only formal-sector financial institution with any outreach and true track record in rural finance. Established by decree in 1992 to assist the development of the agriculture sector in Lao PDR, APB operated under this separate mandate until March 2000, when it was brought largely under the provisions of the law governing commercial banks.

Nonperforming Loans (NPLs)

BCEL and LDB have identified a strategy to evaluate and reduce nonperforming loans as well as action plans to address their largest NPL accounts, which, if successfully resolved, will reduce their NPLs substantially and signal the importance of debtors repaying their loans or undertaking the restructuring that is necessary for them to reschedule debt and repay loans. The 20 largest NPL accounts comprise about 90% of BCEL's flow NPLs, and the top 37 NPL accounts comprise a significant portion of LDB's NPLs.

Deposit Mobilization

In Lao PDR, saving mobilization is a function that is not well performed by the financial system. Nevertheless, deposits constitute the main resource of Lao commercial banks, accounting for 60% of total liabilities.

Before the Asian economic crisis of the mid–1990s, inflation had been high in Lao PDR. Inflation rose especially rapidly, from a 12-month rate of 17% in December 1997 to 142% in December 1998. Therefore, interest rates were negative and saving became less attractive to customers. Nevertheless, due to the sound macroeconomic management adopted by the government, including prudential monetary and fiscal policies, Lao PDR has been experiencing a satisfactory decline in inflation. The average inflation rate for 2004 was 10.5%, and this decreased further to 5.6% in June 2005.[13] As a matter of fact, there are many reasons why saving mobilization is low in Lao PDR, starting with a low initial pool of savings. Certainly the limited outreach of the banking system is a factor in the mobilization of savings. In the rural areas, the amount of cash savings which is not mobilized by the system is estimated to amount to the equivalent of US$ 45 million.[14] But this is not surprising in a country where less than 25% of the population lives in urban areas and where population density is below 20 persons per square kilometer: the cost of mobilizing deposits is very high. The high cost is increased still further by the country's limited infrastructure (such as roads or electricity).

[13] Source: National Statistical Centre, Committee for Planning and Investment.

[14] Total savings (cash and non-cash) in rural areas was estimated at US$ 500 million: 90% of households surveyed had financial savings and non-financial savings (cattle and precious stones). Cash accounted for 10% of savings on average, with only 1% (i.e., US$ 5 million) mobilized in bank accounts ("Microfinance in Rural Lao PDR: A National Profile," UNDP, 1997).

Table 4. Structure of Lao Banking Deposits as of 31 December 1999

SBCs	Other banks	Kip	Foreign currency	Indi-viduals	Firms
80%	20%	15%	85%	48%	52%

Source: Bank of Lao PDR, World Bank and ADB, "The Banking and Financial Sector in Lao PDR—Financial Sector"

Interest Rates

Interest rates of commercial banks in Lao PDR are determined in accordance with market forces. During 1996–2000, the interest rate grew rapidly, to 18–22%. In 2001, interest rates of both deposits and loans in Kip were slightly reduced from previous year levels. The reduction was carried out in line with decreases in the inflation rate. Therefore, the interest rate became less attractive, and many customers favored foreign currency savings accounts. The interest rate declined from 16–24% in 2000 to 12–20% in 2002 (Appendix, Table 5).

PERFORMANCE OF NONBANKING INSTITUTIONS IN LAO PDR

As mentioned above, there are a few nonbanking institutions in Lao PDR.

Microfinance

The Lao microfinance system currently is an infant stage with five different types of suppliers. First, APB, the government-owned policy bank, focuses on the agricultural sector: APB promotes specific subsectors and lends at subsidized rates. Second, LDB started micro-lending recently with a focus on micro-traders. Third, about 1600 Village Revolving Funds (VRF), mostly donor-funded, lend with limited outreach. Fourth, there are three microfinance initiatives with no more than 2500 active borrowers each. Fifth and finally, there are numerous moneylenders offering loans at usurious rates. The recent pilot development of MFIs through a government-executed project shows that it is possible, with adequate interest rates, to implement sustainable microfinance scheme in Lao PDR with a repayment rate that exceeds 99%.

Non-Life and Life Insurance Industry

The insurance industry is regulated by the 1990 Insurance Law (11/90) which was inspired by France's Insurance Law, and an implementing decree (No. 1/PM) dated 23 January 1992. The Ministry of Finance is in charge of supervising and implementing the prudential rules. Assurances Generales du Laos (AGL) was established in 1991 and is still the only licensed Lao incorporated insurance company. AGL is a joint venture between the state of Lao (49%) and Assurances Generales de France (51%), now part of the Allianz Group. AGL's non-life insurance accounts for 90% of its business, and car insurance accounts for 40% of collected premiums. Total premiums collected amounted to LAK 11 billion (US$ 2.5 million) in 1998. AGL posted a 15% operating profit.

Social Security in Lao PDR

As the social security industry in Lao PDR is not well developed, the impact of the social security system on the financial sector is negligible and may remain so in the coming years. The system is currently being in part reformed and in part redesigned. It is likely that no significant financial surpluses will be accumulated soon.

The Leasing Industry in Lao PDR

Leasing is a tool well adapted to the needs of new, small, and medium-sized enterprises with no financial history: a leasing decision is based on future cash-flows generated by the leased asset rather than on historical performance of the borrower. Furthermore, it is also adapted to countries where the judicial system is weak, as repossessing an asset in the case of nonpayment is generally easier.

In February 1999, the government issued a leasing decree (No. 11/PM) which set up a legal framework for the development of financial leasing in Lao PDR. The decree requires that a finance lease company be licensed, supervised, and regulated by the BOL, but the prudential norms have yet to be established.

Adequately funding leasing activity will not be easy in Lao PDR. Medium-term funds are scarce, and until the financial sector develops, it is likely that finance lease companies will have to mobilize offshore funds. Raising funds through issuance of financial instruments such as promissory notes domestically, or raising funds offshore, requires BOL approval. In addition, raising funds offshore will require approval by the Foreign Investment Management Committee under the office of the Prime Minister. At present, almost two and a half years after the leasing decree was promulgated, no one in Lao PDR is involved in leasing operations. It appears that the main reason is a lack of understanding of the advantages of leasing.

ROLE PLAYED BY INFORMAL LENDERS IN THE CREDIT MARKETS

There is little research into the informal sector. One estimate based on interviews with microfinance practitioners suggested that moneylenders reach about 25,000 (or about 3%) of households.[15]

These figures suggest that about 160,000 households (or about 20% of the total) have access to financial services while the remaining 80% either have no access or are reliant on borrowing from merchants, relatives, and friends.

The Lao population in rural areas is highly dispersed, and limited infrastructure adds to the cost of financial intermediation and inhibits information flows for lenders and borrowers. These factors, combined with the small-scale nature of transactions, pose serious challenges for developing rural and microfinance. Although it is estimated that 20% of households (about 160,000) live in such remote areas that it may be difficult to develop even microfinance operations, there is still an unsatisfied demand for financial services among the remaining 640,000 households, the majority of which have no access to formal or semiformal financial services. Therefore, the Rural and Microfinance Committee of BOL officially launched the National Policy Statement for Development of a Sustainable Rural and Microfinance Finance Sector in Laos. The Policy Statement is as follows:

- Sustainable rural and microfinance can be effective tools for poverty reduction, which can help Lao PDR to emerge from LDC status by 2020. The GOL reform program in rural and microfinance will enable the sector to expand significantly, with diversity, security, and future sustainability. The RMF reform program is a major contribution into the implementation of the National Social-Economic Development Plan.
- The general vision for development of rural and microfinance sector will focus on four areas of activities as follows:

[15] Bank of Lao PDR, World Bank, and ADB (2002) makes this estimate based on the presence of one moneylender in about 25% of villages with 5 active borrowers on average.

1. Rural and microfinance will significantly expand over time to increase outreach to the majority of the poor in Lao PDR. Currently, the sector reaches only a small percentage of the Lao population.
2. The sector will include a diversity of independent MFIs: These sectors will comprise several new MFIs with a diversity of legal ownership, including private and/or public ownership. It will also develop a variety of methodologies, to reflect the diversity of the Lao people and situation. The MFIs will be managed and governed autonomously. National laws and legal instruments will support the development of the sector.
3. The sector will gradually become sustainable: by 2005, most of the people involved in RMF will share a common understanding of RMF best practice and sustainability. RMF initiatives will have a plan to become sustainable. Interest rates will be set by MFIs' management based on full cost recovery, profitability, and market demand. The management of MFIs will be fully accountable and skilled.
4. The environment will ensure security for depositors: an appropriate legal and regulatory framework will be designed and implemented. Supervision of MFIs, especially large deposit-taking MFIs, will be strengthened in order to ensure depositors' protection.

Source: Policy Statement for the Development of a Sustainable Rural and Microfinance Sector, August 2003

PERFORMANCE OF THE BANKING, NONBANKING, AND INFORMAL LENDERS IN THE CREDIT MARKET

As mentioned earlier, microfinance in Lao PDR is still in its infancy, and the role of moneylenders (informal lenders) in both urban and rural areas is estimated to be quite important: approximately 50% of rural villages have access to moneylenders' services.

Most professional moneylenders operate close to the markets and lend for quick-turnover activities. According to professional observation, rates have been stable for the last few years, ranging from 10–30% per month. However, the largest rural credit sources remain family members, friends and household-to-household loans. Informal arrangements, in particular the so-called "village revolving funds" (VRFs), have grown significantly in the last eight years. Their financial services focus on credit (about US$ 5 million in 1996).

The Emergence of Microfinance Institutions (e.g., Credit-NGOs, Microfinance Banks)

During the second half of the 1980s, Lao PDR embarked on an ambitious program of economic reforms, called the New Economic Mechanism (NEM), whose main purpose was to gradually transform its centrally planned economy into a market-oriented economy. The far-reaching reform program encompassed many critical components, including: a) promotion of private production through improved incentives; b) institutional infrastructure to improve market economy operations; c) the strengthening of Lao comparative advantages through trade liberalization and further specialization; and d) the establishment of price stability through macroeconomic policy measures.

The systemic changes introduced in Lao PDR have contributed to a significant transformation of the country's economic system, away from a rigorously centrally planned economy and towards a form of market economy based on private ownership. The percentage of poor based on the national poverty line declined from 45% in 1992/93 to 39% 1997/98.[16] But the percentage of very poor did not decline, and remained at slightly above 30%.

While Laos is rich in natural resources, their efficient and sustainable exploitation is constrained by an undeveloped infrastructure, a dearth of technical and managerial skills, and limited domestic capital. Two thirds of the population still engages in subsistence agriculture. Hence, the transformation of household economic bases to more sustainable income- generating activities through diversification and encouragement of secondary income are key components of the government's strategy for poverty alleviation.

Microfinance is considered as an important and effective tool, and the government of Lao PDR is endeavoring to develop a sustainable, market-oriented rural finance system to contribute to poverty reduction and economic growth. It is recognized that the sector is in need of both policy reform and institutional capacity development to promote rural microfinance and expand outreach. A more efficient, diverse, competitive, market-oriented rural finance/microfinance system will increase access to finance services and significantly expand income-generating opportunities, generate employment, and reduce poverty.

Recognizing the importance of rural and microfinance activities, the Lao authorities have began to address these issues in the overall rural and microfinance environment. A major program has begun in APB to transform it into a sustainable, market-oriented rural finance institution.[17] The government's rural and microfinance committee (RMFC) has defined a vision for the sector, identified impediments to sector development, and formulated an action plan to remove those impediments. With the assistance of the Asian Development Bank, projects are underway that contribute to promoting the development of an efficient, diverse, competitive, sustainable, market-oriented rural and microfinance sector in Lao PDR by:

- Assisting RMFC to develop a strategy to promote rural and microfinance development (the strategy) that identifies the actions that the government and other stakeholders should take to encourage the participation of consequently contribute to poverty alleviation (the action plan).
- Assisting the department of Supervision of the Bank of Lao PDR (BOL) to develop an enabling legal and regulatory framework (the framework), addressing prudential and non-prudential issues. This process will facilitate the establishment of new financial institutions and ensure the development of a viable rural and microfinance sector, in the process building capacity in BOL to implement and supervise the overall framework.

ASSESSING THE RECENT FINANCIAL PERFORMANCE OF MICROFINANCE INSTITUTIONS

There is one licensed MFI, which was registered by the Central Bank under the BOL Credit Cooperative Regulations (No. 2) adopted on 29 October 1996. The CCSP network was formed by nine credit cooperatives with combined outreach of 1,115 members and a total loan portfolio of US$ 125.301, excluding eight small enterprise loans totalling US$ 37.590. Loan portfolio quality is very good, with a 95% on-time loan repayment rate,[18] excellent client/

[16] World Bank and ADB, " The Banking and Financial Sector of Lao PDR" (15 July 2002).

[17] The ADB project (TA cluster 3413—Lao: Rural Finance Development) comprises interrelated subprojects addressing various aspects of rural financial development. Under the 2th subproject, a diagnostic review and financial audit of APB were carried out, leading to the formulation of a restructuring plan. Under the 5th subproject, which commenced in March 2003, APB is receiving assistance with implementation of the restructuring plan.

[18] Mekong Project Development Facility (MPDF) Needs Assessment Report: CCSP Network and Cooperative Fund (29 May 2002).

member targeting, and strict loan security requirements. Despite only reasonably good on-time repayment rates, the expectation based on this limited field observation is for a very good portfolio quality in terms of member/client selection, income-generating business activities of the borrowers, strict loan security requirements, and no overleap with other microfinance providers.

Additionally, Agriculture Promotion Bank (APB) is the only state-owned specialized bank focusing on rural financing with a significant outreach to rural areas; its clientele is estimated at 120,000 depositors and 130,000 borrowers, of whom about 123,000 are in groups. It applies a group lending methodology, with group consisting of 7 families on average. The borrowers represent about 13% of all rural households in Lao PDR. The APB currently has more than 50 funding agreements with the BOL, ministries, provincial authorities, and international agencies in which interest rate are in some manner controlled. The majority involve subsidies. These funds support about three quarters of APB's total loan portfolio.

A microfinance project launched in 1997, funded jointly by GOL, UNCDF, and UNDP, provides credit and savings to the poor; loans are provided to the target clientele to create or improve income-generating activities. Two rural microfinance projects (MFPs) were established in two provinces using group lending methods. These projects serve about 3000 clients in total.

The PDCS is preparing for its institutionalization as a Credit Cooperative by registering under the regulation on credit cooperatives (No. 2 of 19 November 1994). Its 51 village banks (out of 90 villages) have an outstanding loan portfolio of US$ 113,900 as of 30 April 2002, with 2144 borrowers/members having an average loan size of US$ 53. The village schemes have given LAK 54 million in 3400 credits since they opened. 1620 loans are finished, and all were repaid on time (a 100% repayment rate).

Apart from the initial MFIs (APB, MFP, CCSP, and PDCS), the other MFIs operate as NGOs under the regulations applicable to international NGOs. Any INGOs wishing to operate in Lao PDR is required to obtain a permit from the Ministry of Foreign Affairs. NGOs have to operate within the scope and nature of activities provided by their permits, agreements, or memoranda of understanding signed by the relevant authorities of Lao PDR. The NGO regulations that facilitate INGO operations by setting out the eligibility criteria for establishment in the Lao PDR contain a specific provision (Article 2) that they must be nonprofit organizations. This technically prohibits foreign NGOs from operating self-sustaining microfinance schemes. Most INGOs have begun to offer credit or credit-in-kind activities, and interest rates have been very low—about 1.5% per month. For example: as the village schemes (from NGOs that operate in the provinces) cannot rely on subsidies from government, the burden of raising capital rise must lie on the members. Therefore the interest rates have to cover the capital devaluation through inflation in order for the credit system to be sustainable.

MICRO-LENDING TECHNOLOGIES OR METHODOLOGIES (GROUP/SOLIDARITY LENDING; INDIVIDUAL LENDING, VILLAGE BANKING)

APB is the only Lao bank with a widespread rural network, which enables it to offer a range of services from deposits, and to lend at subsidized rates. APB reaches rural households mainly through subsidized credit to groups, and it has established over 20,000 such groups with an average membership of about 7 families per group or about 3–12 members in a group. APB lends directly to rural households and farmers, making loans to both individuals and groups. In the case of credit to groups, a group guarantee serves as collateral instead of tangible assets. Individual loans are also granted, mostly to agro-processing units at high interest rates (30–34%) against the collateral of land or housing.

CCSP was registered by the central bank as the first credit cooperative under government regulations, and it operates in 2 districts with 51 villages. The purpose of a loan is limited to income-generating and/or micro-business activities. Apart from the group liability, the following additional forms of loan security are required: an original land title (to put psychological pressure on borrowers to repay); a declaration that the heirs will assume the debt in the case of the borrower's death; and guarantees from persons outside the solidarity group, if deemed necessary. Most of the INGOs began their credit or credit-in-kind activities between 1994 and 1996. On aggregate, interest rates have been about 1.5% per month. Commodity-based lending, in which "inputs" are temporarily provided and repaid in the form of "outputs," have been common among INGO-funded projects.

COLLATERAL AND COLLATERAL SUBSTITUTES USED TO SECURE REPAYMENT OF MICRO-LOANS

The Commercial Bank Decree stipulates that "a loan from a commercial bank shall be secured by collateral such as an original land title." The requirement for a borrower or third party to provide some form of security should also be applicable to microfinance institutions. The BOL Credit Cooperatives Regulation refers to the taking of collateral to secure loans. The CCSP offers a single individual loan product denominated in Kip to its members. Loan conditions are considered to be overly strict, including such forms as original Land titles, declarations that heirs will assume debts in the case of a borrower's death, and guarantees from persons outside the solidarity group if necessary. The Secured Transactions Law provides for the seizing of immovable assets, such as land, houses or factories, and movable property. The other form of security contemplated by the Secured Transactions Law is a guarantee created by contract, whereby an individual or a legal entity agrees to repay a debt on behalf of a debtor in the event that the debtor is not able to do so. A guarantee can be made by more than one person or by a group known as joint guarantors.

POLICY AND LAW SUPPORTING AND PROMOTING MICROFINANCE

Lao PDR faces many challenges in implementing microfinance. Only 7% of poor households have access to rural and microfinance services. Access to basic financial services such as safe places to deposit saving and to borrow money at affordable rates is an important tool for people to be able to increase their income, build their businesses, and manage the events of life. Therefore, to encourage development of a sustainable rural and microfinance sector, the government has formulated high-level policies consistent with its vision for the financial sector and documented these in a "Policy Statement for the Development of Sustainable Rural Microfinance."

The Policy Statement aims to build common understanding and consensus on the government's vision and policy reforms in rural and microfinance, and to provide the basis for strengthening existing rural and microfinance initiatives and institutions to ensure that the industry will become more sustainable; it also aims to put in place a legal and regulatory environment for the emergence of new sustainable private rural and microfinance institutions.

Recent analysis of the status of rural and microfinance in Lao PDR indicates that the objectives and strategies to achieve the overall vision in the Policy Statement translate into specific actions that have been proposed by government and have already been agreed upon and included in the Policy Matrix for the ADB Banking Sector Reform Loan (BSRPL) (Appendix, Table 8).

SUPPORT PROVIDED BY THE GOVERNMENT FOR MICROFINANCE

The government is currently reviewing the constraints on regulating and opportunities for improving the regulatory framework; recommendations were formulated as a step-by-step approach to regulation. A major reform program has begun in APB to transform it into a market-oriented rural financial institution.

LEGAL SUPPORT FOR THE COLLECTION OF LOANS

The legal credit documents used by the MFIs are simple agreements by groups and individual borrowers to repay the loans. These are normally certified by the village chief and as such cannot be legally enforced in the case of a default. However, it is the nature of microfinance that large numbers of the very small amounts are lent to clients. Therefore, the only recourse to the MFIs is peer pressure or impounding savings; where recourse does exist it is mainly in the formal group guarantees with the MFIs that are used as collateral.

PROTECTIONS FOR BORROWERS WHO FAIL IN THEIR BUSINESSES

The bankruptcy of a deposit-taking microfinance institution is conducted in accordance with the Enterprise Bankruptcy Law. Regulations consist of a set of enforceable rules that restrict or direct the actions of market participants, altering, as a result, the outcomes of those actions. Regulation is "prudential" when it aims to protect the financial system as a whole and the safety of deposits, particularly small deposits, in individual institutions.[19] The primary central banking functions are the formulation and implementation of monetary policy and regulation and the supervision of financial institutions. The latter involves ensuring that there is no excessive risk-taking and no run on financial institutions that would result in the collapse of the banking system. A distinction is made between protective and preventive regulatory measures. Protective measures are for the protection of banks and their clients, most importantly their depositors, when a collapse is imminent or has occurred. They include lender-of-last-resort measures, whereby the central bank will usually provide assistance to an institution in difficulty (and thus indirectly to the depositors), and deposit insurance that aims to provide direct protection to the creditor. Preventive measures are intended to mitigate the adverse effects of protective measures and to ensure safety and soundness. The more robust the safety net of protective measures is, the greater is the moral hazard, and the more important are the preventive measures.

THE REGULATORY AND SUPERVISORY INFRASTRUCTURE

The Lao government has made progressive efforts to improve the regulatory framework through the Decree Law No. 2 of March 2000 on Commercial Banks and through BOL regulations that cover capital adequacy, lending to large borrowers, foreign currency exposure, loan classification, and provisioning. Recent review of Law No. 2 on Commercial Banks indicated that certain articles in the Decree needed to be improved to bring the prudential framework into line with the Basle Committee's 25 core principles for effective banking supervision. Supervision is normally effected both onsite and offsite. In offsite supervision reporting information from financial institutions is scrutinized to obtain a picture of the financial performance and risk profile of the institution.

BOL has supervisory policies and procedures for the formal sector. However, these policies and procedures are not adapted to the supervision of microfinance activities. Accordingly, there is not yet a system for supervision of MFIs, and this still needs to be developed. Regarding the possibility of delegated supervision, for the time being the Rural and Microfinance Committee (RMFC) of BOL is effectively the only institution qualified to supervise MFIs.

[19] CGAP, 2002 (I).

THE ROLE OF THE CENTRAL BANK VIS-À-VIS MICROFINANCE INSTITUTIONS

The Central Bank of Lao PDR is both the Regulator and Supervisor for MFIs. APB is the only state-owned bank with significant outreach to rural areas through its widespread rural network, which offers a range of services and lends at subsidized rates. There is only one cooperative, registered by the central bank as First Credit Cooperative under Government Regulation No. 2.

The first government-supported microfinance project is a joint project of the government (Ministry of Finance) and UNDP/UNCDF. The central bank can have a role in the promotion of sound rural and microfinance by supporting pilot projects, conducting research, collecting and publishing information, and providing advocates and trainers. The bank can best contribute to rural and microfinance by enabling regulatory and supervision practice that encourages MFIs to become established and licensed to engage in rural and microfinance activities.

As mentioned earlier, Lao microfinance is in an infant state, although a number of steps have been taken to develop microfinance institutions. Therefore, it is too early to assess the impact of the role of the BOL on the Lao microfinance sector; some time will be needed for it to develop.

SECOND-TIER BODIES FUNCTIONING AS "REGULATORS"

Beside the APB (the state-owned bank) and one licensed Cooperative de Crédit de Soutien aux Petites Unités de Production (CCSP), there are three microfinance initiatives which have been sponsored by donors and NGOs. The other INGOs wishing to operate in Lao PDR are required to obtain a permit from the Ministry of Foreign Affairs. NGOs have operated within the scope and nature of activities specified by their permits, agreements, and memoranda of understanding signed by the relevant authorities of Lao PDR. The NGO regulations that facilitate INGO operations in the Lao PDR contain a specific provision (Article 2) that they must be nonprofit organizations. This technically prohibits foreign NGOs from operating self-sustaining microfinance schemes.

Credit cooperatives operating under the BOL Credit Cooperative Regulations are required to keep accounts and submit these accounts (statements of assets, balance sheets) to the BOL. Under the NGO Regulations, INGOs have to submit semi-annual and final reports, including financial summaries of all projects, to the Ministry of Foreign Affairs.

LAWS AND POLICIES THAT ENABLE MICROFINANCE INSTITUTIONS TO REGISTER AND OPERATE

The Lao PDR does not have any specific regulations relating to the establishment, organization, and operations of associations, social funds, or local NGOs. In the absence of such regulations, the legal status of those entities providing microfinance services remains uncertain, and their organization and operations are not subject to any particular corporate governance regulation. Each project follows its own set of management rules.

According to the Decree on Commercial Banks No. 2 (22 March 2000) and the Bank of Lao Regulation on Credit Cooperatives No. 2 (19 November 1994), any institution that intends to carry out microfinance activities, including the mobilization of voluntary deposits from the general public for the purpose of lending, shall apply for a license to the BOL. Such an institution is referred to as a "deposit-taking microfinance institution" and is considered a type of [nonbank] financial institution.

Institutions that intend to carry out microfinance activities other than the mobilization of voluntary deposits, such as NGOs, associations, village funds, village banks, and other entities engaged in credit-only activities, must register with the relevant registration body in accordance with Part II (Article 6) of the Microfinance Regulation for the Lao PDR. The Bank of Lao PDR is the body authorised to issue a license to a deposit-taking microfinance institution. Such an institution is referred to as a "registered microfinance institution." Upon request, the BOL may permit a registered microfinance institution that operates in remote areas where no other banking services are available, to mobilize small voluntary deposits, the amount of which is determined by the BOL.

REQUIREMENTS FOR REGISTRATION AND LICENSING

The Bank of Lao PDR is the body authorized to issue a license to a Deposit-taking Microfinance Institution. The institution must fill the following conditions in order to apply:

1. Be incorporated under the Laws of Lao PDR as a limited liability company (between 1–20 shareholders), or a public limited company (at least 7 shareholders and minimum registered capital of LAK 50 million), or an enterprise with state ownership, and may be Lao-owned or foreign-owned or both. Foreign entities applying for a license for the establishment of a deposit-taking microfinance institution shall comply with the Law on the Promotion and Management of Foreign Investment in Lao PDR and its implementing regulations.
2. Have a minimum paid-up capital of not less than LAK 660 million or such higher amount as the Bank of Lao PDR may determine from time to time.
3. Have members of the board of directors, managers, and shareholders holding more than 10% of the capital or voting rights who are familiar with banking or microfinance operations in accordance with the criteria specified in the applicable Decree.
4. Have a business plan demonstrating the viability of the planned operations.
5. Have, either itself or through its shareholders, a proven local or international track record in microfinance or banking activities of at least 2 years.

Licensing Process: The licensing Body shall, within 90 days of receipt of the full application file, issue the license, if it is satisfied that:

1. All the requirements specified in Articles 8 and 9 of the Microfinance Regulation have been complied with.
2. The applicant Deposit-taking Microfinance Institution is or will be in a position to meet its liabilities to present or future customers in full as and when such liabilities accrue.
3. The affairs of the Deposit-taking Microfinance Institution are not being or are not likely to be conducted in a manner that is detrimental to the interests of its creditors and depositors.

MINIMUM CAPITAL REQUIREMENTS AND OTHER MAJOR CONDITIONS FOR REGISTRATION AND LICENSING

Minimum capital provides a buffer to absorb financial shocks. Generally the requirements for MFIs are lower than for commercial banks (see Table 5).

Table 5. Suggested Prudential Regulation for APB, SCUs, and MFIs in Lao PDR

Regulation	APB	SCUs	MFIs
Minimum capital	LAK 30 billion (US$ 2.7 million equivalent)	LAK 33 million (US$ 3000 equivalent)	LAK 660 million (US$ 60,000 equivalent)

REGULATIONS ON OWNERSHIP

The issue of foreign ownership is an important aspect in the development of microfinance. Currently, in Lao PDR foreign participation is addressed in several different pieces of legislation.

The Foreign Investment Legislation does not include any specific limitations on ownership structure by way of maximum capital contributions to a joint venture commercial bank. The only requirement relates to the classification of the provision of banking services in the "conditional" list of investments requiring a specific license from BOL. It is, however, unclear whether the limited activities of "credit-only" services would fall on the "conditional" list.

The Foreign Investment Legislation refers to the Business Law with respect to legal forms available to foreign investors. Therefore, foreign investors, in the same way as local entities or individuals, may choose any of the legal structures in the Business Law under which to establish a presence in Lao PDR.

Subject to the restrictions in terms of budget amounts, INGOs may operate directly in Lao PDR. The general approach is that they are entitled to directly provide microfinance services if they have obtained the relevant permit from the Ministry of Foreign Affairs. Thus, while Lao PDR regulations do not at present include any specific prohibitions or limitations with respect to foreign ownership structure, the right of foreign entities to participate (either solely or together with local entities or individuals) in the provision of microfinance services through the establishment of one of the legal entities as described in the Business Law and Business Decree should be explicitly allowed.

RULES AND PROCEDURES FOR A FOREIGN INVESTOR WISHING TO INVEST IN THE MICROFINANCE INDUSTRY

The Foreign Investment Legislation refers to the Business Law with respect to the legal forms available to foreign investors; thus a foreign entity, in the same way as local entities or individuals, may choose any of the legal structures in the Business Law to establish a presence in Lao PDR. The operation and management of domestic and foreign companies established in Lao PDR are governed by the same regulations, namely the Business Law and Business Decrees. Subject to restrictions in terms of budget amounts, INGOs may operate directly in Lao PDR; the general approach is that they are entitled to directly provide microfinance services provided they have obtained the relevant permit from the Ministry of Foreign Affairs. The detailed rules/regulation for individual/entities to be shareholders in MFIs will be discussed below.

RULES OR REGULATIONS SPECIFYING THE QUALIFICATIONS OF INDIVIDUALS WHO FUNCTION AS MEMBERS OF THE BOARDS OF MFIS

The Microfinance Regulation for the Lao PDR, Schedule A (Microfinance Regulation), sets out the criteria for determining whether a person is fit and proper to become a member of the board of directors, a manager, or a substantial shareholder (holding more than 10% of capital or voting rights) of a Deposit-taking Microfinance Institution. According to these criteria, the BOL shall consider the following, in so far as they are reasonably determinable:

I. Education background in finance and banking.
II. Microfinance and /or relevant financial sector institution experience.

A person/entity shall be disqualified from holding the position of board of directors membership, manager, director or substantial shareholder if such person/entity:

1. Has been convicted of fraud or has been subject to an investigation or to a professional, administrative, or judicial proceeding of a material nature.
2. Has contravened the provisions of any laws or regulations designed for the protection of members of the public against financial loss due to dishonesty or incompetence of, or malpractices by, persons engaged in the provision of banking, insurance, investment, or other financial services.
3. Was a director of an institution that has been liquidated or is under liquidation or management of the Bank of Lao PDR, or is under receivership.
4. Has taken part in any business practices that in the opinion of the Bank of Lao PDR, were fraudulent, prejudicial, or otherwise improper (whether unlawful or not) or which otherwise discredited his/her methods of conducting business.
5. Has taken part or been associated with any other business practice as would, or has otherwise conducted him/herself in such manner as to, cast doubt on his or her competence and soundness of judgement.
6. Has been declared insolvent.
7. Is involved either as an employee, shareholder, or manager in other microfinance institutions in such a way as there may be a potential conflict of interest.

Generally, it is necessary that a national MFI be an autonomous, distinct specialized bank/financial institution that provides specialized financial services to the poor segment of Laos society. It must be a broad-based, stakeholder-owned structure with ownership from among the government, private sector, and donor agencies, thereby ensuring more credibility and better governance to the national MFI.

REGULATIONS/POLICY ON INTEREST RATES ON LOANS AND DEPOSITS

The Microfinance Regulation for the Lao PDR (Article 5) provides that interest rates shall be determined by the microfinance institution itself and shall be at such a level as to cover the cost of funds, administrative costs, taxes, loan loss provisions, and profits, and to ensure the operation and financial self-sustainability of the MFI. Likewise, if APB wants to engage in microfinance, it can set its own interest rates to cover the aforementioned costs and profit margin for the sustainability and viability of its microfinance operations.

Accordingly, removal of subsidies and deregulation of interest rates is a prerequisite for sustainable financial intermediation. There is a need for increased awareness by bankers and politicians about the relationships between subsidies, interest rates, self-sustainability, and financial sector deepening.

The use of government funds to assist the poor in Lao PDR will remain a priority. However, the implementation of the APB's restructuring plan and the consequent phasing out of its subsidized interest rates will improve the enabling environment. If APB is able to mobilize deposits as a result of interest deregulation, then APB's borrowing from the government will be reduced and further government funding for poverty reduction freed up. Therefore, if APB decides to engage in microfinance, implementation of the government's vision for a sustainable rural and microfinance sector requires strategic action as follows:

- All interest rate subsidies from all formal sector and government sources are phased out within three years.
- Interest rates are fully deregulated for all financial institutions.
- Remaining administrative pressure on spreads in the formal and semiformal sectors is removed.
- Subsidies are targeted through budgetary distributions to the most needy by means other than the interest rate.

- Subsidies are available to new financial institutions to assist in start-up (under strictly controlled conditions).

CAPITAL ADEQUACY; RISK ASSET TO CAPITAL RATIO

Capital adequacy regulations also aim to ensure a buffer to absorb financial shock. Based on best-practice principles, the main suggested prudential regulations for APB, Credit Union and MFIs have been set out as in Table 6.

Table 6. Suggested Prudential Regulation for APB, SCUs, and MFIs in Lao PDR

Regulation	APB	SCUs	MFIs
Capital adequacy	16% of risk weighted assets	10% of assets	16% of risk weighted assets

LOAN LOSS PROVISIONING

Regulations are designed to ensure that there is compensation for loan losses and that accounting and performance indicators represent the true state of the business. Existing regulation (BOL 98) requires loan classification to be carried out every three months.

Loans and advances are classified as NPLs when:

I. Payment interest or repayment of principal is 90 days in arrears (special mention).
II. Loan is more than 90 days in arrears (substandard).
III. Loan is 180 days in arrears (doubtful) or 360 days in arrears (bad).

Provision for loans classified as special mention, substandard, doubtful, or bad shall be calculated based on the outstanding principal of each type of classified loan in accordance with the minimum level below:

I.	Special Mention	10%
II.	Substandard	20%
III.	Doubtful debts	50%
IV.	Bad	100%

SUPERVISION AND REGULATION BY THE AUTHORITIES

Prudential supervision is the preserve of the Central Bank. Prudential regulations do not put priority on documenting traditional collateral (real estate, securities, etc.) over loan repayment history in assessing the quality of credit. The regulatory authorities assess the credit quality of MFIs' loan portfolios base on supervision both on- and offsite. In the offsite supervision, information reported by the financial institution is scrutinized to obtain a picture of its financial performance and risk profile. (The details are discussed below.)

Limits on Unsecured or Uncollateralized Loans

Under the Rural and Microfinance Promotion Strategy and Legal and Regulatory Framework (currently being drafted), "micro-loans" are loans with or without collateral, whose maximum principal does not exceed the equivalent of US$ 500 or such other amount as the Bank of Lao PDR may determine from time to time. However, MFIs' portfolios are largely unsecured, and borrowers' main incentive to repay is future loan access.

Group Guarantees and Other Nontraditional Forms of Collateral Are Recognized

The nature of microfinance is large numbers of small loans and simplified forms of loan documentation. Micro-loans can be made with or without collateral. Collateral cannot be registered, and where it does exist it is mainly in the form of group guarantees. In the case of credit to groups, the guarantee serves as collateral instead of tangible assets. A guarantee can be made by more than one person or by an entity. Individual loans are also granted to groups at higher interest rates (30–34%) against the collateral of land or housing.

MICROFINANCE LOANS AND CONSUMER LOANS

The rural nature of the Lao economy means that deepening of rural finance sector can be an important stimulus to economic growth and the development of microfinance is also important. By improving poor people's access to financial resources, a well-functioning financial system directly supports their climb out of poverty. Financial services including small loans, savings products, payment transfers, and small loans for consumption that are provided by MFIs are considered as legitimate microfinance loans. However, regulations do not classify consumer loans as microfinance; consumer loans are operated separately under the Banking Law.

DOCUMENTATION FOR MICROFINANCE LOANS

The Rural and microfinance promotion Strategy and legal and Regulatory Framework and the Prudential Regulations are not specific for the types of documents require to evaluate the credit-worthiness of microfinance borrowers.

Microfinance loans are different from commercial bank loans and are potentially less stable: loan delinquency can be a source of volatility for Microfinance Institutions. However, most micro-credit lending is group-based; in the case of credit to groups, group guarantees serve as collateral instead of tangible assets, in case of default by individual members.

METHODS OF SUPERVISION FOR MICROFINANCE INSTITUTIONS

Supervisors, normally individuals trained in the Uniform Interagency Bank Rating System (CAMEL), are used to analyze and assess the financial health of MFIs in Lao PDR. Supervision is normally effected both on- and offsite. In offsite supervision, information reported by financial institutions is scrutinized to obtain a picture of their financial performance and risk profile. Sample checks onsite are carried out to verity the reliability of the information and to assess the professionalism of the management and staff, the efficacy of policies and procedures, and the ability to manage risk.

In offsite supervision financial reports submitted by financial institutions are periodically reviewed. To be effective there must be accurate and adequate information, supplied on a regular basis in a consistent format. The objectives are to monitor the performance of licensed institutions and detect irregular transactions and movements that differ significantly from industry averages. Supervisors must be satisfied that the financial condition of the institution and the profitability of the business are fairly reflected in the institution's published financial statements.[20]

Ratio analysis should cover several factors: sustainability—are there financial resources to continue operations?; efficiency—does the institution serve clients at reasonable cost?; quality—is portfolio quality being maintained?[21] Trends should be monitored in asset volume, financial income, financial costs, loan lost provisions, operating expenses, profits, loan portfolio, loan arrears, deposits, indebtedness, and each of the ratios. The analysis is system-

[20] Bale Committee on Banking Supervision, "Core Principle for Effective Banking Supervision," 1997.
[21] The Small Enterprise Education and Promotion Network, "Financial Ration Analysis of MFI," 1995.

atically documented, and procedures exist for following up on and correcting any identified areas of weakness.

Onsite inspection is the periodic and systematic inspection of financial institutions at their place of business. Full onsite inspections take place at least annually.

REGULATORY AND SUPERVISORY AUTHORITY AND THE NATURE OF MICROFINANCE LOANS

Understanding and awareness of the constraints of the rural and microfinance sectors in Lao PDR are necessary; the existing policy and regulatory framework does not provide an enabling environment for sustainable development. The Lao authorities have begun to address these issues in the overall rural and microfinance environment, and a Rural and Microfinance Committee (RMFC) has been set up in the BOL. In the meantime, the RMFC has formulated a strategy and detailed plans to implement it to promote and support the development of microfinance. Regulations on the microfinance industry are also being drafted, and consultations are underway with various stakeholders.

The "Draft of the Microfinance Regulation for the Lao PDR[22] contains the following provisions:

Based on Law No. 5 on the Bank of Lao PDR, dated 14 October 1995, as amended on 14 October 1999. Referring to the proposal of the Governor of the Bank of Lao PDR.

Part I: General Provisions

Article 1: Scope of Application

Microfinance activities carried out by commercial banks or credit cooperatives shall be respectively governed by the Decree on Commercial Bank, No: 02, dated 22 March 2000, and the Bank of Lao Regulation on Credit Cooperatives, No: 02, dated 19 November 1994; and any amendments thereof shall not be governed by the provisions of this Decree.

This Decree regulates the establishment and operations of Microfinance Institutions conducting Microfinance Activities within the territory of Lao PDR that are not commercial banks or credit cooperatives.

PERMITTING MICROFINANCE NGOS TO MOBILIZE SAVINGS FROM THE PUBLIC

NGOs cannot mobilize savings from public to finance their microfinance initiatives. Commercial bank microfinance organizations and cooperatives licensed by the BOL under the decree on Commercial Banks No. 02 (dated 22 March 2000) and the BOL Regulation on Credit Cooperatives No: 02 (dated 19 November 1994) are able to mobilize deposits from the public or savings from their members and lend out those deposits.

THE TRANSFORMATION OF NGOS INTO FORMAL INSTITUTIONS

All other institutions that intend to carry out microfinance activities without mobilizing voluntary deposits, such as nongovernmental organizations, associations, village fund banks, and other entities engaged in credit-only activities, are required to register with the relevant registration body in accordance with Part IV of the " Microfinance Regulation for the Lao PDR." Such institutions shall be referred to as "Registered Microfinance Institutions (but not licensed banks)." Upon request, the Bank of Lao PDR may permit a registered Microfinance Institution that operates in remote areas where no other banking services are available to mobilize small voluntary deposits, the amount of which shall be determined by the BOL.

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[22] First Initiative/Lao PDR, Development of a Rural and Microfinance Strategy and Legal and Regulatory Framework/3rd TA Workshop, December 2003.

The most common types of transformation are: when an NGO begins limited deposit-taking or upgrades to MFI status; when pre-cooperatives such as village associations become regular cooperatives or credit unions; and when specialized banks expand and diversify sufficiently to become full-service licensed banks. However, NGO transformation can face particular problems. For example, the transfer of a portfolio from an INGO to a local NGO can encounter problems with the permissible role of foreign institutions, taxation on the transfer of assets, and labor law issues in connection with the transfer of staff. Other examples include possible restrictions on the transfer of "charitable assets" to a private company when an NGO upgrades to MFI status, and restrictions on an NGO's ability to hold shares in a private company, particularly if this becomes the main activity of the NGO.

REGULATIONS GOVERNING MICRO-INSURANCE AND SIMILAR PRODUCTS

There is only one insurance company; it is regulated by the 1990 Insurance Law, which was inspired by France's Insurance Law. The company is wholly owned by the government, with the Ministry of Finance as the sole shareholder; it was formed and licensed on 20 January 2000. The Ministry of Finance is charged with managing the fund, supervising the industry, and implementing the prudential rules. Participation in the fund will be compulsory for all licensed banks, but initially branches of foreign banks are not included in the insurance scheme. Contributions are paid twice a year based on average deposits during the immediately preceding six months. Initial funding of LAK 100 million for the scheme has been provided by the MOF. The company cannot offer services in local areas.

TRAINING NEEDS OF REGULATORS AND SUPERVISORS

It was mentioned at the beginning of this report that microfinance in Lao PDR is still in its infancy. Most credit and savings cooperatives have been unsuccessful. Donors to projects in the Lao PDR are also responsible for this situation, because they have limited experience and knowledge of microfinance best practices. A wider understanding of the advances of sustainable microfinance is still needed among policy makers in order to improve the policy environment. With the assistance of the Asian Development Bank, the Bank of Lao has launched a project to assist the RMFC in developing a strategy to promote rural and microfinance development; the project will identify the actions that the government and other stakeholders should take to encourage the participation of alternative financial institutions that focus on sustainability and outreach, and consequently contribute to poverty alleviation; and will help the BOL to develop a legal and regulatory framework that addresses prudential and other management issues, that will facilitate the establishment of new financial institutions and ensure the development of a viable rural and microfinance sector, in the process building capacity in BOL to implement and supervise the overall framework.[23]

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Bank of Lao PDR, World Bank, and ADB. "The Banking and Financial Sector in Lao PDR-Financial Sector Note," 2002.

[23] First Initiative/Lao PDR, Development of a Rural and Microfinance Strategy and Legal and Regulatory Framework/3rd TA Workshop, December 2003.

ADB, TA cluster 3413—Lao: Rural Finance Development comprises interrelated subprojects addressing various aspects of rural financial development. Under the 2th subproject, a diagnostic review and financial audit of APB were carried out, leading to the formulation of a restructuring plan. Under the 5th subproject, begun in March 2003, APB is receiving assistance with implementation of the restructuring plan.

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APPENDIX

ESTIMATES OF SUPPLY AND DEMAND FOR MICROFINANCE

The figures in the following tables are conservative staff estimates of the potential and actual demand for micro-finance products and services. Sources include the National Statistic Center, banks, and microfinance practitioners.

Table 1. Estimated and Actual Numbers of Microfinance Borrowers and Depositors (as of 2000)

	Borrowers	Depositors
Estimated numbers		
Total population of Laos in 1999	5,100,000	5,100,000
Number of households in Laos in 1999	800,000	800,000
Number of household which can be reached by a microfinance institution (70% of households)	560,000	560,000
Penetration rates: 40% for credit and 50% for saving	224,000	280,000
Total number of potential clients assuming 1.2 borrowers per household and 2 depositors per household	268,000	268,000
Actual numbers		
Suppliers		
Moneylenders*	250,000	–
Lane Xang Bank	2,000	8,000
Agriculture Promotion Bank**	30,000	120,000
Village Revolving Funds	8,000	3,000

*Micro-credit is defined as outstanding loans below Kip 30 million and micro-saving as deposits below Kip 5 million.

**Staff estimates: livestock and handicraft loans are used as proxy for micro-finance loans.

Table 2. Actual Microfinance Borrowers and Micro Depositors (as of 2001)

Supplier	Lending methodology	Interest rate	Source of funds	Estimated borrowers	Estimated depositors
Moneylenders	–	20%	Self-funding	25,000	–
Lao Development Bank (focus on micro-traders)	Collateral	2.6%	Government funds	2,000	8,000
Agriculture Promotion Bank	Group guarantee, collateral	0.7%	Government funds	30,000	120,000
Village Revolving Funds	Group guarantee	1.5%	NGOs	8,000	3,000
MFIs (CCSP, MFP, PDCS)	Group guarantee	3–4%	NGOs	5,000	6,000
			Total	70,000	137,000
Project potential clients*				268,000	560,000
Penetration rate of potential clients**				26%	24%

*Based on the assumption that 70% of all households (i.e., 560,000) can be reached by an MFI, from which a 40% penetration rate is assumed for credit (i.e., 224,000) and a 50% penetration rate is assumed for savings (i.e., 280,000). Potential clients are then projected at 1.2 borrowers and 2 depositors per household, resulting in 268,000 borrowers and 560,000 depositors.

**25% of potential clients (borrowers and savers alike) have access to microfinance services.

Table 3. Comparison among the Different Types of Microfinance Providers: Main Features (December 2000)

	Formal institution		Project		Informal
	APB	LX Bank	VRFs	CCSP, MFP, PDDP	Money-lender
Years of existence	10	2	8	3	>100
Number of active borrowers	30,000	2,000	8,000	5,000	25,000
Main loans use	Agriculture IGAs	Trade IGAs SEs	IGAs	Trade IGAs SEs	Trade IGAs SEs
Annual loan size in '000 Kip	M:? M:30,000	M:200 M:30,000	A:400	M:120 M:3,000	M:100 M:20,000
Average interest rate per month (flat method)	0.7%	2.6%	1.5%	3–4%	10–30%
Location of service	Bank	Workplace	Village	Village	Workplace
Saving service	Yes	Yes	Yes	Yes	No
Loan maturity	1 year	1 year	6 mos.	6 mos., 1 year	3–6 mos.

Table 4. Lao PDR , East Asia and Pacific Region, and Low-income World: Comparing Development Indicators

		Lao PDR	East Asia/ Pacific	Low-income	
Poverty and social characteristics 2002					
Population mid-year (million)		5.5	1,838	2,495	
GNI per capita (Atlas method, US$)		310	950	430	
GNI (Atlas method, US$ billion)		1.7	1,740	1,072	
Average annual growth, 1996–2002					
Population (%)		2.4	1.0	1.9	
Labor (%)		2.2	1.2	2.3	
Most recent statistics (latest data available 1996–2002)					
Poverty (% of population below national poverty line)		39	–	–	
Urban population (% of total population)		20	38	30	
Life expectancy at birth (years)		55	69	59	
Infant mortality (per 1,000 live births)		88	33	81	
Child malnutrition (% of children under 5)		40	15	–	
Access to improved water source (% of population)		37	76	76	
Illiteracy (% of population age 15+)		34	13	37	
Gross primary enrollment (% of school-age population)		113	106	95	
Male		121	105	103	
Female		104	106	87	
Key economic ratios and long-term trends	1982	1992	2001	2002	
GDP (US$ billion)	–	1.1	1.7	1.7	
Gross domestic investment/GDP	–	–	22.1	–	
Export of goods and service/GDP	–	17.0	–	–	
Gross domestic saving/GDP	–	–	–	–	
Gross national saving/GDP	–	–4.3	–	–	
Current A/C balance/GDP	–	0.3	–4.7	–	
Interest payments/GDP	–	170	0.6	0.6	
Total debt/GDP	–	4.9	142.6	158.6	
Total debt service/export	–	–	7.9	–	
Present value of debt/GDP			74.0	–	
Present value of debt/exports			235.5	–	
(continued on next page)					

Average annual growth	1982	1992	2001	2002	2002–06
GDP	4.5	6.3	5.7	5.0	–
GDP per capita	1.8	3.8	3.3	2.6	–
Export of goods and services	–	–	–	–	–

Source: World Bank, "Economic Indicators of Development," 2003

Table 5. Interest Rates—Kip, Bath, and US$ Accounts

	2000 Dec	2001 Dec	2002 Jan	2002 Mar	2002 June	2002 Sep
Deposit rates						
Kip						
Savings	6.0–12.0	4.0–12.0	4.0–12.0	4.0–12.0	4.0–12.0	4.0–12.0
3 mos.	12.0–15.0	6.0–16.0	6.0–16.0	6.0–14.0	6.0–14.0	6.0–16.0
6 mos.	14.0–20.0	8.0–18.0	8.0–18.0	8.0–18.0	8.0–18.0	8.0–18.0
12 mos.	16.0–24.0	10.0–20.0	10.0–20.0	10.0–24.0	10.0–24.0	10.0–20.0
24 mos.	18.0–27.0	12.0–26.0	22.0–23.0	22.0–23.0	22.0–23.0	21.0–24.0
Bath						
Savings	1.0–3.0	0.5–2.0	0.5–2.0	0.5–2.0	0.5–2.0	0.25–1.5
3 mos.	1.5–3.75	1.0–3.0	1.0–2.5	1.0–2.5	1.0–2.5	1.0–2.0
6 mos.	2.0–4.0	10.–3.0	1.0–3.0	1.0–3.0	1.0–3.0	1.0–2.25
12 mos.	2.0–4.5	1.5–3.5	1.5–3.5	1.5–3.5	1.5–3.5	1.5–2.5
24 mos.	4.0–5.0	3.0–4.0	3.5–4.0	3.5–4.0	3.5–4.0	3.50
US$						
Saving	0.5–3.0	0.25–2.0	0.5–2.0	0.5–2.0	0.5–2.0	0.25–1.5
3 mos.	1.0–4.0	1.0–3.0	1.0–2.5	1.0–2.5	1.0–2.5	1.0–2.0
6 mos.	1.0–5.0	1.0–3.5	1.0–3.0	1.0–3.0	1.0–3.0	1.0–2.5
12 mos.	1.5–6.0	1.0–4.0	1.0–3.5	1.0–3.5	1.0–3.5	1.0–3.0
24 mos.	3.75–7.0	2.25–5.0	2.25–4.0	4.5–5.0	4.5–5.0	4.5
Lending rates						
Kip						
Agriculture/ forestry	10.0–24.0	16.0–24.0	18.0	14.0–18.0	14.0–18.0	14.0–18.0
Industry/ handicrafts	22.0	20.0–22.0	20.0–21.0	16.0–21.0	16.0–21.0	16.0–20.0
Construction/ transport	24.0–28.0	22.0–26.0	23.0–25.0	18.0–25.0	18.0–25.0	18.0–23.0
Commerce/ services	24.0–32.0	18.0–28.0	22.0–23.0	22.0–23.0	22.0–23.0	22.0–23.0
Bath						
Agriculture/ forestry	5.5–16.0	5.0–18.0	4.5–6.0	4.0–6.0	4.0–6.0	4.0–4.5
Industry/ handicrafts	7.0	6.0–7.0	5.50	5.0–5.5	5.0–5.5	5.0–5.5
Construction/ transport	8.0–18.0	6.0–8.0	6.0–6.5	6.0–6.5	6.0–6.5	6.0–6.5

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Commerce/ services	7.0–14.0	5.0–5.5	4.5–5.5	4.5–5.5	4.5–5.5	6.5–7.0
US$						
Agriculture/ forestry	6.0–12.0	5.5–6.0	5.0	4.5–5.5	4.5–5.5	4.5–5.0
Industry/ handicrafts	7.0	6.0–7.0	5.50	5.5–6.0	5.5–6.0	5.50
Construction/ transport	8.0–14.0	6.5	6.5	6.5–7.0	6.5–7.0	6.5
Commerce/ services	7.0–14.0	7.0–9.0	5.5	6.5–7.5	6.5–7.5	6.5–7.5
Overdrafts						
Kip	22–36.0	24.0–32.0	24.0–46.0	24.0–46.0	24.0–46.0	22.0–46.0
Bath	16.0–19.0	9.0–18.0	9.0–34.0	8.5–34.0	8.5–34.0	8.5–34.0
US$	12.5–14.0	9.0–14.0	8.5–26.0	8.5–26.0	8.5–26.0	8.5–23.0

Source: Bank of Lao PDR, “Economic and Monetary Statistics, September 2002”

Table 6: Rough Estimate of Operational and Financial Self-sufficiency of CCSP–Vientiane and the CCSP Network during 2001 (in US$)

Financial items	CCSP–Vientiane	CCSP–Vientiane (% of network)	CCSP network
1) Financial income costs	262,000	62%	420,000
2) Operating costs	77,795	23%	339,600
Administrative costs	63,395	41%	154,100
Loan provision	13,000	65%	20,000
Depreciation	1,400	6%	23,000
Training	–	0%	42,500
3) Financial income–operating costs	184,205	–	80,400
Operating self sufficiency	142%	–	124%
4) Financial costs	220,520	75%	292,442
5) Operating +financial costs	298,315	47%	632,042
6) Operating margin (3–4)	(36,315)	–	(212,042)
Financial self-sufficiency	88%	–	66%
7) Adjusted cost for liabilities	5,385	42%	11,400
8) Operating+fin+adjust.cost (5+7)	303,700	–	643,442
Financial self-sufficiency	86%	–	65%

Source: MPDF Needs Assessment Report: CCSP Network and Cooperative Fund, 29 May 2002

Table 7. Microfinance Projects in Lao PDR

<table>
<tr><td colspan="4">Income generating enterprises (IGE)</td></tr>
<tr><td>Loan cycle</td><td>Amount (Kip)</td><td>Amount (US$)</td><td>Duration</td></tr>
<tr><td>First cycle</td><td>60,000–300,000</td><td>7–37</td><td>6 mos.</td></tr>
<tr><td>Second cycle</td><td>60,000–500,000</td><td>7–16</td><td>6 mos.</td></tr>
<tr><td>Third cycle</td><td>60,000–1,000,000</td><td>7–122</td><td>6 mos.</td></tr>
<tr><td>Fourth cycle</td><td>60,000–2,000,000</td><td>7–244</td><td>1 year*</td></tr>
<tr><td colspan="4">*The one-year loan term is only granted to clients with a perfect repayment history. The interest rate is 4% per month, flat interest rate calculation.</td></tr>
<tr><td colspan="4">Small enterprise loan (individual loan for which group accountability does not apply)</td></tr>
<tr><td>Loan size</td><td colspan="3">3,000,000–9,500,000 Kip (US$ 366–1,160)</td></tr>
<tr><td>Loan use</td><td colspan="3">Working capital and fixed assets</td></tr>
<tr><td>Target clients</td><td colspan="3">Successful small entrerprise for 3 years or more</td></tr>
<tr><td>Collateral</td><td colspan="3">Assets</td></tr>
<tr><td>Repayment</td><td colspan="3">Monthly</td></tr>
<tr><td>Loan term</td><td colspan="3">1 year</td></tr>
<tr><td>Interest rate</td><td colspan="3">4% per month</td></tr>
<tr><td colspan="4">Working capital market loan</td></tr>
<tr><td>Loan use</td><td colspan="3">Working asset such as restocking inventory</td></tr>
<tr><td>Target clients</td><td colspan="3">Small market shop owners</td></tr>
<tr><td>Collateral</td><td colspan="3">Group</td></tr>
<tr><td>Repayment</td><td colspan="3">Fortnight or monthly</td></tr>
<tr><td>Loan term</td><td colspan="3">1 month</td></tr>
<tr><td>Interest rate</td><td colspan="3">4% per month</td></tr>
<tr><td colspan="4">Savings products features</td></tr>
<tr><td>Total amount</td><td colspan="3">10% of loan amount</td></tr>
<tr><td>Minimum required balance</td><td colspan="3">3,000 kip (US$ 0.37)</td></tr>
<tr><td>Maximum deposit amount</td><td colspan="3">10,000 kip (US$ 1.22)</td></tr>
<tr><td>Interest rate</td><td colspan="3">22% per annum calculated on minimum monthly balance</td></tr>
<tr><td>Maximum withdrawable amount</td><td colspan="3">Not more than 10% of loan amount</td></tr>
<tr><td colspan="4">The CCSPs</td></tr>
<tr><td>Loan amount</td><td colspan="3">10 million Kip (US$ 1,053)</td></tr>
<tr><td>Loan use</td><td colspan="3">Income-generating and /or micro-business</td></tr>
<tr><td>Target clients</td><td colspan="3">Individual</td></tr>
<tr><td>Collateral</td><td colspan="3">Group of 3–12 members</td></tr>
<tr><td>Repayment</td><td colspan="3">Monthly interest rate payments and repayment of principal at maturity date</td></tr>
<tr><td>Collateral</td><td colspan="3">Apart from the group liability,additional loan security is requested: original land title; declaration that the heirs assume debts in the case of borrower's death; guarantees from persons outside the solidarity group, if deemed necessary</td></tr>
<tr><td>Loan term</td><td colspan="3">6 months</td></tr>
<tr><td>Interest rate</td><td colspan="3">4% per month</td></tr>
<tr><td colspan="4">(continued on next page)</td></tr>
</table>

PDDR	
Loan amount	–
Loan use	Cash crops, livestock, handicraft, and petty trade
Target clients	Individual
Collateral	Group
Repayment	Monthly interest rate payments and repayment of principal at maturity date
Collateral	Apart from the group liability, additional loan security is requested: original land title; declaration that the heirs assume debts in the case of borrower's death; guarantees from persons outside the solidarity group, if deemed necessary
Loan term	6 months
Interest rate	Interest rate based on three components: a 3% management charge, a 15% contribution to operating costs, and a third variable amount to cover inflation and the change in the price of a selected commodity over period of the loan

Table 8. Lao PDR Action Plan for Implementing a Strategy to Promote Rural and Microfinance Development

	Short-term, to end 2006: "Getting the Framework Right"	Medium-term, 2007–2009: "The Transition to Sustainability"	Long-term, 2010–2015: "Extending Access to All"
The Policy Framework			
Objective 1: Enabling the policy framework			
Key policy changes	• By end 2003, the government approves and adopts a Policy Statement for the Development of Sustainable Rural and Microfinance reaffirming the government's commitment to strengthening existing rural and microfinance initiatives and institutions to ensure that the industry will become sustainable and have autonomous management and to put in place an enabling legal and policy environment for the emergence of private microfinance institutions (see Objective 4 below for establishment of the MFI Association). • By end 2003, PMO endorses the Strategy and Action Plan.	• By end 2007, the government completes phase-out of all policy lending and lending at subsidized interest rates from all state-owned financial institutions and where deemed necessary delivers non-interest subsidies through other budgetary mechanisms.	• 2010–2015, the government maintains and enhances market-oriented policies.
(continued on next page)			

Formalization of the consultative and regulatory impact assessment regime	• By end 2003, the government extends the mandate of the RMFC to be responsible for the oversight and coordination of Strategy implementation. • From June 2004, RMFC undertakes regular rural and microfinance best practice dissemination and awareness creation workshops and seminars achieving national coverage of all relevant provincial officials. • From June 2004, quarterly consultations take place between the government and the MFI Association (see Objective 4) to review progress with the implementation of the Action Plan, constraints and issues encountered in resolution, and mutually agreed-upon action for their remedy.	• By end 2007, the government puts in place a formal system for monitoring the impact of existing policies and regulations (national and provincial) that affect rural and microfinance and for new policies and regulations makes industry consultation, a formal regulatory impact assessment, and RMFC approval mandatory prior to implementation. • 2007–2009, RMFC provides targeted assistance to provinces including as required continued best practice dissemination and awareness creation. • 2007–2009, quarterly consultations continue between the government and the MFI Association to review progress with the implementation of the Action Plan, constraints and issues encountered in resolution, and mutually agreed-upon action for their remedy.	• 2010–2015, the government maintains consultative relationships.
Strategy integration and enhancement	• By end 2005, BOL prepares and adopts a financial sector strategy covering 2006–2010 reflecting the government-approved policies for the development of sustainable rural and microfinance.	• 2007 through 2009, BOL leads strategy implementation and updates the strategy by end 2009	• 2010 through 2015, BOL continues to lead strategy implementation and update the strategy as required.
The Prudential Regulatory and Supervisory Environment			
Objective 2: A sound prudential regulatory and supervisory environment			
Enhancing the regulations	• By June 2004, BOL submits for consideration by the Standing Committee of the National Assembly necessary amendments to the Law on Commercial Banks that promote good governance practices, good banking principles in line with Basel Core Principles, and equal opportunities in the financial sector.	• By end 2007, BOL enhances regulation and supervision of rural and microfinance institutions through upgrading risk management practices required of rural and microfinance institutions	• 2010–2015, BOL continues to upgrade the prudential and supervisory environment for rural and microfinance institutions using best practice lessons and feedback from its own experience

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	• By end 2003, BOL revises the Regulation on Loan Classification for Commercial Banks and Financial Institutions under BOL supervision.		
Regulating and supervising APB	• By end 2003, BOL makes APB's status as a commercial bank explicit. • By end 2003, BOL adopts a set of prudential regulations for APB adapted to the specific risk exposures faced by a specialized agricultural bank. • By end 2003, APB complies with all prudential regulations other than on capital adequacy. • By end March 2004, BOL commences monthly offsite monitoring and half-yearly onsite inspection of APB. • By end March 2004 and 2006, APD undergoes audit to IFRS*. • By end June2005 and 2006, APB publishes its annual report and financial statement in accordance with IFRS.	• By June 2007, APB complies with regulation on capital adequacy. • By end of March 2007, 2008, and 2009, APB undergoes IFRS audit; by end of June 2007, 2008, and 2009, APB publishes its annual report and financial statements in accordance with IFRS.	• 2010–2015, APB maintains compliance with prudential regulation, disclosure requirements, and risk management best practices.
Regulating and supervising the non-State sector	• By September 2003, BOL approves regulations and bylaws applicable to three pilot SCUs. • By end 2003, BOL approves guidelines for the offsite monitoring and onsite supervision of three pilot SCUs. • By end March 2004, BOL commences monthly offsite monitoring and half-yearly onsite inspection of three pilot SCUs. • By end 2004, BOL adapts and implements regulations, bylaws, and guidelines for the establishment, operation, dissolution, and winding-up of SCUs and MFIs based on best practice principles for the regulation and supervision of microfinance. • By end 2004, BOL adopts and implements monthly offsite monitoring and half-yearly onsite supervision of SCUs and MFIs that fall under the prudential supervision regime.	• By end 2007, the government secures technical assistance to help licensed SCUs and MFIs progressively upgrade risk management.	
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	• By end 2006,all existing SCUs and MFIs, including as required project-based initiatives, comply with the regulations.		
Building supervision capacity	• By end 2006, BOL develops internal capacity to carry out SCU and MFI regulation and supervision independent of TA support.	• By end 2009, BOL identifies and trains supervisory intermediaries to extend the outreach of prudential supervision in line with the growth of SCUs and MFIs.	• 2010–2015, BOL maintains oversight but delegates prudential supervision of MFIs if appropriate.
The State-owned Sector			
Objective 3: A market- oriented State-owned sector			
Restructuring APB	• By end 2003, APB adopts and initiates implementation of a financial restructuring plan, approved by APB`s Board on behalf of the government • By end 2003, APB transfers policy landing utilizing funds from BOL and other agencies of the Lao government off its balance sheet. • By end 2003, 2004, 2005, and 2006 respectively, MOF and BOL agree with APB on performance targets and other conditions for the recapitalization, including specific requirements for portfolio workout and NPL resolution, and enter into a governance agreement with APB for such performance based recapitalization. • By end 2006, APB funds its operations primarily from deposits from the public and commercial instruments. • By end March 2004, 2005, 2006 and 2007 respectively, MOF injects additional capital into APB in accordance with the governments and performance targets. • By end 2006, the government phases out using APB as an agent for channelling any policy lending.	• By end 2007, APB formulates a plan for equitization and submits the plan to BOL and MOF • By end 2008, the government approves a plan for APB's equitization, and by end 2009 APB is to be equitized.	• By end 2010, APB is partially privatized. By end 2015, APB is fully privatized.

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Improving governance and creating management autonomy	• By end 2003, MOF and BOL approve changes in the mandate of APB's Board of Directors to fully reflect its fiduciary, strategic, supervisory, and management development responsibilities in the context of improved governance and increased management autonomy.	• At end 2006, 2007, and 2008, APB continues to update rolling three-year corporate plans, and these are approved by APB's Board on behalf of the government.	• At beginning 2010, APB prepares and executes share offering
	• By end 2004, MOF ensures that the Board of APB is strengthened to include expertise in commercial banking, risk management, and governance. • By end 2003, 2004, and 2005, APB presents and APB's Board approves rolling three-year corporate plans. • By end 2003, MOF and BOL issue all necessary instructions to enable APB to set its own interest rates on loans and deposits and to make all new loans on a commercial basis using risk-based pricing.		
Building capacity	• By end 2005, APB upgrades its IT system to ensure that accurate accounting records and financial information are available on a timely basis to enable informed management and Board decision-making. • By end 2005, APB has a functional risk management capability for liquidity, interest rate, foreign exchange , and operational and reputational risk management	• By end 2007, establishes a computerized credit scoring system for different customer segments	
The Non-state Sector			
Objective 4: A diverse and competitive non-state sector			
Pilot testing and start-up support	• By end September 2003, BOL licenses three pilot commercial-oriented member-owned saving and credit unions. • By end 2004, the government puts in place measures to provide financial and technical assistance support for the start-up of privately owned formal SCUs and MFIs and where eligible the transformation of village funds into formal MFIs.	• 2007 to 2009, government phases out start-up support. • 2007 to 2009, the MFI industry and/or the private sector assumes responsibility for technical assistance.	
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Practitioners' representation	• By June 2004, practitioners establish a formal MFI industry representative body with pioneer voluntary membership from the private sector, mass organizations, interested INGOs, donors, and any other legitimate stakeholders to represent the industry in policy dialogue with government (the MFI Forum). • By December 2004, in consultation with government, the MFI Forum establishes an agreed-upon Microfinance Code of Practice for its members concerning the design and operation of microfinance initiatives, consistent with international best practice and government policies and regulations, and including schemes that are not regulated and supervised by BOL. • By end 2006, all schemes sponsored by the members of the MFI Association comply with the Microfinance Code of Practice.	• 2007 to 2009, the MFI Forum becomes a center of excellence, promoting and disseminating good practice to its members and helping to build public awareness about microfinance through campaigns and the education system. • 2007 to 2009, MFI Forum enhances self-regulation in non-prudentially supervised microfinance scheme.	
The Non-prudential Regulatory Environment			
Objective 5: A supportive non-prudential regulatory environment			
Amending the legal framework	• By end 2004, government approves amendments to the secured transactions law to allow effective security over collateral, stronger enforcement processes, and direct enforcement by lenders. • By end 2004, government ensures that the legal status of MFIs is established, private and foreign ownership of MFIs permitted, MFIs' rights as lenders are protected and the security enforcement can be effective; and MFIs are exempted from the requirements to notarize and register security.	• 2007 to 2009, the government ensures consistency in full nationwide implementation.	
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	• By end 2006, MOF harmonizes the tax treatment of all institutions providing microfinance services. • By end 2006, BOL/MOF put in place a chart of accounting standards.		
Ensuring implementation capacity	• By June 2004, MOJ ensures that a commercial division is established within the court system to deal with commercial transaction cases, presided over by specialist judges and with rules limiting appeal to the Supreme Court. • By end 2005 the government ensures a fully computerized secured transactions registry is in place.		

Source: FIRST Initiative/Lao PDR; Development of Rural and Microfinance Strategy and Legal and Regulatory Framework, 3rd TA Workshop, December 2003

MALAYSIA

Yow Sau Khong
National Productivity Corporation

INTRODUCTION

Malaysia is a multi-ethnic, multi-religious, and multi-cultural country with a population of 24.5 million people in 2002, comprising 66.1% Bumiputra (Malays and other indigenous people), 23.8% Chinese, and 7.4% Indians. The country is made up of two distinct regions, Peninsular Malaysia and East Malaysia comprising Sabah and Sarawak.

According to the World Bank, Malaysia has one of the most remarkable growth records in modern history. The country had been experiencing rapid economic development until it was adversely affected by the Asian financial crisis in 1997 and 1998. From the mid–1980s to 1996, the gross domestic product (GDP) recorded high average growth of more than 8% per annum. The Malaysian economy recovered from the Asian financial crisis with a strong growth of 8.3% in 2000. However, in the subsequent year, the country experienced another economic slowdown due to the sluggish world economy. The challenge is to mitigate the adverse impact of external environment and put the economy back on track towards sustained growth.

In terms of socioeconomic aspects, Malaysian has generally made marked improvements. Per-capita income increased from MYR 1,132 in 1970 to MYR 13,683 in 2002. Purchasing power parity has also improved significantly from US$1,247 to US$8,862. At the same time, the incidence of poverty has declined substantially, from 52.4% of total households in 1970 to 5.1% in 2002.[1]

POVERTY IN MALAYSIA

Generally, the pattern of poverty in Malaysia is closely interrelated with ethnic, sectoral, and regional groupings. Further, poverty has largely been perceived as a rural phenomenon. In recent years, however, urban poverty is becoming a growing concern with rapid urbanization, structural transformation, and rural-to-urban migration.

Absolute poverty in Malaysia was very high in 1970, when more than half of the population (or 52.4%) was poor and of this segment 60% were Bumiputra. They were living mainly in the poorer regions of Kelantan, Trengganu, Kedah, and Perlis in Peninsular Malaysia and in Sabah and Sarawak, and specifically in the rural areas of these regions. The incidence of poverty has declined to a great extent over the past three decades (Fig. 1). The overall incident of poverty decreased from 8.6% in 1995 to 5.5% in 2000 and further to 5.1% in 2002. In line with this, the number of poor households declined from 365,600 to 267,900. The incidence of hardcore poor also showed a declining trend, from 2.1% in 1995 to 1.0% in 2002, which corresponds to 52,900 households (Table 1). There would have been more progress if not for some reversal during the financial crisis when absolute poverty increased to 8.5% in 1998. Nonetheless, with the economic recovery, the incidence of poverty declined to 7.5% in 1999.

[1] Budget Speech 2004 (12 September 2003).

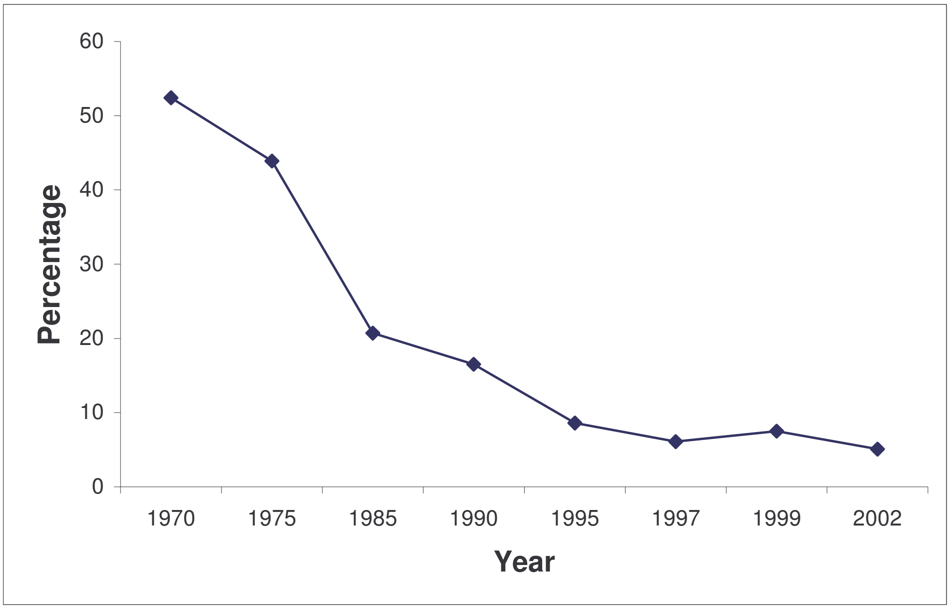

Fig. 1 Absolute Poverty (%), 1970–2002

Table 1. Incidence of Poverty, Selected Years

	1970	1985	1990	1995	1997	1999	2002
Incidence of poverty (%)[1]	52.4	20.7	16.5	8.6	6.1	7.5	5.1
No. of poor households ('000)			574.5	365.6	274.2	360.1	267.9
Incidence of hard-core poverty (%)[2]		6.9	3.9	2.1	1.4	1.4	1.0
No. of hard-core poor households ('000)			137.1	88.4	62.4	66.0	52.9
Total households ('000)	–	–	3,486.6	4,212.3	4,488.1	4,800.0	5220.6

Source: Seventh Malaysia Plan, Mid-Term Review Eighth Malaysia Plan, and Eighth Malaysia Plan

[1] The poverty line income in 2002 was RM529 for Peninsula Malaysia and RM690 for Sabah and RM600 for Sarawak.

[2] Estimated using half the poverty line income.

In 1970, the incidence of poverty showed an enormous gap between rural and urban areas: three fifths of rural people lived in poverty while one fifth of the urban people were poor (Table 2). This pattern of a higher incidence of poverty in the rural areas remains today, although the rural–urban gap has shrunk significantly. The three decades of economic development has resulted in both rural and urban households recording reductions in poverty. The incidence of rural poverty decreased to 21.1% in 1990 and further to 11.4% in 2002. At the same time, urban poverty declined to 7.1% in 1990 and further to 2.0% in 2002. Similarly, the incidence of hardcore poverty in the rural area is consistently higher that the urban areas. The incidence of rural hardcore poverty declined to 2.3% in 2002, while in the urban areas it decreased to 0.4%. Nevertheless, urban poverty, while still low, will become more critical with rapid urbanization and rural urban migration.

Table 2. Incidence of Rural-Urban Poverty, Selected Years

	1970	1985	1990	1995	1997
Incidence of urban poverty (%)	22.3	8.5	7.1	3.7	2.1
Incidence of rural poverty (%)	60.0	27.3	21.1	15.3	10.9
Incidence of urban hardcore poverty (%)	-	2.4	1.4	0.9	0.5
Incidence of rural hardcore poverty (%)	-	9.3	5.2	3.7	2.4

Source: Dr. Zainul Ariff bin Haji Hussain

Besides disparity between incidence of rural and urban poverty there exist other dimensions of relative poverty in Malaysia. Basically, relative poverty is measured by inequality in income distribution between groups. Generally, income distribution patterns from 1970 to 1990 showed improvements, indicating narrowing income inequality. However, the Gini coefficient, a summary of income disparity, increased marginally from 0.4421 in 1990 to 0.4432 in 1999, indicating a slight worsening of income distribution.[2]

Rural households earned about 55% the income of urban households in 1999 compared to 51% in 1995 (Table 3). While this disparity has shrunk since 1995, the gap remains significant. Income distribution among the ethnic groups generally increased from 1995 to 1999, at an average rate of 5.5%. At the same time, income disparity between the Bumiputra and Chinese narrowed when the income ratio disparity decreased from 1:1.80 in 1995 to 1:1.74 in 1999. However, the Bumiputra–Indian income disparity increased from 1:1.33 to 1:1.36 due to a higher average annual growth rate of 6.0% recorded among the Indian population.

Table 3. Mean Monthly Gross Household Income by Ethnic Group, 1995 and 1999

Ethnic group	1995 (RM)	1999 (RM)	Average annual growth rate (%) 1995-1999
Bumiputra	1,604	1,984	5.5
Chinese	2,890	3,456	4.6
Indians	2,140	2,702	6.0
Others	1,284	1,371	1.7
Malaysia	*2,020*	*2,472*	*5.2*
Urban	2,589	3,103	4.6
Rural	1,326	1,718	6.7

Source: Eighth Malaysia Plan

On a sectoral basis, the agriculture sector recorded the highest rate of poverty. In 1990, the incidence in the agriculture sector was 32.5% while that in the manufacturing sector was 10.6%. By 1997, the figures had dropped, but the agriculture sector still recorded the highest incidence of poverty at 16.4% as compared to manufacturing at 2.9%. Within the agriculture sector, the incidence of poverty among paddy farmers is the highest, followed by coconut smallholders, estate workers, rubber smallholders, and fishermen.

In terms of region, the less industrialized states such as Kelantan, Trengganu, Sabah, Kedah, and Perlis have a higher incidence of poverty than the more industrialized states of Selangor, Pulau Pinang, and Johor. While there was a marked reduction in the incidence of poverty in all states, in 1997 the incidence of poverty in states of Kelantan, Trengganu, Sabah,

[2] Third Outline Perspective Plan (OPP3).

Kedah, and Perlis was still high at more than 10%. Similarly, the incidence of hardcore poverty is more pronounced in those states.

POVERTY ERADICATION PROGRAMS

Malaysia has formulated a range of policies and plans for the management of national development. These development programs over the past four decades have consistently placed emphasis not only in achieving economic expansion but also in addressing the problems of poverty and economic imbalances. Eradicating poverty and bridging the income equality gap have continued to be the focus of all major development policies in Malaysia. Accordingly, the government allocated a significant portion of development expenditure for poverty reduction. In 1971–1990, a total of MYR 32.9 billion, or 19.1% of total development expenditure, was spent on programs focusing specifically on the poor and generally on the rural population. The expenditure rose to MYR 34.6 billion, or 22.5% of total expenditure, over the decade 1991–2000.

The main policies and programs on poverty reviewed here include the New Economic Policy, the National Development Policy, and the National Vision Policy.

New Economic Policy (1971–1990)

In 1970, the New Economic Policy (NEP) was launched under the First Outline Perspective Plan (OPP1) for the period 1971–1990. The NEP was a comprehensive formulation and implementation of poverty eradication programs. It was an exercise in social engineering designed to lessen socioeconomic imbalances among ethnic groups and across regions. This was of utmost importance in a multi-ethnic and culturally diverse society like in Malaysia, where the potential for inter-group tensions was inherent. Its objectives were to achieve national integration and unity through two strategies: (i) to reduce and eventually eradicate poverty by raising income levels and increasing employment opportunities for all Malaysian, irrespective of race; and (ii) to accelerate the process of restructuring Malaysian society to correct economic imbalances so as to reduce and eliminate the identification of race with economic function. The basic philosophy was “growth with equity,” with national unity as the overriding objective.

The policy was undertaken within the context of a rapidly growing economy. It was deemed necessary to provide increased employment or economic opportunities for the poor and other disadvantaged groups, to enable them to get out of the poverty trap and participate in the mainstream of economic activities. It was also important that in the process of distributing the benefits of development, no ethnic group would experience any sense of absolute deprivation; as such, distribution should not take the form of a reallocation of existing wealth but should result from expanding and new sources of wealth.

It was determined that the incidence of poverty in Peninsular Malaysia should be reduced from 49.3% to 16.7% and that the ownership of share capital in the corporate sector should be restructured such that the shares held by Bumiputra would increase from 2.4% to at least 30%. It was also decided that the employment pattern at all levels should reflect the racial composition of the population.

National Development Policy (1991–2000)

The OPP2, which embodied the National Development Policy (NDP), was then launched in 1991 to replace the NEP. The NDP, which was implemented over the decade of 1991–2000, aimed at bringing about a more balanced development. It reaffirmed the relevance of the basic policies of the NEP in eradicating poverty and restructuring society and extended them into the NDP. The NEP experience had shown that growth combined with effective government policies for poverty eradication and restructuring contributed significantly towards the substantial improvement in income distribution and the reduction of ethnic imbalances in the country. Additionally, there were modifications to the strategy; the new goals in the NDP were: (i) to shift the focus of the anti-poverty strategy towards eradication of hardcore poverty while at the same time reducing relative poverty; (ii) to focus on employment and the rapid development of an active Bumiputra Commercial and Industrial Community (BCIC) as a more effective strategy to increase the meaningful participation of the Bumiputra in the modern sectors of the economy; (iii) to rely more on the private sector to be involved in the restructuring by creating greater opportunities for growth; and (iv) to focus on human resource development as a fundamental requirement for achieving the objectives of growth and distribution.

While the incidence of poverty had been reduced considerably by 1990, further reduction could only be achieved if greater emphasis was given to eradication of hardcore poverty and to the reduction of relative poverty. Subsequently, under the National Development Policy (NDP), the target was to reduce the incidence of poverty in Malaysia to 7.2% and the incidence of hardcore poverty to 0.5% by 2000. This progress would largely come from the rapid growth of employment in the non-agricultural sectors and the declining dependence of the rural labor force on traditional sources of income.

During the NDP period, the Development Program for the Hardcore Poor, or Program Pembangunan Rakyat Termiskin (PPRT), was introduced specifically to assist the hardcore poor. The program established a register based on the profile of hardcore poor households and contained a package of projects tailored to meet their specific needs, such as increased employability and income, better housing, food supplements for children, and educational assistance. These programs include (among others) Rancangan Permulihan Rumah (assistance for repairing existing houses) and Program Peningkatan Ekonomi Kampong (assistance to encourage income-generating activities such as the making and selling of noodles, cakes, handicrafts, etc.). Direct assistance was given to the hardcore poor who are disabled and aged. In addition, the government also launched the Amanah Saham Bumiputra (ASB)–PPRT loan scheme in 1992. This special investment scheme enabled each hardcore poor person to obtain a MYR 5000 interest-free loan to purchase shares in a unit trust scheme so that the dividends could supplement their income.

Strategies and Programs under the NEP and NDP

The main strategy for poverty eradication was to provide opportunities to the poor to be involved or gain employment in higher-paying jobs or activities so that they could be self-supporting and increase their incomes. Since the poor were largely engaged in the agriculture sector, they were encouraged to be involved in modern farming and value-added processing of agricultural products as well as in non-farm or off-farm activities, which usually generate higher income. The emphasis was therefore on increasing agriculture production and promoting rural development by increasing productivity and diversifying sources of income. The range of programs implemented under the NEP and NDP are as follows:

- Resetting the landless and those with uneconomic holdings in new land development schemes. The settlers were provided with single unit houses complete with piped water and electricity.
- Undertaking in-situ development of existing agricultural land through rehabilitation and consolidation of farm plots, replanting of old commercial crops with new higher-yielding clones, and better planting techniques.
- Integrating agricultural and rural development with downstream processing of farm products and encouraging village industries and rural entrepreneurship to generate additional sources of income.

- Introducing double-cropping or off-season cropping for padi, inter-cropping and farming on the same plot of land to supplement the income derived from main crops.
- Establishing farmers' markets in urban centres so that farm produce can be sold directly and fetch better prices.
- Providing training and education on topics pertaining to farming as well as work attitudes and values to motivate participants to become more productive farmers.
- Providing industrial and vocational training for rural laborers, coupled with credit facilities and related support, to enable them to be employed in non-farm occupations or start their own businesses in rural areas and urban centres.
- Improving access to education as well as providing textbooks and financial assistance to children of poor households.
- Providing infrastructure and social amenities as part of a broader program to improve the quality of life of all Malaysians. For the rural population, this includes the provision of potable and piped water, electricity, roads, medical and health services, and schools, including rural hostels.

As a result of these efforts to eradicate poverty, there were strong indications that show reduction in incidence of overall poverty at the end of the NEP and NDP. The incidence of poverty was reduced to 16.5% in 1990 (target NEP: 16.7%) and subsequently to 5.5% in 2000 (target NDP: 7.2%). In addition, the incidence of hardcore poverty was reduced to 0.5% in 1999. The general pattern of income distribution improved: the income share of the top 20% of households fell from 55.7% in 1970 to 50% in 1990 and slightly increased to 50.5% in 1999. Correspondingly, the income share of the bottom 40 of households increased from 11.4% in 1970 to 14.5% in 1990 and fell slightly to 14% in 1999. The Gini coefficient showed narrowing income inequality from 1970 to 1990 but increased marginally from 0.4421 in 1990 to 0.4432 in 1999, indicating a slight worsening of income distribution.

In the restructuring of society, Bumiputra participation in the economy has achieved considerable progress. For example, Bumiputra employment has seen a clear realignment from agriculture to manufacturing, and there has been a marked increased in the numbers and percentages of Bumiputra employment in the higher occupational categories and in the professional sector. However, the target set has not been met, and it remains the focus of restructuring efforts.

National Vision Policy (NVP), 2001–2010

The National Vision Policy (NVP) incorporates the key strategies of the NEP—eradicating poverty irrespective of race and restructuring society—and of the NDP—balanced development. The NVP will build on the effort to transform Malaysia into the developed country envisaged under Vision 2020, which is based on the concept of "total development" and represents the culmination of the concept of balanced development. This approach reaffirms Malaysia's strong commitment to human development as the way to raise the quality of life and standard of living of the population to the levels enjoyed by the developed nations.

Among the new policy dimensions introduced in the NVP that emphasize the need to build an equitable society are as follows:

- Addressing pockets of poverty in remote areas and among the Orang Asli and Bumiputra minorities in Sabah and Sarawak, as well as increasing the income and quality of life of those in the lowest 30% income category.
- Achieving effective Bumiputra participation as well as an equity ownership rate of at least 30% by 2010.
- Increasing the participation of Bumiputra in the leading sectors of the economy.

Poverty will be a less pressing issue because of the significant progress made under the earlier policies. The incidence of poverty is targeted to be reduced further, to 0.5% by the end of 2005. Poverty eradication programs will be more target-specific by addressing pockets of poverty, particularly in remote areas as well as among the disadvantaged groups. Programs have also been introduced to address the issues of urban poverty, especially among people those residing on the peripheries of urban areas. In addition, all poverty eradication programs under the NVP have been consolidated under the Skim Pembangunan Kesejahteraan Rakyat (Scheme for the Development of the People's Wellbeing) (SPKR). The goals of the SPKR include creating income-generating projects, providing greater access to basic amenities, and inculcating the concept of self-reliance, which is an essential element in reducing poverty and building self-esteem among the hardcore poor. Among the income-generating projects are petty trading, cottage industries, livestock and aquaculture projects, and the commercial production of food crops.

Key Elements in Malaysia's Success in Poverty Reduction

In Malaysia, we have seen the relentless efforts of the government in addressing poverty. The government has consistently included poverty eradication as a goal in national development. Appropriately, the government has taken an active and direct role in reducing poverty and ethnic imbalances in terms of income, employment, ownership of capital assets, education, and entrepreneurship. The reduction of the incidence of poverty to 5.1% in 2002 from about half of Malaysia's population in 1970 represents a significant achievement. This track record was lauded as remarkable by many quarters, both in terms of the speed and magnitude of the decline and in view of the country's a diverse ethnic and cultural environment. A wide combination of interrelated factors contributed to this achievement. Among these factors are the following:

Rapid and Sustained Economic Growth

Government policies have long supported economic growth and an open policy towards trade and investment. Growth was driven by Malaysia's industrialization policy from 1969 on, which aimed to transform the economy from an agriculture-based one to a manufacturing-based one. It first embraced import substitution to create more jobs, encourage the growth of domestic industries, and diversify the economy and minimize its dependence on primary products. Later, in the 1970s and 1980s, Malaysia shifted to an export-led strategy and adopted liberalization and deregulation measures to encourage substantial inflows of foreign direct investments in order to expand the size of its markets abroad. Export and tax incentives were given to pioneer industries, especially in the Free Trade Zones which promoted export-oriented industries. During this period, the government also maintained a fairly stable macroeconomic situation conducive to the growth of private enterprise and the preservation of socio-political stability.

To a large extent, the sustained and rapid economic growth of the national economy during this period contributed to the decline in the incidence of poverty despite the effects of three major recessions. Specifically, real GDP grew at an average annual rate of 6.7% during 1971–1990 and 7.0% during 1991–2000. While such growth was singularly inadequate for successful poverty reduction, it was nevertheless necessary to support employment expansion and new economic opportunities for the poor. The labor-intensive industrialization strategies adopted until the late 1980s had created significant job opportunities and succeeded in combating the high levels of unemployment caused by the rapid growth of the labor force. Unemployment fell to about 2–3% by the late 1980s, and by the early 1990s the country was already facing labor and skill shortage in certain sectors.

Focus on Agriculture and Rural Development

In addressing poverty, the government has placed strong emphasis on rural and agricultural development. This is largely because the rural sector, which was mainly agriculture-based, was characterized by a high incidence of poverty, low productivity, and a lack of basic economic and social infrastructure. The relative failure of rural development before 1970 resulted in the government‘s playing an interventionist role in the sector. Government efforts were focus on agrarian reforms as the major strategy in transforming the rural and agriculture sector into a commercial-oriented one. The purpose was to increase agricultural productivity and to generate higher incomes. Reform measures included tenancy reform, land development and settlement, land consolidation, and in-situ development. Besides these agrarian transformations, the country also aided rural industrialization and integrated development projects with institutional support and services. Among others, these services included the provision of training and entrepreneurial development; the upgrading of technology and promotion of marketing; and loans and grants. The success of these measures is reflected in the reduction in the poverty incidence in the rural sector from almost 60% in 1970 to about 11.4% in 2002.

In addition, the government employed policies and programs that are both innovative and relevant. Programs specifically targeting the hardcore poor since 1988 have included efforts to increase their employability and income, build better housing, and provide food supplements and educational assistance for children. Other more recent targets include pockets of poverty in urban areas as well as among the Orang Asli and Bumiputra minorities in Sabah and Sarawak. Another such program is the special unit trust scheme for the hardcore poor.

Reinforcing an Enabling Environment

The government has also sought to reinforce an environment that facilitates poverty reduction. One of the means is through improving the quality of life through the provision of basic infrastructure and social amenities to as many people as possible, especially in rural areas. Expenditures for public development have consistently averaged about 32% of total government expenditure. These expenditures included the provision of piped water, electricity, roads throughout the country, and social services including education, health, and housing. In particular, Malaysia has ensured education opportunities to all, because education is the prerequisite for the upward mobility of the poor. In fact, much of the country’s achievement in poverty reduction can be attributed to education.

Malaysia has developed a strong culture of consultation and cooperation in formulating development policies. Several channels and levels of communication have been forged within the government as well as between the public and the private sector and among labor groups, NGOs, and other groups in society. The public and private sectors work closely together in developing the country. Specifically, in addressing poverty, the government has recognized the important role of NGOs, and in particular that of the microfinance agency Amanah Ikhtiar Malaysia (AIM) through its various micro-credit schemes to eradicate poverty.

In a multi-racial environment with wide inequality in terms of economic opportunities and income, the government has intervened and adopted affirmative action programs or pro-poor growth programs to provide fairer and increasing opportunities for education, employment, and enterprise among all racial groups. Without such initiatives to promote opportunities across ethnic groups, poverty may lead to social unrest and violence. Further, Malaysia has maintained a relatively stable political situation where there is peaceful coexistence among the different ethnic groups and socioeconomic development has been unhindered by strife.

In summary, the experience of Malaysia shows that in spite of challenges within a plural society, the government has been successful in reducing poverty. This has been largely attributed to government policies that ensure the high and stable rate of economic growth; employment creation through labor-absorbing industries, agriculture, and rural development;

and a significant level of public investment in education, health, and infrastructure. The government's poverty reduction programs, including the proactive policy that helped reduce ethnic inequalities, have had a significant impact on poverty reduction. Nevertheless, the situation is still complex and challenging; there are new changes and concerns that need to be addressed. The government will continue to assume a key role in managing national development.

MALAYSIA'S FINANCIAL INSTITUTIONS

Malaysia has a modern and sophisticated financial system. It has a strong foreign banking presence in the economy, and operating side-by-side with the conventional banking system is the comprehensive Islamic banking system. In terms of structure, the financial institutions can broadly be divided into the banking system and the nonbank financial intermediaries (Table 4).

Table 4. Financial Institutions

Banking System	Nonbank Financial Intermediaries
Bank Negara Malaysia	Provident and pension funds
Banking institutions	Insurance companies
Commercial banks	Development financial institutions
Finance companies	Savings institutions
Merchant banks	National Savings Bank
Islamic banks	Cooperative societies
Others	Other nonbank financial intermediaries
Discount houses	Unit trusts
Representative offices of foreign banks	Pilgrims Fund Board
Offshore banks in Labuan IOFC	Housing credit institutions
	Cagamas Berhad
	Credit Guarantee Corporation
	Leasing companies
	Factoring companies
	Venture capital companies

The banking system consists of Bank Negara Malaysia (BNM), the central bank of Malaysia; the banking institutions and other financial institutions, such as the discount houses; the representative offices of foreign banks; and the offshore banks in the International Offshore Financial Centre in Labuan (Labuan IOFC). The total assets of the financial system totalled MYR 1,762.6 billion in 2004, which was equivalent to 394% of GDP. The banking system, the largest component of the financial system, accounted for about 68% of the total assets of the financial system (Appendix 1).

BNM, as the central bank, is at the apex of the banking system, and is responsible for the regulation and supervision of the banking system, with the exception of the offshore banks operating in the Labuan IOFC, which come under the purview of the Labuan Offshore Financial Services Authority (LOFSA). In 1989, the Banking and Financial Institutions Act 1989 (BAFIA) was introduced to replace the Banking Act of1973 and the Finance Companies Act of 1969. BAFIA is intended to provide integrated supervision of the financial system and to modernize and streamline the laws relating to banking and banking institutions. The BAFIA places commercial banks, finance companies, merchant banks, discount houses, and money brokers under BNM's supervision. As of the end of 2004, there are 23 commercial banks, of which 10 are domestic banks and 13 are foreign-controlled, with 1,960 branches and a network of 4,098 ATMs. A total of 13 commercial banks offer Internet services. There are 6 finance companies with 316 branches, 10 merchant banks, and 7 discount houses. There are also two Islamic banks (Appendix 2). The Islamic Banking Act of 1983 governs Islamic banking in Malaysia. The Act empowers BNM to supervise and regulate Islamic banks.

The nonbank financial intermediaries (NBFIs) comprise five groups of institutions: provident and pension funds, insurance companies, development finance institutions (DFIs), savings institutions, and a group of other nonbank financial intermediaries. The NBFIs are supervised by the various government departments and agencies. The insurance companies were brought under the supervision of BNM effective 1 May 1988. Companies involved in scheduled businesses such as leasing, factoring, building credit, development finance, and credit token businesses are required to register and submit periodic returns to BNM for monitoring purposes. On 15 February 2002, the enactment of the Development Financial Institutions Act 2002 (DFIA) provided BNM with the regulatory and supervisory framework to monitor the activities and performance of six prescribed DFIs.

A recent development in the Malaysian banking industry is the merger program for domestic banking institutions that was initiated in 1999 and concluded in 2000. The merger exercise was promoted to resolve the problems associated with the smaller and weaker banking institutions which became apparent during the financial crises of 1997–1998. The pre-crisis fragmented domestic banking sector that including 71 banking institutions was consolidated into 10 banking groups. In 2001, the banking groups focused on completing the process of business integration and rationalization. The consolidation and rationalization of domestic banking institutions represents a major structural enhancement to the banking system. The merged banking groups are better capitalized to meet future calls for capital expenditure as well as to undertake a wider scope of business activities. The operational business process and rationalization exercise will allow for greater operational efficiency and cost effectiveness.

The Central Bank

The Central Bank of Malaysia (Bank Negara Malaysia, BNM) was established under the Central Bank of Malaysia Act 1958 (CBA) (Revised 1994) on 26 January 1959. The objectives of BNM as outlined in the CBA are to promote monetary stability and a sound financial structure; act as a banker and financial adviser to the government; to issue currency in Malaysia and to keep reserves to safeguard the value of the currency; and to influence the credit situation to the advantage of the country

BNM is the regulatory and supervisory authority for the banking industry. BNM's functions also include the regulation and supervision of the insurance industry, money-changers, and development finance institutions. Pursuant to these functions, BNM is vested with comprehensive legal powers under various Acts and Ordinances to regulate and supervise the financial system. BNM administers and enforces the following Acts: the Banking and Financial Institutions Act of 1989 (BAFIA), the Islamic Banking Act of 1983, the Insurance Act of 1996, the Takaful Act of 1984, the Money-Changing Act of 1998, the Exchange Control Act of 1953, the Anti-Money Laundering Act of 2001 (AMLA), the Development Financial Institutions Act of 2002 (DFIA) and the Payment System Act of 2003.

The Banking and Financial Institution Act of 1989 (BAFIA) provides for integrated supervision of the Malaysian financial system and modernizes and streamlines the different regulatory regimes overseeing the banking and other financial institutions; the Act also introduced new prudential requirements. Broadly, the BAFIA empowers BNM with the authority to regulate deposit-taking institutions, stipulate entry criteria for licensed institutions, and prescribe comprehensive protective regulations to protect the interests of depositors and maintain the confidence and integrity of the banking sector. With regard to the protection of depositors' interests, the BAFIA stipulates that in liquidation, depositor claims are given priority over all other liability claims against the banking institution.

The BAFIA provides BNM with the powers to regulate and supervise all licensed institutions, namely commercial banks, finance companies, merchant banks, discount houses and money brokers. Discount houses and money brokers were previously supervised by BNM on an administrative basis. In addition, BNM is also vested with the power to regulate and supervise, if necessary, the scheduled institutions—namely, credit and charge card companies, building societies, factoring and leasing companies, and development finance institutions. This provision is also applicable to the representative offices of foreign banks or foreign institutions carrying on businesses similar to the operations of finance companies, discount houses, money brokers and scheduled institutions. The operations of scheduled institutions are not subject to any formal regulation or supervision by BNM. In fact, this group of institutions continues to be governed by its own separate legislation. Nonetheless, the BAFIA accorded BNM with powers to investigate and take corrective actions, including assumption of control of scheduled institutions, so as to promote monetary stability and sound financial structure as well to protect the interest of the banking public. These powers may be discharged by extending, in whole or in part, the regulatory and supervisory regime currently applicable to the licensed institutions to any scheduled institutions. These include imposing lending restrictions and capital and liquidity requirements as well as requiring scheduled institutions to submit regular information as may be deemed necessary for prudential monitoring purposes.

The development financial institutions (DFIs) are specialized financial institutions established by the government as part of an overall strategy to develop and promote specific sectors, such as agriculture, small and medium enterprises (SMEs), shipping, and capital-intensive and high-technology industries for the sake of the social and economic development of the country. DFIs are regulated under the Development Financial Institutions Act of 2002 (DFIA), which focuses on promoting effective and efficient development financial institutions (DFIs) and ensuring that the roles, objectives, and activities of the DFIs are consistent with government policies and that their mandated roles are effectively and efficiently implemented. The DFIA also emphasizes efficient management and effective corporate governance, by providing a comprehensive supervision mechanism and mechanisms to strengthen the financial position of DFIs through the specification of prudential requirements. The designated development financial institutions under the ambit of DFIA include the National Savings Bank; Development and Infrastructure Bank of Malaysia Berhad; Industrial and Technology Bank of Malaysia Berhad; People's Cooperative Bank of Malaysia Berhad; Malaysia Export Credit Insurance Berhad; and Export-Import Bank of Malaysia Berhad.

The supervisory functions of BNM are well established. The bank adopts a two-prong approach, namely regulation and offsite monitoring, and onsite examination in its supervisory activities. The offsite monitoring and onsite examination is premised on the risk-based supervisory approach. Regulation is concerned with the formulation and implementation of specific rules and regulation with clearly defined standards such as maximum amount of loans to a single borrower, large loan limits or lists of permissible investments. Offsite monitoring continually reviews the financial conditions of the banking institutions through the submission of statistical returns and reports by individual institutions. The analysis will focus on important areas of capital adequacy, asset quality, earnings performance and liquidity position, including the conduct of monthly stress test. Onsite examination focuses on assessing the types and extent of risks to which banking institutions are exposed. The approach is to plan and scope a customized examination to match the size, activities and risk profiles of the banking institutions.

BNM applies the CAMEL (Uniform Interagency Bank Rating System) framework to evaluate the overall financial condition of a banking institution. This encompasses the review of a banking institution's capital adequacy, asset quality, management quality, earning performance, and liquidity position. The CAMEL rating of a banking institution is reviewed at least once a year during each onsite or offsite review. This rating may be used for monitoring purpose and for allocating supervisory resources, including the frequency of onsite examination.

OVERVIEW OF THE MICROFINANCE INDUSTRY

According to the Asian Development Bank, microfinance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and their microenterprises. A summary of the different categories of microfinance intermediaries *I*n Malaysia is presented in Table 5.

Table 5. Microfinance Intermediaries in Malaysia

	Nongovernmental organization	Development financial institution	Cooperatives and credit unions	Government institutions and agencies
Strategy/ purpose	Social and economic impact: poverty eradication	Social and economic impact: micro-enterprise development	Social and economic impact	Social and economic impact: poverty eradication, distribution, entrepreneur development
Legal form	Trust companies	Development banks	Cooperatives, credit unions	Government agencies
Clients	Targeted rural and urban poor, mainly women	Individuals and micro-enterprises, low income groups	Members	Targeted communities and indigenous groups
Services	Micro-credit	Loans and savings	Loans and savings	Loans Micro-credit
Sources of funding	Grants and soft loans	Government funds, deposits	Members funds' in the form of share subscriptions and deposits	Government funds, multilateral institutions
Examples	Amanah Ikhtiar Malaysia, Partners in Enterprise Malaysia, Yayasan Usahamaju	Bank Pertanian, Bank Simpanan, Rakyat, Bank Islam, Credit Guarantee Corporation	Urban credit co-operatives, Bank Kerjasama	MARA, YTN

Source: Topology adapted from Jansson (2001)

Basically, there is only one dominant MFI in Malaysia: the Amanah Ikhtiar Malaysia (AIM), which targets the very poor. The exceptions are a few minor operators that have the tendency to concentrate around urban areas. In general, banking institution lending is based on conventional terms and not targeted for the poor. However, micro-credit lending has been introduced through development financial institutions aimed at providing small and medium enterprises with adequate and easier accessibility to funding sources. This is one of the government's pro-growth measures aimed at spurring domestic investments; it was adopted in 2003. Lending, especially to small businesses, has been an important factor in supporting the domestic economy. The two development financial institutions that have established micro-credit schemes are Bank Simpanan Nasional (BSN) or National Savings Bank, and Bank

Pertanian Malaysia (BSN), or Agriculture Bank of Malaysia. BSN is to finance non-agricultural projects and BPM is to manage loans to small businesses and enterprises in the agriculture sector. There is also the Credit Guarantee Corporation (CGC), which helps SMEs with inadequate or no collateral to gain access to credit by providing guarantees for loans obtained from banking institutions. However, the loan size of some of these micro-credit schemes may be higher than the amounts available through conventional microfinance. In addition, there are cooperatives that provide financing to their members at a minimal interest rate in order to encourage saving among members. A large number of co-op members are fixed-income employees, particularly in the public, statutory, and private sectors, and are quite well off.

Micro-credit Schemes of Nongovernmental Organizations

In Malaysia, the first micro-credit scheme was implemented in September 1987, through Amanah Ikhtiar Malaysia (AIM). It was born out of "Projek Ikhtiar" and is the first nongovernmental organization (NGO) aimed at poverty alleviation in the country. Specifically, AIM was established "for the sole purpose of assisting very poor households to lift themselves out of poverty, primarily by means of benevolent loans to be used for financing income-generating activities."[3] It is a group-based program, modelled on the Grameen Bank of Bangladesh, which builds on personal relationships, trust, group participation, and joint liability. AIM operates in nine states of Malaysia.

Currently, AIM has two micro-credit schemes, the Economic Financing Scheme and the Special/Social Financing Scheme. The former is to finance economic activities while the later provides financing to single mothers and fishermen. The social scheme provides education loans to children of the hardcore poor as well as loans for housing renovations and installation of utilities, such as water and electricity. Loans given out by AIM range from MYR 100 to MYR 10,000 for each borrower without collateral or guarantor.

There are three types of loans for economic financing under the Ikhtiar Loan Scheme (SPI). Ikhtiar Loan Scheme 1 (SPI 1) offers the first borrower a maximum loan of MYR 1000. Borrowers who have a good repayment record on their first loan are considered for a second loan, which is twice the amount of the first loan up to a maximum of MYR 2000, followed by a maximum of MYR 3000 for the third loan, MYR 4000 for the fourth loan, and MYR 4900 for the fifth and subsequent loans. Ikhtiar Loan Scheme 2 (SPI 2) offers a range of loans from MYR 5,000–9,900. Borrowers who have shown good repayment records in SPI 1 and with monthly income of at least MYR 600 will be considered for this loan. The repayment period is between 50 and 150 weeks. The third loan is Ikhtiar Loan Scheme 3 (SPI 3), which offers MYR 10,000. Borrowers with good repayment records and with monthly income of at least MYR 1000 are considered for loans from this scheme. It is specially designed to give opportunities to those who need capital to expand their business activities. The repayment period is between 50 and 150 weeks. Loans may be used to start or expand any type of legitimate income-generating activity of the borrower's choice, based on their experience, skills, and capabilities. The major activities are petty trading, agriculture, animal husbandry, and fishing.

The Ikhtiar Loan Scheme is exclusively focused on very poor rural dwellers (the bottom 30%) to get maximum effect from a limited amount of resources. To ensure the right target, AIM uses a special means test to determine the eligibility of its potential members. Field staff members assess an applicant's house structure, family profile, and sources of income, assets, and ownership of land for means testing. The scheme uses a specialized delivery system with a number of special characteristics: suitable loan conditions (no collateral, no guarantor, no legal threat or legal action); simple procedures; training and testing; group formation; collective responsibility; small loans and weekly repayment; weekly meetings; close supervision,

[3] D.S. Gibbons and Shukor Kasim, *Banking on the Rural Poor*, p. 74.

and availability of subsequent loans. The Ikhtiar Loan Scheme has proved that the poor are bankable and have shown their creditworthiness by repaying their loans.

The number of loans disbursed by AIM reached 57,290 in 2002 and amounted to MYR 140.7 million (Table 6). From its inception until June 2003, AIM provided micro financing totalling MYR 863 million to some 490,700 borrowers. AIM has an overall good repayment rate of 96% (2001: 96.5%; 2002: 95.5%) from its loan schemes. The setback was from the Single Mother Loan Scheme and the Fisherman Financing Scheme, which have poor repayment performances.

Table 6. Number and Amount Finances (1988–2002)

	1998	1999	2000	2001	2002
Numbers	42,668	39,600	46,451	55,067	57,290
Amount (RM)	102,685,700	82,980,990	107,247,260	128,126,650	140,712,480
Sahabat members	56,557	60,815	69,017	79,492	87,438

Source: Ilias Ahmad, "Current Situation of Micro-finance in Malaysia and Its Issues"

AIM has the support of the federal and state governments. Grants and soft loan are given to support its operational and administrative cost (Table 7). This relatively easy access to funds has enabled AIM to increase its outreach quite rapidly. Nevertheless, the small administrative fee of 4% charged does not cover its operating costs, and it could not be sustainable and self-dependent.

Table 7. Sources of Operational Costs and Revolving Loan Capital

On-lending Fund	Amount
Government—interest-free loan	RM 300.0 million
Government—grant	RM 18.2 million
Financial institution—soft loan	RM 28.05 million
Government agency	
LKIM—interest-free loan	RM 4.0 million
Rural Development Ministry—grant	RM1 2.8 million
Grants for operational costs	
Federal and state governments	RM 30.0 million

Source: Ilias Ahmad, "Current Situation of Micro-finance in Malaysia and Its Issues"

Another example of an MFI is Partners in Enterprise Malaysia (PIE), which was established in 1995 to meet the economic and social needs of urban poor people.[4] PIE is managed by a voluntary Management Board comprising individuals from the business and professional sector with an advisory council. PIE launched a pilot project in April 1996 for a two-year period in order to assess the applicability of microfinance groups within the urban context in Malaysia. Technical assistance to project design and staff training was provided by Opportunity International.

"Projek Usahamaju Gombak" targets the urban poor who are petty traders living in squatter areas of Gombak. Borrowers with household incomes fixed at a maximum of MYR 1750 for a family size of 5 persons can qualify for participation in this program. It is designed to meet the microfinance needs of small traders and those involved in the informal economy.

[4] www.pie.com.my.

Small loans are provided for small and micro-businesses. The first loan is fixed at the maximum of MYR 2000, the second loan at MYR 3000, the third at MYR 4000, the fourth at MYR 6000, and the fifth at MYR 8000. Repayment is over 25 weeks. An administrative charge of 9% is charged to the borrowers. In 1996, PIE lent a total of MYR 75,000 to 33 borrowers, all of whom were women. Of these women, only four faced difficulties in repayment. For 1997, the target was 170 loans.

Micro-credit Schemes of Financial Institutions

Over the years, the government has implemented several measures to address the financing needs of SMEs, which it sees as the catalyst for growth in generating domestic investment and stimulating economic growth. For example, in 1998, in response to the economic crisis, the government allocated funds for a micro-credit program for petty traders and hawkers in urban areas. The Package of New Strategies, in May 2003, allocated MYR 1 billion to a micro-credit scheme for small businesses and enterprises. The scheme is run by Bank Simpanan Nasional (BSN), a savings institution, and Bank Pertanian Malaysia (BPM), with the aim of assisting low-income groups and small businesses and individuals interested in venturing into petty trading. BPM was provided with MYR 500 million and BSN with MYR 300 million, and an additional MYR 200 million was allocated to the micro-credit scheme of AIM. These two financial institutions, BSN and BPM, were used because they are government-owned financial institutions, and may have been seen as complementing the banking institutions to meet the financial requirements of the economy. Further, these two financial institutions have established infrastructures in terms of their extensive branch networks throughout the country. On the other hand, the banking system has traditionally not provided micro-credit due mainly to the higher risk because of the lack of collateral and the cost associated with it.

The goal of the micro-credit scheme is to reduce financing cost and facilitate access to credit as well as prevent small borrowers from resorting to illegal moneylenders, through the relaxation of loan conditions in several ways:

- Lowering interest rates on loans to 4%.
- Waiving collateral requirements with loans based on securitization of cash flow. This is the use of the surplus projection (turnover minus operating cost) to guarantee repayment of the loans. Base on the cash flow analysis, if there is a surplus, then there is potential in the business.
- Scheduling loan repayment based on cash flow projections.
- Introducing a mentoring system, wherever relevant, to ensure timely repayment on a daily, weekly, or monthly basis, depending on the borrower's cash flow. The mentoring system is only practised by BSN.[5]

The Bank Pertanian Malaysia (BPM), or Agriculture Bank of Malaysia, was established in 1969 to promote sound agricultural development in the country, through the provision of loans and advances. The main functions of the bank are to coordinate and supervise the granting of credit facilities for agricultural purposes and to mobilize savings, particularly from the agriculture sector and community. BPM has a network of 181 branches, 5135 mobile units, and 142 ATMs nationwide. Since 1978, BPM has introduced the GIRO facility, which is an interbank fund transfer system to provide payment and remittance services to customers.

BPM implements a two-pronged approach in extending its loan and credit facilities. First, it assists smallholders, farmers, fishermen, and livestock producers by financing their projects through special government interest schemes on favorable terms such as low concessionary interest rates. These schemes are usually financed with funds allocated by the government to

[5] EPU, "New Strategies Towards Stimulating the Nation's Economic Growth," 21 May 2003.

carry out certain development projects. Second, BPM provides loan to agricultural entrepreneurs and private individuals who are interested in investing in agricultural projects at competitive commercial interest rates. These commercially viable agricultural projects are funded with deposits mobilized by BPM itself.

One of the special concessionary loan schemes implemented by BPM is the microfinancing facility. This is only for small businesses and enterprises in the agricultural sector, and includes activities such as farming, processing, and marketing. BPM provides non-collateral loans of up to MYR 20,000 per borrower or business partnership, with annual interest of 4% and repayment period not exceeding 4 years based on securitization of cash flow. BPM launched its micro-credit facility on 3 June 2003. The response has been overwhelming for various activities, such as aquaculture, marine fishing, poultry farming, planting of short-term (yields within 3–4 months) and long-term crops (yields after 4 months), and food processing, as well as working capital and marketing. By 3 May 2005, BPM had approved 17,609 applications for funds totalling MYR 202 million (Table 8). The recovery rate for loan repayment to date has been 75%.

Table 8. Number and Amount of Loans Approved (3 May 2005)

Loan size	Number of loans	Amount approved (RM million)
Less than RM 5,000	4453	18.8
RM 5,000–RM 10,000	5865	53.0
RM 10,001–RM 15,000	2554	36.6
RM 15,001–RM 19,999	414	7.2
RM 20,000	4323	86.5
	17,609	202.1

Source: Bank Pertanian Malaysia

The extension of micro-credit at the current interest rate of 4% will become an issue if the fund is not supported by grants or soft loans from the government. Additionally, implementing the scheme will definitely add more burden to BPM in terms of increased operational cost. The scheme will involve increased credit risk due to its relaxed borrowing conditions without collateral or guarantors.

The Fund for Food (3F) scheme was introduced in 1993 for the financing of food production, processing, distribution, and marketing. The objectives are to promote food production, to reduce the imports of food, and to stabilize food prices. It is one of the funds administered by the central bank. The fund provides low-interest, small-scale loans to small farmers and Farmers' Associations. BPM is one of the institutions that disburses the funds, and it is being regulated by BNM. Under the revised guidelines, the interest rate charged was lowered from 7.75% to 4% per annum and the loan tenure extended from 5 to 8 years. The minimum loan eligibility was reduced from MYR 50,000 to MYR 10,000. As at the end of 2003, MYR 171 million had been approved under the 3F scheme in BPM.

The main savings institution in Malaysia is the National Savings Bank or Bank Simpanan Nasional (BSN), which was established in 1974 through a reorganization of the former Post Office Savings Bank system. The role of the NSB is to promote and mobilize private savings, especially of small savers, in order to finance national economic development. The BSN provides a convenient and easily accessible medium for small savers, due to its large network of branches. Its operations thus focus on retail banking and personal finance to meet the needs of individual and household customers. At the end of 2004, BSN operated through

393 branches covering both the urban and rural areas, and supported by 599 ATMs. It has a customer base of about 11.6 million account holders.

Under the pro-growth package, BSN was given the mandate to manage a MYR 300 million micro-credit scheme to finance non-agricultural activities. BSN micro-loans are also without collateral or guarantors, and range from MYR 5000 to MYR 20,000 per borrower with annual interest of 4% and repayment period from 1 year to a maximum of 5 years. However, the main difference between the micro-credit scheme of BPM and BSN is the mentor system applicable under BSN. Under this system, a mentor is appointed by an association to help identify potential borrowers who have the repayment capability as well as the ability to assist the borrowers in securing loans. While BSN will administer the loan, the mentor from the particular association will serve as a link between the bank and the potential borrower. The mentor should be a successful businessperson who can provide guidance, advice, and support in order to ensure that the borrower has a good track record in repayment, is of reliable character, and will use the loan for income generation through a small business venture. Each mentor can supervise up to 10 mentees or borrowers. They have to undergo training and must be approved by BSN before they can assume their role. The training aspects include filling out loan forms, developing business proposals, and working out the financial plan and cash flow. The mentor has three aims: to ensure repayment and reduce defaulting; to ensure that the business succeeds; and to enable the borrower to attain a better quality of life through his or her small business. To date, there are about 400 association members with 13,000 mentors registered with BSN.

Similarly, the response to BSN's micro-credit facility has been overwhelming. In 2004, the micro-credit scheme recorded an increase of 46.9%. Since the launch in June 2003, a total of MYR 723 million has been disbursed to 82,657 applicants, mainly for food stall businesses, retail trading activities, and business services.[6] However, it is doubtful whether the scheme can be sustainable given that it is very risky at 4% interest, and without collateral or guarantor requirement.

Bank Islam Malaysia (BIM), which provides Islamic banking services, has a special scheme for the poor. Under this scheme, BIM uses funds allocated by YPEIM (Foundation for Development of Islamic Economy in Malaysia) as well as its own funds to lend out up to MYR 2000 and MYR 5000 per individual, respectively, to finance economic activities. Besides direct lending, BIM indirectly disburses loans to the very poor through AIM, which acts as technical assistant and credit intermediary. BIM has been less successful than AIM in reaching the poor due to lack of suitably trained staff to locate the poor. Further, most of BIM's branches are located in urban areas, while the poor are situated in rural and remote areas. Borrowers also need constant supervision and guidance to ensure good repayment rates, and cost associated with the scheme is high because of costs of funds, operating costs, write-offs of bad debts, and opportunity costs.[7]

The Credit Guarantee Corporation (CGC) was established in 1972 with Bank Negara Malaysia and all the commercial banks and finance companies as its shareholders. With the participation of its partners, a total of over 2600 branches of all commercial banks and finance companies throughout Malaysia, CGC manages viable credit guarantee schemes. The objective of CGC is to assist SMEs, particularly those without collateral or with inadequate collateral, to obtain credit from financial institutions by providing guarantee cover on their facilities. CGC schemes for SMEs are not necessarily micro in nature, but the loan size at the lower end may be considered a micro-credit. One example is the Small Entrepreneur Guarantee Scheme (Skim Jaminan Usahawan Kecil) to assist small entrepreneurs who have viable businesses to obtain financing at reasonable cost from participating financial institutions.

[6] Bank Negara Malaysia. Annual Report 2004. Malaysia: BNM, 2005.
[7] http://members.ozemail.com.au/~fdc/bim.html.

They have to be Malaysian-owned and -controlled companies or entrepreneurs registered with an authoritative body. This scheme provides credit ranging from MYR 10,000 to MYR 50,000 at interest rates not exceeding the base lending rate (BLR) plus 1.5%, with the tenure of the guarantee cover for a maximum of 5 years. The guarantee fee is 1.25% per annum based on the guarantee cover and is payable annually in advance.

Bank Kerjasama Rakyat Malaysia Berhad, a rural cooperative bank was established in 1954 under the Cooperative Ordinance 1948. The main objectives of the bank are to improve the living standard of its members through the provision of financing and financial and advisory services to its members and to encourage savings among its members. The bank has 103 branches all over the country to provide personal, property, education, and other financing facilities to members of the public and cooperatives. The bulk of the financing outstanding is in the form of consumption credit. This is attributed to the bank's emphasis on providing small financing ranging from MYR 5000 to MYR 50,000, with repayment periods of 5 to 7 years. The loan size at the higher end may not qualify as micro-credit, and further the service is made available to fixed-income employees.

Micro-credit Schemes of Cooperative Societies

Cooperative societies are savings institutions that comprise both urban credit cooperatives and rural credit cooperatives set up with the aim of providing opportunities for their members to save, invest, and participate in economic enterprises. The urban credit cooperatives comprise employees' credit societies, thrift and loan societies, thrift and investment societies, and unions of credit cooperatives, which were established primarily to mobilize savings and subsequently to provide consumer credit and serve as an investment channel for members. The members of these cooperatives are mostly salaried employees, particularly in the public and private sectors. On the other hand, the rural cooperative societies, while not exclusively targeting the poor, include farmers' organizations and agro-based cooperative societies, which are geared towards rural and agricultural development as well as the improvement of rural poverty. The rural cooperative societies seemed to have very limited success and tend to be utilized only by a few of their members. The cooperative societies are registered with the Department of Cooperative Development, which was established in July 1922. As of June 2004, the number of urban credit cooperatives totalled 449 with about 1.9 million members (Table 9). Generally, cooperatives rely on conventional sources of capital such as share capital, subscription capital, and accumulated income.

Table 9. Performance of the Finance/Banking Cooperatives as of 30 June 2004

Function	No. of co-ops	Individual members	Coopera-tives mem-bers	Share capital (RM million)	Subscripti on (RM million)	Total assets (RM million)
Banking	3	709,991	1189	1,697.7	0.55	16,712.5
Financial	446	1,172,643	140	3,093.6	2358.98	5,149.3

Source: http:// http://www.jpk.gov.my

Micro-credit Schemes of Quasi-governmental and State-based Agencies

The government, together with quasi-governmental agencies such as PNB, MARA, and PERNAS, have taken measures to tackle poverty, develop entrepreneurship, and promote income-generating activities through established schemes and have provided funds for micro-credit facilities. These facilities are aimed at establishing easy and quick accessibility to credit for small traders and hawkers and small-scale entrepreneurs, including women entrepreneurs, and to facilitate entry into micro-businesses or expansion of small businesses. These funds include the "Small-Scale Entrepreneur Fund" and the "Economic Business Group Fund

(TEKUN)." The TEKUN scheme provides credit of from MYR 1000 to MYR 10,000 for first-time borrowers and up to MYR 20,000 for second-time borrowers with good track records. The facility is made accessible to small traders without collateral at a service charge of 8% per annum.

Credit facilities are also made available for rural development programs. For example, in order to increase the household income of the hardcore poor, the repayment schedule of the Amanah Saham Bumiputra (ASB)–PPRT loan scheme was reviewed and expanded to cover the hardcore poor and *Orang Asli* (native Bumiputra). Each family obtained an interest-free loan of MYR 5000 to participate in the ASB scheme, so as to increase their household income through annual dividends and bonuses.

There are also state-based micro-credit programs, for example the Projek Usahamaju (PU) in Sabah. The PU, also a Grameen Bank replicator, was the offshoot of an action research project to reduce poverty organized by the Institute for Development Studies (IDS) Sabah and Koperasi Pembangunan Desa (KPD). PU has since been institutionalized to form Yayasan Usahamaju (YUM) in 1995. YUM has 23 branches, one in every district throughout Sabah. YUM has outlined five objectives: to reach out to a large proportion of the poor rural women in Sabah; to pull the income of rural women above the poverty income line; to encourage and enhance the role of rural women in family economic development; to help poor families to be self-reliant; and to promote savings among rural women.

The main program of YUM is to provide interest-free micro-credit without collateral or guarantors in order to increase the incomes of rural women in Sabah and improve their living conditions. There are three types of loans under the loan program. The first, Program Pinjaman Am 1 (SPA 1), offers a package comprising the loan itself and savings including compulsory, group, and emergency savings. Total loans range from MYR 100 to MYR 6000; the maximum first loan is MYR 2000, the second is MYR 4000, and the maximum of subsequent loans is MYR 6000. The repayment period is between 50 and 150 weeks, with an administration charge of 11% for each successive 50 weeks. The second type of loan, Program Pinjaman Am 2 (SPA 2), is intended for members who have crossed the income poverty line. Total loan amount is between MYR 7000 and MYR 20,000 at an administrative fee of 11% annually. The third type of loan is the Skim Peniaga Pasar (SPP), provided specially for petty trading, with a loan size of between MYR 100 and MYR 1000 at an administration charge of 4% a month.

YUM has been performing well in terms of the repayment rate from its loan program (Table 10). From 1990 to March 2004, 14,019 members from 1,152 villages utilized 25,106 loans from YUM. Nevertheless, it has been reported that YUM is facing repayment problems, and its progress toward financial viability has been slow because of large operation costs.

Table 10. Amount Financed (1988–2002)

	1998	1999	2000	2001	2002
Amount (MYR million)	3.492	3.950	3.233	3.378	0.223
Members	909	1503	970	1085	176
Repayment rate	98.16%	98.06%	98.33%	98.46%	96.97%

Source: http://www.sabah.gov.my/yum/dasar_dan_maklumat.htm

The Village Micro-Credit Program is another program to address extreme poverty; its loans are extended to the *Orang Asli* (Bumiputra). It was introduced to enable them to gainfully utilize their free time to undertake economic activities, especially in agriculture and in micro-business. For effective implementation of the scheme, credit is provided on a group basis through the Village Development Committee for villages involved in the one-product, one-village program. The implementation is supervised by the District Development Committee and the Implementation and Coordination Unit, PM's Department.

Micro-credit through Pawnbroking

Pawnbroking has been perceived as a reliable source of affordable loans since borrowers do not have to bear additional loan costs other than the commission for keeping and safe-guarding gold products used for collateral. Pawnshops are licensed under the Pawnbrokers Act of 1972 and offer a quick and convenient source of credit. The interest rate that can be charged under the law is 2% per month or 24% per annum.[8] This is considered high since the loan given out is more than covered by the value of the collateral. Pawnshops are important especially to people with low incomes and little education, whose credit status excludes them from formal financial markets. At the end of 1995 there were 282 pawnshops in Malaysia; borrowers numbered about one million for that year, with an average loan size of only MYR 803.00.[9]

Bank Islam participates in partial financing of the Kelantan State Islamic Pawnbroking Project, amounting to MYR 5 million. Under this project, the state agency gives out loans to the poor and desperate customers against their jewelry. Most of the clients are businesswomen operating as hawkers and petty traders. They save part of their profits and convert them into jewelry, which they wear on their persons. In times of need they deposit the jewelry with the agency for cash on short terms against payment of a service fee of 12% per annum. Besides pawnshops, there are a few banks offering Islamic pawnbroking services. Compared to conventional pawnbroking, Islamic pawnbroking costs less than 20% per annum. Banks involved in the Islamic pawnbroking scheme are Bank Kerjasama Rakyat and EON Bank's Islamic Banking. Bank Kerjasama Rakyat launched its Ar-Rahnu Islamic pawnbroking scheme in 1993; by December 2001 the scheme had attracted 591,151 customers, who had received loans totalling MYR 6.4 million.[10] EON Bank's Ar-Rahnu scheme was launched in August 2002, operating through a total of 10 EON bank branches. As of 15 September 2003, a total of MYR 3.2 million worth of loans had been extended to customers.[11]

Summary

Malaysia has been providing microfinance for income-generating activities towards poverty reduction. There is only one major NGO microfinance institution, AIM, providing micro-credit to the rural poor. On a much smaller scale is YUM, which operates in the state of Sabah. Other microfinance intermediaries include savings institutions such as Bank Simpanan Nasional and credit cooperatives. However, as recently as 2003, the government introduced micro-credit through two development financial institutions that are already being regulated and supervised by the central bank. These schemes are not targeting the poor in particular, but rather are aimed at microenterprises. The goals are to make it easier for small businesses to get financing, to lower the cost of borrowing, and to be more expeditious in approving loans. It has also been announced that the cooperative movement will be strengthened as another potential source of financing. This new approach is also aimed at ensuring access to finance, especially for microenterprises and low-income groups.

GOVERNMENT POLICY ON MICROFINANCING

"The important discovery of micro-financing, a powerfully effective and efficient tool in poverty reduction and in bridging the income gap between the poor and the rich, marks the

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[8] Kon Lim Yap, "Consumer Credit Regulations in Malaysia: A Country Report." Ministry of Domestic Trade and Consumer Affairs, Malaysia.
[9] Ismail Abdul Ghafar and Nor Zakiah Ahmad, "Pawnshop as an Instrument of Microcredit in Malaysia." *International Journal of Social Economics* 24.11 (1997).
[10] Bank Kerjasama Rakyat, Annual Report 2001.
[11] "EON Bank Introduces Cost-competitive Islamic Micro-credit Facility," EON Bank Group Malaysia, Press Room, 25 September 2003.

beginning of a new era towards the ultimate eradication of poverty in our nations" (Dato' Seri Dr. Mahathir Mohamad.[12]

Malaysia acknowledges the role of microfinancing as an important instrument for poverty alleviation. While poverty alleviation programs have been broad-based in Malaysia, micro-credit programs are seen as complementing the government's efforts in reducing poverty. As such, the government especially supports and sponsors these programs. Nevertheless, it has been noted that "the official Malaysian approach to eliminating poverty, and to the provision of micro-financing services as an element in that process, has been essentially "social-welfarist." Microfinance services for people without access to conventional financial institutions have been seen within the framework of a redistributive social policy involving substantial subsidies."[13]

It should be mentioned that the problem of poverty is closely related to the social problems of a multiracial economy. Therefore, the approach to poverty eradication cannot be separated from the issue of obtaining ethnic balance in socioeconomic and political terms (Nair 2001). The thrust of the government's policy in poverty eradication and income distribution is therefore a unique Malaysian approach aimed towards a more equitable distribution of economic progress.

The government is supportive of the programs of AIM by being the main sponsor. The government provides loan capital in the form of grants as well as interest-free loans to AIM to be distributed to the poor. At the same time, the respective state governments have also supported AIM with grants and contributions to the operational cost. AIM branches and regional offices work together with government agencies to organize programs and workshops for AIM members. Similarly, YUM receive grants from the Sabah state government for its activities. The policy of subsidizing these micro-credit schemes that target the poor is appropriate in Malaysia, where the relatively small number of hardcore poor and the poor are at present unable to obtain credit from the banks without pledging the required collateral and meeting other restrictive conditions. With the support of the government, AIM has been instrumental in reaching the poorest of the poor and contributes significantly to government efforts to eradicate poverty.

The micro-credit scheme implemented in 2003 is seen as a new, comprehensive framework to complement existing financial intermediaries that are successful and sustainable. The provision of microfinancing together with other resources such as the development of the venture capital industry and a better framework for SME financing will be an important priority so as to enhance alternative sources of financing and to ensure that credit is made available to all segments of the economy. The objective is to unlock the potential of the large number of small businesses and microenterprises that are contributing to domestic economic growth. The underlying philosophy is significant. Small businesses are being treated as a new source of growth. Not only will the development of small businesses address the issue of poverty, but their continued success will further enhance their contribution the economy. This microfinancing initiative was undertaken by BNM as one of the main thrusts of the financial sector's policy measures to ensure continuous access to financing:

> A significant initiative undertaken in 2003 was the strengthening of the existing infrastructure and institutional arrangement to extend the outreach of financial services to microenterprises. In February 2003, Bank Negara Malaysia proposed to leverage on the extensive branch network of Bank Simpanan Nasional and Bank Pertanian Malaysia to provide microfinancing. To equip these development financial institutions with the necessary best practices and skills to provide microfinancing, initiatives were undertaken to

[12] Speech by the then Prime Minister of Malaysia, Dato' Seri Dr. Mahathir Mohamad, at the opening of the RSC-AP Meeting, Kuala Lumpur, 13 October 1997.
[13] John D. Conroy, *The Challenges of Microfinancing in Southeast Asia*, p. 6.

> develop micro-finance products, operating manuals and systems as well training programs for loan officers and branch managers.[14]

The government recognized that one of the challenges facing microenterprises is access to financing. More often than not, microenterprises lack a financial track record; limited credit history and insufficient collateral contribute to their difficulty in accessing financing from the formal banking system. The characteristics of microfinancing include the provision of very small loans, frequent repayment intervals, and close monitoring to ensure timely repayment. Given the unique features of microfinancing, the conventional banking system is considered not the appropriate mechanism to address the financing needs of microenterprises. Further, it has been noted that the financing needs of this group of borrowers have not been adequately met through existing MFIs. Therefore, the central bank has decided to further strengthen existing infrastructure, enhance their effectiveness, and establish new institutional arrangements so as to extend the outreach of provision of financial services to all microenterprises and low-income groups. Consequently, the micro-credit scheme was launched and implemented by BSN and BPM.

In addition, BNM is directing its attention to the cooperatives as another potential source of financing for microenterprises:

> Bank Negara Malaysia is also working with the Ministry of Land and Cooperative Development and Department of Cooperative Development to strengthen the cooperative movement as a potential source of financing for microenterprices and low-income groups. Efforts are underway to enhance the infrastructure and regulatory and supervisory frameworks to achieve this objective.[15]

The implementation of the micro-credit scheme through two development financial institutions and later through the cooperative movement represents the efforts of the government to develop a more diversified financial structure. This is necessary to ensure that there is increased access to financial services by all economic sectors, regions, and communities.

LEGAL AND REGULATORY ENVIRONMENT

Currently, much attention is focused on the need to have an appropriate legal and regulatory environment for MFIs. This is because microfinance is unlikely to achieve anything like its potential unless it can be undertaken in an enabling environment. For Malaysia, there is a scarcity of MFIs and understandably an absence of any set of legal structures for MFIs thus far. While this has not been a constraint on the development of MFIs, there are some key elements of policy framework that should be considered for microfinance in Malaysia.

In terms of the legal framework, at present there are no set processes for the establishment of microfinance NGOs. Neither are there any legal barriers to their establishment. In the case of AIM, AIM was established as an Incorporated Private Trust and applied for exemption from the Moneylenders' Ordinance 1951 that was administered by the Housing and Local Government Ministry. This was to avoid the possibility that disbursing its loans and collecting an administrative charge on them might contravene the Ordinance. The Moneylenders' Ordinance of 1951 regulates moneylending activities. Even though AIM does not charge interest on its loans, it does levy an administrative charge and receive back more than it lends out. Another example is PIE, which was incorporated as a company under the Companies Act of 1965. PIE was also granted exemption from the 1951 Moneylenders' Ordinance by the Ministry of Housing and Local Government. These microfinance NGOs are not banks and are not licensed to accept deposits.

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[14] Bank Negara Malaysia. Annual Report 2003 (Malaysia: BNM, 2004).
[15] Bank Negara Malaysia. Annual Report 2003 (Malaysia: BNM, 2004).

Since there are no clear registration guidelines for MFIs, the government should establish simple straightforward licensing requirement suitable for MFIs, and keep them outside the ambit of the Moneylenders' Ordinance of 1951.

There is currently no regulatory and supervisory framework for microfinance NGOs. Basically, there is no critical mass of MFIs in Malaysia, and the question raised is whether there is actually a need to have a regulatory and supervisory framework for the MFIs. In addition, existing microfinance NGOs do not mobilize savings from the public. Loan capital comes basically from donor grants and soft loans that are not from commercial borrowings. Again, it has been recommended that while every effort needs to be made to ensure that institutions that mobilize deposits from the public are appropriately regulated and supervised likewise, there is less reason to supervise an institution that does not mobilize deposits. As such, this situation is appropriate since MFIs do not accept deposits from the public.

Initially, interest rates on loan are regulated through guidelines issued by the Central Bank. However, a new interest rate framework was implemented on 26 April 2004. Under the new framework, the maximum lending rates charged by banking institutions are no longer subject to the previous bank lending rate (BLR) formula, and the maximum lending spread of 2.5 percentage points above BLR has also been removed. Instead, banking institutions are free to set their own BLR based on their own cost structure and lending strategy as well as the level of competition in the industry. With the removal of the ceiling on lending rates, loans are increasingly priced according to the risk profile of different borrowers and market segments. The flexibility in the pricing of spreads will allow wider access to financing for borrowers who previously faced difficulties in obtaining loans. Since the introduction of the new interest rate framework, there has been no change in the BLRs quoted by banking institutions, with one exception, indicating that the respective BLRs were already at a competitive level. It has also been reported that several banking institutions have already introduced specialized lending packages for individuals and small businesses. But whether these banks will enter microfinance is questionable given the characteristics of micro-lending, including the high transaction cost of making very small loans with frequent repayment intervals and close monitoring to ensure timely repayment of loans.

At the same time, BNM still maintains the prescribed lending rates for financing to certain sectors to ensure that they have access to financing at reasonable cost. The sectors affected include BNM-administered special funds for SMEs, which provide financing to SMEs at below market rates, ranging between 3.75% and 5%; and the ceiling still applies on lending rates on housing loans extended to low- and middle-income borrowers under the Lending Guidelines to Priority Sectors. Additionally, lending rates on hire-purchase loans remain subject to the Hire-Purchase Act of 1967, while lending rates on credit card loans are subject to the maximum interest rate of 18% per annum as prescribed in the Credit Card Guidelines issued by BNM. With regard to micro-credit extended by DFIs, the interest rate is fixed at 4%, much less than would be required to cover the extra costs associated with micro-banking lending. The extension of micro-credit at subsidized rates will become an issue unless the government provides grant assistance or soft loans or bears the differential margin for the banks.

It is unclear whether these directed credit schemes targeting microenterprises will actually benefit poor borrowers. In any case, it is generally suggested that government should abolish interest rate ceilings for microfinance programs and remove any subsidy that inhibits sustained access and competition. Instead the government should promote micro-credit at competitive market rates in order to be able to cover the schemes' operating and financial costs, thereby ensuring the financial sustainability of the micro-credit scheme.

As discussed, micro-credit schemes that have been introduced through several DFIs are being regulated and supervised by the central bank. DFIs are specialized financial institutions established by the government as part of an overall strategy to develop and promote specific strategic sectors. They are regulated and supervised by the Development Financial Institutions Act of 2002 (DFIA). DFIA provides a comprehensive regulatory framework to ensure safe and sound financial management of the DFIs. The DFIA takes into consideration the unique roles, functions, and objectives of each DFI, the relevant provisions in the existing statutes, and the current supervisory standards that are provided in the Banking and Financial Institutions Act of 1989 (BAFIA) and the Insurance Act of 1996. It aims to ensure that the policies and objectives of DFIs are consistent with government initiatives. Under the DFIA, BNM would be the single regulatory and supervisory body for the DFIs. In performing its role, BNM's focus will be to promote effective and efficient DFIs, which will eventually minimize the cost to the government of meeting its policy objectives.

DFIA provides a comprehensive supervision framework which incorporates prudential rules, onsite and offsite supervision, reporting requirements, and disclosure standards. It also provides the regulator the necessary power to deal with any mismanagement and malpractices. DFIA provides the mechanism to strengthen the financial position of DFIs through prudential requirements such as the management of assets and capital and liquidity management.

The cooperative societies are registered with the Department of Cooperative Development, under the Ministry of Land and Cooperative Development. The Department ensures that the cooperative societies adhere to the laws and principles of cooperatives in accordance with the provision of the Cooperative Act of 1993 and the Cooperative Regulations of 1995. The 1993 Cooperative Act makes provision for the constitution, registration, control, and regulation of cooperatives. Both the Cooperative Act and the Regulations emphasize good management practices such as transparency, accountability, prudence, and overall quality. All cooperatives, while subjected to the Cooperative Act, are under two different Ministries that are responsible for cooperative development. The Ministry of Agriculture is responsible for the development of agro-based and fisheries-based cooperatives, whereas the Ministry of Land and Cooperative Development is responsible for credit, construction, transportation, consumer, industrial, services, plantation, and housing cooperatives (Table 11).

Table 11. Regulation and Supervision of Microfinance Intermediaries in Malaysia

Type of MFIs	Regulation and supervision	Government agency
Micro-finance NGO	No regulatory and supervisory framework	Self-regulatory
DFIs	Development Financial Institution Act of 2002, a comprehensive and regulatory framework for DFIs	Central Bank
Cooperative, credit unions	Cooperative Act of 1993 and Co-operative Regulations of 1995 provide a specific regulatory framework for cooperative societies	Department of Cooperative Development
Pawn shops	Pawnbrokers Act of 1972 regulates the business of pawnbroking carried out by pawn shops	Ministry of Housing and Local Government

Conclusion

Microfinance intermediaries in Malaysia include NGOs, specialized credit windows of financial development banks, cooperative societies, and quasi-governmental and state-based agencies. Development financial institutions that are offering micro-credit are already being regulated and supervised by the central bank, while credit cooperatives are supervised by the Department of Cooperative Development. On the other hand, there are a very limited number of MFIs in Malaysia and an absence of a regulatory and supervisory framework for microfinance NGOs. Nevertheless some regulatory components have to be in place for the development of MFIs in Malaysia. These include the provision of a transparent licensing requirement for microfinance NGOs and the removal of subsidized interest rates to reflect the high transaction cost. MFIs in Malaysia do not collect deposits and are not subjected to any prudential regulation or supervision.

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APPENDICES

Appendix 1. Assets of the Financial System

	Annual change		As of end–2004*p*	
	2003	2004*p*		
	MYR billion			% share
Banking system	122.4	142.9	1,189.9	67.5
Bank Negara Malaysia	38.6	84.0	284.9	16.2
Commercial banks	66.3	128.1	737.1	41.8
Finance companies	11.2	–73.5	68.4	3.9
Merchant banks	2.8	–1.3	42.8	2.4
Islamic banks	0.8	3.9	24.9	1.4
Discount houses	2.8	1.7	31.9	1.8
Nonbank financial intermediaries	45.5	56.6	572.7	32.5
Provident, pension, and insurance funds	30.6	35.4	383.2	21.7
Employees Provident Fund	18.0	20.0	240.2	13.6
Other provident and pension funds	1.6	4.7	51.1	2.9
Life insurance funds	9.8	10.1	74.1	4.2
General financial funds	1.2	0.6	17.8	1.0
Development financial institutions[1]	6.6	11.2	90.3	5.1
Other financial intermediaries[2]	8.3	10.0	99.2	5.7
Total	168.0	199.5	1,762.6	100.0

[1]Includes Bank Simpanan Nasional (National Savings Bank), Bank Kerjasama Rakyat Malaysia Berhad, Bank Pertanian Malaysia, Malaysia Industrial Development Finance Berhad (MIDF), Borneo Development Corporation, Sabah Development Bank Berhad, Sabah Credit Corporation, Export-Import Bank Malaysia Berhad, Bank Pembangunan dan Infrastruktur Malaysia Berhad, Bank Industri dan Teknologi Malaysia Berhad, Malaysia Export Credit Insurance Berhad, Credit Guarantee Corporation Malaysia Berhad (CGC) and Lembaga Tabung Haji (Pilgrims' Funds Board).

[2]Includes unit trusts run by Amanah Saham Nasional Berhad (ASNB) and Amanah Saham Mara Berhad, cooperative societies, leasing and factoring, Borneo Housing Mortgage Finance Berhad, and Malaysia Building Society Berhad.

p = preliminary

Source: Bank Negara Malaysia

Appendix 2. Banking System: Key Data

	As at end–				
	2000	2001	2002	2003	2004
Number of institutions	64	49	47	46	41
Commercial banks	31	25	24	23	23
Finance companies	19	12	11	11	6
Merchant banks	12	10	10	10	10
Islamic banks	2	2	2	2	2
Risk-weighted capital ratio (%)	12.5	13.0	13.2	13.8	13.8
Commercial banks	12.2	12.8	13.2	14.1	13.9
Finance companies	11.5	12.1	12.0	11.6	10.2
Merchant banks	17.1	19.6	19.0	19.2	21.9
Islamic banks	17.1	14.4	12.6	11.7	12.5
Office network	2,835	2,675	2,531,	2,563	2,429
Commercial banks	1,758	1,660	1,631	1,685	1,960
Finance companies	933	874	755	729	316
Merchant banks	22	19	17	17	17
Islamic banks	122	122	128	132	136
ATM network	3,694	4,169	4,213	4,396	4,651
Commercial banks	3,004	3,386	3,477	3,707	4,098
Finance companies	560	605	551	477	273
Islamic banks	122	178	185	212	280
Number of banks with internet services	3	8	12	12	13
Commercial banks	3	8	12	12	13
Persons served per office					
Commercial banks	13,256	13,959	15,040	14,866	13,051
Finance companies	24,920	26,474	32,490	34,362	80,949
Islamic banks			191,641	189,773	188,08
Number of employees	96,159	93,329	90,864	90,844	93,948
Commercial banks	70,226	67,398	65,866	66,458	78,032
Finance companies	20,725	20,488	19,430	18,634	9,190
Merchant banks	2,339	2,402	2,451	2,429	2,690
Islamic banks	2,869	3,041	3,117	3,323	4,036

Source: Bank Negara Malaysia

Appendix 3. Bank Pertanian Malaysia

Year of establishment: 1974

Objectives: Bank Pertanian Malaysia was established to promote sound agricultural develoment through the provision of loans and advances. The main function of the bank is to coordinate and supervise the granting of credit facilities for agricultural purposes and mobilize savings, particularly from the agriculture sector and community.

Agriculture, forestry, and fishery	Loans approved (MYR million) 2004	Loans disbursed (MYR million) 2004
Oil palm	196.8	121.2
Food crops	85.3	81.4
Livestock	60.4	69.2
Fishery	122.7	46.8
Forestry	21.0	1.4
Tobacco	0.7	19.7
Rubber	8.4	9.3
Others	600.3	574.9
Total	1,095.5	923.9

Total Assets, Gross Loans, and Deposits

Year	Assets (MYR million)	Loans (gross) (MYR million)	Deposits (MYR million)
1970	10.18	0.30	0.00
1975	206.00	78.39	142.08
1980	812.59	284.70	630.76
1985	1447.91	746.89	1064.34
1990	1402.81	1127.69	1182.98
1995	3975.60	1760.81	3244.40
2000	5087.78	2063.17	4229.29
2001	4537.69	2173.87	3560.79
2002	4430.61	2363.60	3504.59
2003	5092.68	2745.92	3764.70

Source: Bank Pertanian Malaysia

Appendix 4. Bank Simpanan Nasional

Year of establishment: 1974

Objectives: Bank Simpanan Nasional is a savings bank, incorporated under the National Savings Bank Act of 1974; it focuses on retail banking and personal finance especially for small savers.

	Deposits accepted		Interest rate/ rate of return (%)	
Deposit facility	As of end-2003	As of end-2004	2003	2004
Savings deposits	1,230.7	1,103.7	1.30 ~ 4.51	1.00 ~ 2.00
Fixed deposits	3,422.0	4,654.2	3.00 ~ 3.70	3.00 ~ 3.70
GIRO deposits	3,595.9	4,054.1	1.30 ~ 2.30	1.00 ~ 2.00
Islamic deposits	281.9	252.0	1.96 ~ 3.40	1.90 ~ 5.52
Premium savings certificates	904.7	922.8	1.50	1.50
Total	9,435.2	10,986.8		

Investments	MYR million	
	As at end-2003	As at end–2004
Quoted shares	1,389.0	1,277.7
Malaysian Government Securities	1,923.7	2,267.1
Private debt securities	1,084.7	819.7
Subsidiary companies	437.8	437.8
Associate companies	231.8	231.8
Total	5,067,0	5,034,1
Number of branches	398	393
Number of account holders (‘000)	10,252	11,446
Number of automatic teller machines (ATM)	591	599

Source: Bank Simpanan Nasional

Appendix 5: Bank Kerjasama Rakyat Malaysia Berhad

Year of establishment: 1954

Objectives: Bank Kerjasama Rakyat Malaysia Berhad mobilizes savings and provides financing services to its members as well as non-members.

Sector	Financing outstanding (MYR million)			
	As of end-2003		As of end-2004	
	Members	Non-members	Members	Non-members
Agriculture	45.2	11.7	48.3	10.2
Purchase of property	1,201.9	696.5	2,246.8	822.7
General commerce	46.4	424.7	45.7	399.5
Purchase of securities	15.8	101.5	10.8	78.9
Purchase of motor vehicles	278.3	0.7	649.6	0.6
Consumption credit	6,120.0	735.3	6,656.8	1,032.1
Manufacturing		100.3		100.8
Others		178.4		251.1
Total	7,707.6	2,249.1	9,658.0	2,695.9

Source: Bank Kerjasama Rakyat Malaysia Berhad

NEPAL

Rabindra P. Rajbhandari
Nepal Rural Development Organisation

BACKGROUND

Poverty in Nepal

The Himalayan Kingdom of Nepal, lying on the southern slope of the Himalaya mountain range, covers an area of 147,181 square kilometers; it is landlocked, bordering China to the north and India on the other three sides, i.e., east, south, and west. A snow-capped high mountainous and hilly region, with significant physical diversity, covers more than 80% of the land mass; only 20% of Nepal's land is arable.

Out of the Nepalese population of 23 million, estimates suggest that 42% live below the poverty line, defined as having income below one US dollar a day, which is not sufficient to support a minimum daily requirement of 2150 calories. The poor are rural-based subsistence farmers who barely manage to make half of their yearly income from agriculture production; they earn less than 25% from off-farm employment and the remainder from miscellaneous subsistence activities.

The average annual growth rate in GDP has been 4.5% over the past two decades, and the per capita income of US $250 per annum is perhaps the lowest in the whole eastern region of Asia.

In Nepal, the rural poverty rate is twice as high as than that of urban areas, i.e., 44:23, and more than 90% of the poor live in rural areas. Only 4% of people living in the urban Kathmandu Valley are poor, compared with 56% of those living in the mountains (Table 1).

Table 1. Poverty Incidence by Region 1995–1996

Region	Poverty incidence	Poverty gap	Illiteracy (% pop.)
Nepal	42	0.121	64
Urban	23	0.070	37
Rural	44	0.125	67
Urban Kathmandu valley	4	0.004	24
Other urban	34	0.109	45
Hills	41	0.136	58
Mountains	56	0.185	75

Source: Prennushi, 1999

Poverty incidence in Nepal is deep and pervasive, with wide disparity across regions. The difficult terrain, landlockedness, poor natural resource base, and long-lived feudal social infrastructure have made the task of economic development extremely challenging.

Over the last two decades, the Nepalese economy has diversified significantly. The share of agriculture has decreased from 62% of the economy to less than 40%, and the share of industry has grown to 20% (Table 2).

Table 2. Economic Performance Indicators
(averages in % unless stated otherwise)

Per capita	1971–1980	1981–1990	1991–2000	2001–2002
Income growth	0.4	2.0	2.4	–1.5
GDP growth	2.4	4.3	4.9	0.8
Share of agriculture	62.7	52.8	41.8	38.8
Share of industry	12.7	15.0	19.5	20.2
Share of services	24.6	32.2	38.8	41.0
Investment as % of GDP	13.1	19.4	23.5	24.1
Public investment	3.9	7.9	7.0	6.1
Private investment	9.2	11.5	16.5	18.0
Revenue to GDP	6.5	8.5	9.8	11.6
Expenditures to GDP	11.0	17.6	16.8	16.8
Deficit to GDP	4.4	6.5	4.9	4.4
O/w Domestic Financing	1.1	2.8	1.8	2.8
Expert to GDP	12.1	12.0	22.8	20.0
Import to GDP	17.3	22.0	34.4	31.1
M2 to GDP	17.1	28.5	39.9	53.2
Domestic credit to government (net)	2.7	12.3	10.8	11.6
Domestic credit to parastatals (net)	1.8	2.7	0.7	0.5
Domestic credit to private sector (net)	5.1	10.3	21.9	31.8
Inflation (CPI average)	7.8	10.2	8.3	2.8
Lending interest rates	13.5	15.6	11.6	7.7
Exchange rate (NRS US$)	11.4	16.6	58.6	76.6

Source: World Bank staff estimate

Human Development Indicators

Apart from income levels, poverty levels can be measured more broadly in terms of access to basic social and economic infrastructure resources that help to improve the quality of life at various levels of income. Among these, education is by far the most important, since it would enable the poor to climb out of poverty over time; but others, such as access to health care, safe drinking water, and sanitation, also contribute to improved living standards and life expectancy. Nepal has made significant progress over the past two decades in terms of such human development indicators

Table 3, compiled from Nepal Human Development Reports 1996 and 2001, shows both the current situation and recent progress in this regard.

Table 3. Human Development Indicators, 1996 and 2001

	Region adult literacy rate (above 15 years)		Average life expectancy		% of pop. having drinking water		Human development indicators (Index 1.00)	
	1996	2000	1996	2000	1996	2000	1996	2000
Ecology zone								
Mountain	27.5	44.5	52.7	59.8	–	79.2	0.271	0.378
Hill	40.2	55.5	58.0	65.1	–	76.2	0.357	0.51
Terai	35.9	46.8	59.5	62.4	–	83.4	0.344	0.474

(continued on next page)

Urban/Rural								
Urban	63.5	69.0	55.0	71.1	62.0	92.3	0.518	0.616
Rural	34.5	48.0	53.7	58.7	61.0	78.1	0.306	0.446
Nepal	36.7	50.7	55.0	59.5	61.0	79.9	0.325	0.466
Dev. Region								
Eastern		43.4		62.0		77.7		0.484
Central		47.1		61.3		85.1		0.493
Western		48.3		62.8		83.8		0.479
Midwest		50.4		53.2		65.5		0.402
Far west		42.6		52.1		82.3		0.385

Source: Nepal Human Development Reports, 1996 and 2001

Despite significant progress in recent years, human development indicators are still low for Nepal; and they show significant urban/rural and geographical variations: (i) The Human Development Index (HDI) for urban areas (0.616) far outstrips that for rural areas (0.446), because of far better access in urban areas to services, resources, and opportunities. (ii) Similarly, HDI for the mountains (0.378) is far below than that of the hill areas (0.51). The scattered dwelling of communities in the high mountains sharply limits access to services and resources to disadvantaged people living there. Human development in the hills is higher than in the Terai southern lowland region (at the national average), is part because many large towns and cities (including Kathmandu) are located in the hills. (iii) Among the developed regions, HDI is highest for the central region (0.493), followed closely by the eastern (0.484) and western (0.479) regions. This is largely due to the fact that most of Nepal's trading centers and productive economic activities are concentrated there. In contrast, the midwestern (0.402) and far western (0.385) regions, far from the center of power, have been traditionally neglected. Despite recent efforts to include them in the country's modernization process, these areas (except for midwestern Terai) made little progress in terms of the level of improvement in HDI between 1996 and 2000. Gender inequality, rural/urban and regional disparities, and poor health care facilities are prominent even today and have placed Nepal in 144th position out of 174 nations in the Human Development Index rank of UNDP 1999.

Recently released HDI reports Nepal's HDI at 0.504 and ranked the country140th among 177 nations, as against 0.584 for the South Asian Region as a whole. Life expecting at birth is reported at 61.9 years, increased from 56 years in 1996/97; the adult literacy rate is 49.2%, increased from 37.8% in 1996/97. Net enrollment ratio for primary school is 80.4%, up from 67.4% in 1997/97; and GDP per capita stands at 1370 in PPP US$.

Unemployment

Population growth of 2.2% per annum has eroded the limited gains, and the demographic profile of a labor force growing by more than 400,000 per year is a major challenge in avoiding further deterioration in the poverty situation. Rapidly growing unemployment is perhaps the main reason for the rising revolutionary insurgency problem in the country today. If population grown cannot be arrested and if no rapid economic growth program is undertaken, continued poverty seems to be a long-term proposition. The solution lies in population control vis-à-vis productivity growth, but this will take a long time.

There will remain a large number of absolute poor. At this junction the only desirable program in the immediate short term is a sustained program to support the poor with subsidy transfers through welfare-oriented and productivity-oriented programs. Government, international agencies, international nongovernmental organizations (INGOs), and NGOs, with a wide range of integrated projects, have started investing in various poverty alleviation programs in Nepal. These programs have initiated various welfare improvements: improved nutrition, sanitation, and hygiene; basic education; and increased access to credit for the poor through targeted micro-credit programs.

There is no easy poverty alleviation strategy for Nepal. The solution must lie in growth, which so far has been elusive despite 50 years of planned development. Most of the growth has been concentrated in the modern sector and has not reached the poor. The need is for a growth strategy focused is on enabling measures, setting preconditions which would require the poor to help themselves by targeted micro-credit along with carefully designed welfare-oriented program interventions.

Poverty Reduction Strategy

Tenth Five-year Development Plan (2002/2007)

His Majesty's Government of Nepal (HMG/N) announced a comprehensive Poverty Reduction Strategy, (PRSP) at the Nepal Development Forum 2000. The PRSP focuses on reducing overall poverty from about 42% to 30% as its key target along with raising the literacy rate to 63%, reducing infant mortality from 64 to 45 per 1000, raising life expectancy from 62 to 65 years, increasing access to drinking water from 72% to 85% of the population, increasing access to electricity to 55% from 40% at present, and providing telephone facilities in all of the country's 4500 villages by the end of the Tenth Plan period (2002/2007).

PRSP is in line with the Tenth Plan, which in itself is a part of the long-term goals Nepal has targeted:

Poverty reduction rate to	10%
Semi-employment to	10%
Literacy to	100%
Population growth to	1.5%
Road and water to	100%
Electricity to	50%
Maternity mortality rate to	250/100,000

The country has targeted overall achievement of a growth rate of 8.3% % by the end of the twelfth five-year development plan in 2016/17. The Tenth Plan is a part of Nepal's long-term development concept.

	Overall Economic Indicators		
1.	Yearly growth rate	6.2	From 4.4 in 9th plan
2.	Agricultural growth	4.1	3.0
3.	Nonagricultural growth	7.3	5.3
4.	National saving/GDP ratio (%)	22.7	19.6
5.	Total investment/GDP ratio (%)	26.8	25.8
6.	Fixed investment ratio	25.4	24.6
7.	Marginal capital or productivity ratio	4.3	4.3
	Social Indicators		
1.	Infant mortality per 1000	45	64
2.	Total reproductive rate (%)	3.5	4.1
3.	Maternity mortality rate (per 100,000)	300	439
4.	Use of family planning (%)	50	39
5.	Delivery by skilled man power (%)	55	36.3
6.	Life expectancy (years)	62	57.6
7.	Primary education (%)	90	80.4
8.	Literacy (%)	70	52.7
9.	Women's literacy (%)	65	37.4

10.	Drinking water access (%)	85	69
11.	Population growth rate (%)	2.1	2.27
12.	Below poverty line (%)	30	38
13.	HDI	0.517	0.466
14.	HPI	34.0	39.2
	Infrastructure Indicators		
1.	Road access districts	70	63
2.	Irrigation land	1471	1117
3.	Telephone access (population %)	40	11
4.	Telephone access (villages)	4500	1761
5.	Computer access (villages)	1500	NA
6.	Electricity access (%)	30	17
7.	Electricity access (villages)	2600	1600
8.	Agricultural rural roads (km)	10,000	NA

Source: 2001: Tenth Plan Concept Paper

Poverty Alleviation Fund (PAF)

The government has recently initiated a Poverty Alleviation Fund (PAF) under an Ordinance promulgated in 2003, which will be used as an umbrella program to strengthen target-oriented programs. A budget allocation of NPR 225 million has been made as the initial contribution, and the fund anticipates donor support from bilateral and multilateral agencies.

The major objectives of the fund are to alleviate existing poverty through a process of empowerment of the poor, socially and economically, by improving access to essential services and opportunities. The fund aims to achieve this objective through social mobilization and greater participation of the poor in decisions regarding local development. The focus of the fund's activities will primarily be on capacity building of the poor through social, economic, and physical infrastructure development. It will undertake a wide range of programs in areas like health, education, literacy, technical and vocational skills, youth employment training, and physical infrastructure developments like rural roads, small bridges, micro-irrigation projects, and drinking water. The promulgating ordinance says: "The fund will provide financial and technical assistance to resource mobilization to poverty alleviation and institutional development and also to provide the basis and procedures for providing grant or assistance to local NGOs and CBOs." The PAF so far on an experimental basis has started its programs in 6 model districts of the country: two in high mountain areas, two in hilly regions, and two in the southern plain where poverty incidence has been high. The coverage will be made in 57 Village Development Committees (VDC), village units defined for administrative purposes through NGOs and community-based organizations (CBOs) working in the local situation. PAF claims that the work procedure has been designed in such a way that it attracts less political interest, in the hope of avoiding the failures of earlier programs and also taking into consideration the ongoing internal insurgency conflict.

MICROFINANCE IN NEPAL

The microfinance sector has witnessed greater participation of the private sector, especially NGOs and Development Banks, as well as the central bank (NRB), in recent years. Microfinance services consist mainly of services which enable poor to have easy access to credit to fulfill a wide range of needs: to meet their regular needs; to invest in self-employment, small micro-enterprises or income-generating activities, to improve their accommodation and pay for their children's education, health, and nutrition; to fulfill social obligations like marriage festivals; to provide for old age and even meet death expenses. All these are not too different from the needs and wants of those who are not so poor in rural areas.

The approach in Nepal has shown a distinct bias towards reaching women of poor households and enhancing women's capacity to generate income through various alternative models of microfinancing. This is a positive sign of faster equal-opportunity development intervention.

The microfinance sector has been able to provide a safe and convenient door-to-door deposit scheme for low-income poor women. The service has explored the vast saving potential of the poor for their future requirements. That it has turned out to be a major source of funds for their credit requirements is evident from the fact that at present between 25% and 30% of the microfinancing funds come from the savings of the poor themselves. The demand for saving services by the poor is as strong as the demand for credit.

Nepal Rastra Bank (NRB, the central bank) has in the course of 14 years of microfinance history initiated various development initiatives and promulgated various regulatory and supervisory financial regulations to sustain microfinance institutions (MFIs) in the country. Nepalese MFIs can be broadly grouped into Commercial Banks, Regional Rural Development Banks (RRDBs), Micro Finance Development Banks (MFDBs), cooperatives, and nongovernmental organizations (NGOs). Commercial bank lending and share participation in other MFIs have been accepted as within the ambit of microfinance lending. Five Regional Rural Development Banks have been established under the sponsorship of the government and the NRB to provide microfinance services targeting poor households in particular. Four NGOs—namely NIRDHAN, Centre for Self-help Development (CSD), Chimek, and Development Project Service Centre—have converted their microfinance operations into Micro Finance Development Banks (MFDBs). All of them are Grameen Bank replicators, following Bangladesh's Grameen Bank model of microfinance. MFIs all together have covered 37 districts out of 75 across the country and have provided services to a known 630,000 rural poor people.

A Rural Credit Review Survey conducted in 1999 indicated that only 10% to 18% of households borrow from the formal financial sector. Despite substantial growth in the numbers of diverse MFIs, the bulk of rural finance is still through non-formal indigenous moneylenders, who charge exorbitant rates of interest—a clear indication that there exists a substantial unmet demand for credit, more in the hills and mountains than on the plains. The reasons behind the demand for credit in the hills and mountains are the small loan size, higher delivery cost, lack of business linkages, and small savings base. These factors have deterred MFI entry in these areas. Financial viability of the MFI is the major deterrent to wide coverage. This factor can be removed only if MFIs are given administrative cost subsidies in the form of subsidized low interest rates on borrowing. Few large financial NGOs have been able to receive donor and international agency support to run microfinance operations, but they have also preferred not to venture into the hills and mountain areas.

Another deterrent factor is the ten-year-old armed conflict between insurgency factions and the government. Large numbers of casualties have been reported, 10,000 by government records, though the actual number may be substantially higher. Financial institutions and their branches and depots have been the prime targets of the conflict. It is estimated that so far 30% of rural branches of the state-owned banks NBL (Nepal Bank Limited), NRB (Nepal Rastra Bank, the central bank), and ADB/N (Asian Development Bank of Nepal) have so far been vandalized during the conflict. There has been sporadic looting of offices of the financial organizations as well, though their operations have so far not been hindered.

Regulatory Framework

Various types of microfinance institutions are involved in providing microfinancial services in Nepal. The regulatory framework for the regulation of these MFIs also greatly varies. NRB and His Majesty's Government of Nepal (HMG/N), through the provisions of banking laws and bylaws, govern and regulate the activities of all types of MFIs and set rules and regulations regarding their entry and exit and financial operations. The Nepal Rastra Bank Act of 1955 and the Financial Intermediary Act of 1998 have empowered NRB to control, regulate, and supervise MFIs, and issue licenses to undertake financial operations.

The commercial banks function under the Commercial Bank Act of 1984 and are supervised by NRB. ADB/N and other financial institutions operate under special charters. Cooperatives function under the Cooperative Act and require NRB licensing for savings mobilization. NGOs are registered under the Society Registration Act of 1978 and require financial licensing from NRB for lending and savings mobilization.

Development banks function under the Development Bank Act 1996 and operate in a more relaxed financial framework than the commercial banks, so far as microfinance is concerned. NRB has played an active role, including directing commercial Banks and second-tier institutions to provide the credit requirements of MFIs, and has also not objected to ownership share capital participation in the case of the Rural Microfinance Development Center (RMDC) and MFIs like RRDBs and MFDBs. In its bid to promote MFIs, NRB even agreed to bear the responsibility of repayment of loan undertaken by MFIs and licensed financial NGOs, as commercial banks were reluctant to finance MFIs. They were more willing to pay a penalty to NRB than to comply with NRB directives to lend in deprived sectors. So NRB has guaranteed the more risky ventures. However, there has not been a single instance in which NRB had to take the responsibility to repay a defaulted MFI loan. So the guarantee clause in FIA 1998 can be interpreted either as being very much microfinance development-oriented or as having been included unintentionally. The latter seems to be more likely, as the provision has now been amended. Now the regulation is more prudent: the promoters of financial intermediary NGOs are held personally liable to guarantee the loans received on behalf of their organizations from commercial banks. However, recently some commercial banks have agreed on secondary collateral guarantees from financial NGOs.

Recently the government has promulgated a comprehensive Bank and Financial Act (2004) for the effective efficient legal implementation of banking-related Acts. The 2004 Act replaced at least five former Acts: Commercial Bank Act (1974), Development Bank Act (1996), Financial Company Act (1985), Agricultural Development Bank Act (1966), and Nepal Industrial Development Corporation Act (1989). The new Act accommodates all these acts and also includes clauses aimed at reform of the financial sector. As such, none of its provisions are deterrents to the development of MFIs. The Societies Registration Act and Cooperative Act provide ample safeguards for guaranteeing the deposits of poor people. NRB has been given ample authority to control, supervise, and regulate MFIs—especially NGOs. The central bank's first and foremost responsibility is licensing, renewal, and regular supervision.

Performance of Banking and Nonbanking Institutions

The beginning of the banking sector reform dates back to 1937, when the country's first private-sector commercial bank, Nepal Bank Ltd. (NBL), was established. It was only after twenty more years passed that the Nepal Rastra Bank (NRB) came into existence as the Central Bank of the country; it was established mainly to ensure issuance of Nepalese currency notes and to circulate them throughout the country; to replace Indian currency, which was widely in circulation then; and to develop a banking system in the country. This also coincided with the country's launching its first planned development effort (First Five-year Development Plan, 1950).

This was followed by the establishment of Nepal Industrial Development Corporation (NIDC) in 1959, Employees Provident Fund (EPF) in 1962, Rastriya Banijya Bank (RBB) (another commercial bank in the public sector) in 1966, National Insurance Company (NIC) in 1967, and Agricultural Development Bank (ADB/N) (formerly established as a cooperative bank) in 1963; and by the merger of the Land Reform Saving Corporation under the Agricultural Development Bank Act in 1967.

These financial organizations dominated the financial scenario of Nepal for more than a decade and a half, until 1984. At that time liberalization and financial sector reform resulted in the establishment of three joint-venture commercial banks in the country, namely Nepal-Arab Bank Ltd. (now NABIL Bank) in 1984, Nepal-Indosuez Bank (now Nepal Investment Bank) in 1985, and Nepal Grindlays Bank (now Standard Chartered Bank) in 1987. This was followed by rapid growth in commercial banking in Nepal, resulting in almost one commercial bank every year. Today there are 17 commercial banks with a combined network of 449 branches as of 2004.

The liberalization approach of the government has helped the financial sector grow very rapidly. The parallel growth of other financial institutions like Development Banks, financial companies, Regional Rural Development Banks, Micro Finance Development Banks, Saving and Credit Cooperatives, Financial Intermediary Nongovernmental Organizations, Postal Banks, insurance companies, Citizen Investment Trusts, the Deposit Insurance and Credit Guarantee Corporation Security Board, and the Nepal Stock Exchange, all have been factors in the creation of a competitive environment and a financial market to attract modern technologies and management to the financial sector.

Licensing NGOs for limited banking functions by Nepal Rastra Bank was a bold step in promoting microfinance. It gave formal recognition to the role of alternative institutions in savings and credit promotion to the poor.

The overall performance of banking and nonbanking institutions as of January 2004 is summarized below.

Commercial Banks

There are 17 commercial banks as of January 2004. The number of commercial bank branches has reached 449. Capital funds of these banks total NPR 12,229.3 million, consisting of 65.04% paid-up capital, 24.63% statutory reserves, 9.82% other reserves, and 0.51% retained earnings. Out of the total deposits of NPR 215,136.6 million, current deposits constitutes NPR 27,386.3 million, savings deposits NPR 105,780.9 million, fixed deposits NPR 64,657.6 million, and other (call deposits and so on) NPR 17,311.8 million. Total borrowing by commercial banks has reached NPR 4324.2 million. Borrowings from NRB, interbank borrowings, and borrowings from foreign banks constitute 22.53%, 29.80%, and 47.67%, respectively. Liquid funds have reached NPR 30,762.8 million. Total investments reached 53,682.4 million. Loans and advances on average have registered an annual growth rate of 7.16% for the period from mid-July 2003 and reached NPR 133,437.4 million. Out of the total loans and advances, lending to the private sector and claims on government enterprises constitutes NPR 129,620.8 and NPR 2787.7 million, respectively. Interest accrued reached NPR 32,805.3 million in mid-July 2003.

Finance Companies

Fifty-eight finance companies are in operation, of which 39 operate in Kathmandu valley only. Capital funds of these companies have reached NPR 3599.8 million, consisting of NPR 2550.8 million core capital and NPR 1049.0 million supplementary capital. Of the total core capital, paid-up capital is NPR 2104.7 million; the balance is general reserves and retained earnings. The loan loss provision amounting to NPR 997.9 million and other reserves amounting to NPR 51.1 million constitute the supplementary capital. Total deposits have reached NPR 17,945.4 million. Borrowing reached NPR 796.5 million in January 2004. Liquid funds have reached NPR 2778.9 million, Investments in government securities, NRB bonds, and other accounts are NPR 1091.4 million and NPR 1484.1 million, respectively. Out of the total loans and advances of NPR 16,366.4 million, hire purchase loans consist of 15.25%, housing loans13.0%, term loans 12.68%, lease financing 4.42%, merchant banking 34.24%, loans against fixed deposits and receipts 4.0%, and other 1.2%.

Development Banks

There are altogether 14 nonbanking Development Banks, five Regional Rural Development Banks, and six Micro Finance Development Banks (MFDBs) (including Nepal Industrial Development Corporation and Agricultural Development Bank). Of these, five banks have their central offices in Kathmandu valley and are operating at national level, and the rest are operating from outside Kathmandu valley as Regional Rural Development Banks. Capital funds of these development banks have reached NPR 4165.72 million. The paid-up capital is NPR 2425.55 million, and general reserves and other reserves amount to NPR 1740.16 million. Of the total deposits of NPR 29,120.79 million, term deposits constitute 95.4% and other deposits are only 4.6%. Their borrowings amounted to NPR 4908.18 million. Liquid funds have increased to NPR 3853.02 million. Investments in government securities, shares and debentures, and other investments account for NPR 1206.25 million, NPR 269.61 million, and NPR 925.18 million, respectively. Loans and advances have reached NPR 31,601.82 million. Major sectors of financing of development banks are agriculture, housing, real estate, industry, and business loans against fixed deposits. Lending in the agriculture sector, housing and real estate, and the service sector increased by 15.49%, 19.74%, and 16.0%, respectively, whereas lending in the industry sector and business sector has decreased drastically. Other assets have increased to NPR 94,838.34 million, of which interest accrued has increased significantly to NPR 1575.57 million.

Regional Rural Development Banks (RRDB)

Five Regional Rural Development Banks are situated in five development regions of the country. Capital funds of these banks have reached NPR 318.25 million, and deposits have increased to NPR 479.38 million. Borrowing, the major source of funds, has reached NPR 1343.4 million. Liquid funds have decreased by 22.76% to NPR 163.23 million, and investments reached NPR 582.38 million. Loans and advances have increased by 3.33% and reached NPR 1352.66 million.

Micro Finance Development Banks (other than RRDB)

As of today there are six privately owned MFDBs. Total capital funds of the six Micro Finance Development Banks (MFDB) have increased by 7.97%, to NPR 337.27 million. Their deposits have increased to NPR 190.33 million. Borrowing, mostly from financial institutions, (including foreign institutions) has reached NPR 1008.49 million, and liquid funds to NPR 323.46 million, Investments have reached NPR 4987.49 million, and loans and advances have reached NPR 1122.52 million. Sectoral loans (for example, in agriculture) have contributed significantly in the growth.

Cooperative Societies

As of 2004 the capital funding of 34 cooperative societies authorized by NRB has increased to NPR 287.40 million. Of the total deposits of NPR 2037.78 million, savings deposits, fixed deposit, and other deposits constitute 51.30%, 40.65%, and 8.05%, respectively. Borrowings from commercial banks, financial institutions, and NRB have decreased to NPR 41.92 million. Liquid funds decreased to NPR 369.90 million. Investment in fixed deposits, other investments, and government securities reached NPR 279.26 million. Loans and advances have increased by 7.67%. Other category loans like commercial loans, production loans and loans against fixed deposits are the major loan and advances. However, this does not include the financial status of thousands of small cooperatives scattered all over the country.

Nongovernmental Organizations (NGOs)

The number of NGOs authorized by NRB to perform limited banking activities has reached 44. Borrowing from domestic and foreign financial institutions, the major source of funds for these NGOs, has increased by 113.9%, and reached NPR 48.8 million. Use of funds of NGOs increased by 106.1% in 2003, Micro-credit loans have increased by 27% to NPR 38.90 million. These figures are based on the data supplied by 27 of the 44 NGOs.

A comparative outreach chart of some MFIs is shown in Table 4.

Table 4. Comparative Outreach Chart of Some MFIs (compiled in December 2004)

Organization	No. of members	No. of borrowers	Outstanding loans (NNPR)
RRDB (Eastern Region)	53,270	47,465	474,620,000
RRDB (Midwestern Region)	19,460	19,460	121,298,000
RRDB (Western Region)	40,390	37,726	309,513,000
RRDB (Middle Region)	37,339	36,635	213,055,915
RRDB (Far Western Region)	19,146	19,146	99,353,000
Nirdhan Uthan Bank	50,458	36,019	3,766,880
Swabalamban Bikas Bank	39,851	31,252	2,372,876
Chimek Development Bank	92,83	6629	56,426,013
Women Co-op Bank	6015	3562	5,436,602
DEPROSC Bank	4654	4654	21,315,556
Nepal Rural Dev. Society Centre (Biratnagar)	8200	7950	30,357,173
Nepal Rural Dev. Organization	2593	1967	9,754,301
Rural Women Development Society (Sunsari)	1460	1279	3,750,013
Terai Rural Women Society	605	401	74,474
Four Square Youth Club (Baglung)	1451	671	1,411,694
Community Women Dev. Centre (Saptari)	1385	1300	4,267,494
Sahara Nepal S & L Coop. (Jhapa)	1334	1136	4,291,773
DERDC (Baglung)	1322	940	2,221,558
Livelihood Dev. Society (Morang)	935	858	2,931,880
Mahuli Community Dev. Centre (Saptari)	793	657	3429767
Bindhavasini S & L Coop. (Kavre)	777	693	2,014,375
Women Helping Coop. Org. (Kathmandu)	719	332	1,085,760
Community Youth Club (Bardia)	687	516	829,915
Manushi (Kathmandu)	675	404	2,229,448
SOLVE (Dhankuta)	600	471	1,065,748
NESDO (Parbat)	575	464	2,480,859
Nepal Women Development Centre (Lalitpur)	335	114	422,260
Rural Awareness Centre (Baglung)	302	89	424,345
Srijana Community Dev. Centre Siraha	275	256	947,580
Nepal Women Comm. Service Centre (Dang)	130	55	22,8288

Financial Performance

The financial performance of some microfinance institutions is shown in Table 5.

Table 5. Operation and Financial Self-sufficiency Ratio (compiled in December 2004)

	OSS (%)	FSS (%)
Regional Rural Development Bank (Western Region)	88	85
Nirdhan Uthan Bank	112.4	111
Swabalamban Bikas Bank	137	107
Chimmek Development Bank	115.26	83.64
DEPROSC Development Bank	79	76
SFCL (average)	107	104
NERUDO	69	69

Table 5 indicates that Small Farmers Cooperatives (SFCL), Swabalamban Bikas Bank, Nirdhan Uthan Bank, and Chimek Bank have achieved financial self-sufficiency. DEPROSC Development Bank and NERUDO have not yet attained financial self-sufficiency, so far as their microfinance activities are concerned.

OVERVIEW OF THE MICROFINANCE INDUSTRY

The evolution of rural finance dates back to the 1950s, when the first credit cooperative was established to finance the agriculture sector. The first credit cooperatives were established in 1956 by executive order of the government in the Rapti Valley, Chitwan, with initial funding by the government through the Cooperative Development Fund. These were the beginning of the formal source of institutional credit in Nepal. Before that the only sources of funding were indigenous moneylenders, landlords, self-help philanthropic organizations called “Guthis,” and government charity on a limited scale during natural calamities. A Cooperative Bank to cater to the needs of the credit cooperatives was established in 1963; this bank later became the Agricultural Development Bank of Nepal under the Agricultural Development Bank Act of 1967. The Land Reform Savings Corporation, established in 1963/64, also was eventually merged with Agricultural Development Bank. ADB/N launched a Small Farmer Development Program (SFDP) on a pilot test basis in 1975 to cater to the needs of rural poor farmers, as it was felt that the existing financial and credit delivery system failed to reach the needy rural poor. The SFDP program aims at organizing farmers into small groups and providing credit against joint group liability or guarantees. This approach can be thought of as the first microfinance approach in the country. The entry point for the formation of groups is usually credit provided by the ADB/N against group collateral. Almost all MFI follow the same methodology today, with some variations. Some incorporate social components as well.

Nepal Rastra Bank (NRB) has initiated various efforts to develop the microfinance system in Nepal. It introduced the priority sector lending program in 1974 by directing commercial banks to invest 5% of their total deposits in the sector designated as the priority sector. Lending requirement to this sector were increased to 7% in 1976 and to 12% in 1990. NRB also directed that 3% of a bank’s total portfolio should be lent to the hardcore poor under the “Deprived Sector Credit” program. Banks that failed to meet the requirement were liable for a penalty of 16% to NRB. Commercial bank lending to microfinance institutions, through equity participation and wholesale loans, has been approved by the Central Bank as a way of being involved in the program itself. Nepal Rastra Bank introduced the Intensive Banking Program in 1981 to ease collateral requirements and to get the banks to engage in group-based lending. The program was implemented by the three commercial banks then in operation: Nepal Bank Ltd. (NBL), Rastriya Banijya Bank (RBB), and Nepal Arab Bank Ltd. (NABIL). Recent development in the financial sector in Nepal has however made such lending easier as lending to RRDB, MFDB, NGOs, and Cooperatives has been included in the ambit of the priority- and deprived-sector lending requirements. As a result, most or almost all commercial banks have achieved their targets for priority sector lending and deprived sector lending at 5–7% interest rates.

Production Credit for Rural Women (PCRW), the first gender-focused program, was initiated in 1982 by the Ministry of Local Development (MOLD) in collaboration with the United Nations Children's Fund (UNICEF) and Nepal Rastra Bank. The women's groups receive credit from Nepal Bank Limited and Rastriya Banijya Bank. The Micro Credit Project for Women (MCPW) was initiated in 1994 with ADB Funds through NBL and RBB credit to women. The project aimed at improving the socioeconomic status of women through the provision of financial services using NGOs as intermediaries.

Regional Rural Development Banks (RRDBs) were set up in 1992 with NRB initiative based on the Grameen Bank model of Bangladesh, focusing on poor women. RRDBs use a group lending approach and a weekly repayment system. Five RRDBs are in operation in the country at present.

A large number of private institutions serving as Micro Finance Development Banks (MFDB) have come into existence and are performing well in the field. They are: Nirdhan Utthan Bank, Swabalamban Bikash Bank, DEPROSC, and Chimek Bikash Bank; a few more are in the pipeline.

Besides these, cooperatives and NGOs also play significant roles in microfinance in Nepal. Though at least 7064 cooperatives are registered under the Cooperative Act of 1992, out of which 826 are Savings and Credit Cooperatives, only 34 Savings and Credit Cooperatives have been granted financial intermediary licenses by NRB. Similarly, formerly there were 25 NGOs, only 44 have obtained financial intermediary licenses from NRB. Over the last decade the Nepalese microfinance sector has expanded considerably in term of services and clients. The MFIs have been to able to reach 630,000 member clients, as shown in Table 6.

Table 6. Key Actors in Nepal's Microfinance Sector

Financial institution	No. of members	%
Regional Rural Development Banks	129,000	20.5
Grameen Bank Replicators	68,000	10.7
Registered Savings and Credit Cooperatives	90,000	14.3
Small Farmer Coop. Ltd.	73,000	11.6
Govt.-supported MF programs	95,000	15.1
SFDP	97,000	15.4
Microfinance NGOs	78,000	12.4
Savings and Credit Cooperatives	NA	
ADB/N NBL NRRB	NA	
Total	630,000	100.0

Source: ADB 2003

The above table indicates that the market is fairly well balanced between the cooperatives, the private and government-owned Grameen Bank replicators and government-supported microfinance programs. Even if the clients of ADBN, NBL, and RBB are added to the above-mentioned rural service providers, the final number of clients/members reached with financial services is only around 1.1 million. This is far below the estimated demand of 3.6 million households in rural Nepal for financial services. Thus, the market for micro and rural financial services appears to be huge, if only the services could be delivered in a sustainable manner.

Microfinance in Nepal has evolved as a mix of formal financial institutions, informal financial institutions, and traditional source of microfinance. Until 1998 NRB used the simple definition of all loans below NPR 15,000 to define microfinance. This was later raised to NPR 30,000.

The ADB has estimated that in Nepal total formal sector loans outstanding to all sectors were NNPR 58.5 billion, with NPR 11.1 billion being in rural lending (ADB 1998); out of this only NPR 4.4 billion was in small and microfinance programs. This does not, however, include lending by more than 7064 cooperatives and an equal number of unregistered cooperatives and community-based organizations. Using sectoral growth assumptions, ADB estimates the rural demand for credit for 1997/98 to be on the order of NPR 18.2 billion. Given the considerable extent of poverty in the country, the demand is likely to be on the order of NPR 20 billion by any conservative estimates at present, and a liberal estimate may inflates the demand by two fold and more.

Informal Lenders

A 1994 Nepal Rural Credit Review Survey, conducted by Nepal Rastra Bank/Asian Development Bank, showed that one fourth of rural borrowers have some access to the formal credit structure. The remaining three fourths of rural borrowers have to rely on informal credit sources like moneylenders, landlords, merchants, goldsmiths, relatives, and acquaintances for financial borrowing.

The Nepal Rural Credit Review Survey also suggests that 87% of borrowers utilize loans for consumption and social/religious purposes, and only 13% for productive purposes such as crop production and livestock raising. The terms of lending by type of informal lenders is presented below.

Table 7. Informal Mode of Lending: Repayment, Duration, and Interest

Lender	Mode of lending	Repayment	Duration	Interest rate	Collateral/security
Landlord	Cash	Labor, kind	1 year	In the form of reduced labor price	Hard collateral
	Kind	Sharecropping (sometimes cash)			Standing crop, bonded labor
Merchant (Mahajan)	Cash Kind	Kind	3–6 mos.	In the form of reduced output price	Standing crop, property
Farmer-lender	Cash Kind	Cash, kind, labor	1 month–1 year	24%–84% and in the form of reduced labor price	Standing crop, property
Goldsmith	Cash	Cash	3–6 mos.	24%–48%	Standing crop, property

(continued on next page)

Pawnbroker	Cash	Cash	3–6 mos.	18%–48%	Standing crop, property
Friends and relatives	Cash	Cash	Not specific (mostly short duration)	Generally interest-free	Peer pressure
Urban-based moneylender	Cash	Cash	1 month–1 year	36% to 60%	Current assets
Other lenders	Cash, kind, service	Cash, kind, labor	1 month–1 year	24% to 84% and in the form of reduced output, and labor price	Hard collateral

The formal financial structure could not address the requirements of rural borrowers, as the formal institutions were overly bureaucratic, collateral-based, and unresponsive to the needs and demands of rural borrowers, Further, the formal sector could not reach into the depths of the rural community for resource mobilization and credit delivery. This situation has highlighted the need for MFIs with new approaches and for rural participation.

MICROFINANCE PROGRAMS IN NEPAL

There are no specific regulations that apply to rural finance in Nepal. Nepal Rastra Bank (NRB) came into existence only in 1956 as the central bank of Nepal. The Financial Intermediary Act (FIA) was promulgated only in 1998. Before that there was no single Act that was pertinent to microfinance. Rather one or more Acts governed all institutions that were engaged in microfinance in Nepal. Major financial institutions were set up under various special charters; for example, NBL, RBB, ADB/N, NIDC, and NGOs were established under the Society Registration Act of 1978. Deposit-taking and rural credit are supervised by NRB as no institution can undertake credit and saving activities without NRB's prior approval. NRB provides licenses for limited banking facilities to some cooperative societies and NGOs under the Financial Intermediaries Act.

Before the promulgation of the FIA in 1998, large numbers of NGOs and more than 10,000 registered and unregistered cooperatives were undertaking lending and savings mobilization without the approval of NRB. Since 1998, 34 cooperatives and 44 NGOs have received licenses from NRB to undertake limited banking transactions, defined as lending to and deposit-taking from members only. But it has been found that in practice large numbers of cooperatives and NGOs in remote areas are still undertaking lending and deposit-taking activities without any approval from NRB. Even the licensed cooperatives have been accepting savings deposits from nonmembers—i.e., from the general public. It seems that this has been tolerated because of the importance of microfinance for poverty alleviation and also since the transactions have been considered insignificant in volume.

Targeted credit programs have become an important element in Nepal's poverty alleviation strategy. Considerable attention has been focused on various programs under the aegis of programs like the Intensive Banking Program (IBP), Rural Self-reliance Fund (RSRF), Small Farmer Development Program (SFDP), Production Credit for Rural Women (PCRW), and Micro-credit Project for Women (MCPW).

Intensive Banking Program (IBP)

The Intensive Banking Program (IBP) was initiated by Nepal Rastra Bank in 1974 as the Small Sector Credit Scheme; it was renamed Priority Sector Credit Program in 1976 and Intensive Banking Program in 1981. NRB directed the two state-owned commercial banks (NBL and RBB) and one joint-venture bank, NABIL, to invest 5% of their deposits in agriculture and cottage industries; this requirement it was later increased to 7% in FY 1984/85 and to 12% in FY 1989/90. The target could not be achieved because of the traditional tendency of the banks to emphasize collateral rather than the viability of the project. Small loan sizes, high overheads, and low recovery rates also made commercial banks reluctant to participate in this program despite the stiff penalties imposed on them for not doing so.

Rural Self-reliance Fund (RSRF)

NRB has for some time promoted the micro-credit approach by creating a special fund of NPR 20 million under its Micro Finance Department. So far it has supported financial help to over to 147 Savings and Credit Cooperatives and 49 NGOs (both licensed and unlicensed) at the low interest rate of 8%, with the added attraction of a 6% rebate on proper loan utilization and timely repayment. The recovery rate with this approach has increased to 92%—a considerably high rate. NRB in itself does not seem to be in favor of continuing the RSRF, as microfinance lenders like RMDC and SFDB have emerged. But in Nepal there are many remote places where licensed MFIs have not gone and do not dare go. In these places RSRF will be the only microfinance fund to rely upon for a long time to come.

Small Farmer Development Program (SFDP)

SFDP was launched in 1975 as a pilot project by ADB/N, with FAO/IFAD assistance. This approach is based on participatory group action by small farmers, through SFDPs relying on a network of facilitators who organize small farmers into groups for credit and development activities. The entry point for the formation of groups is usually credit, provided by ADB/N on group collateral. The program also incorporated components such as training, technical support, and infrastructure and social components such as literacy, school improvement, and child care.

Most of the credit was used for short-term agriculture production, inputs, livestock, consumption, and even repayment of old loans; about 30% were for longer-term investments like irrigation, aquaculture, horticulture, small-scale self-employment, and group income- generating activities. Program design incorporates successful elements of similar programs elsewhere like group liability, rural savings, and intensive technical training support. However, the program lost impetus in the process of implementation and replication, especially following an initial rapid expansion.

Although the program was successful and applauded by all, high overhead cost and low collection rate of the SFDPs limited its sustainability. In 1987 ADB/N, with GTZ support, implemented an action research Institutional Development Program (IDP) with the objective of transferring ADB/N-run SFDPs into cooperatives self-managed by small farmers themselves. Four SFDPs were transformed into a Small Farmers Cooperative Ltd. (SFCL) in 1993 on an experimental basis; the number of SFCLs has now reached 143, in 36 districts.

Production Credit for Rural Women (PCRW)

Production Credit for Rural Women (PCRW) was initiated in 1982 by the Ministry of Local Development (MOLD). It is one of the gender-based poverty alleviation programs geared to mobilizing and organizing rural women. The women's groups organized by the female development workers of the Women's Development Division (WDD) receive credit from formal financial institutions.

The group receives loan from two commercial banks, Rastriya Banijya Bank and Nepal Bank Ltd., for agriculture, livestock, and small industries. PCRW has shown quite impressive progress on aspects of social development such as literacy, drinking water supply, sanitation, child care centers, and environmental and training programs targeting rural women.

WDD's attempts to form women's development communities and build up community-based organizations (CBOs) at the Village Development Committee (VDC) level is a step toward enhancing the self-management capacities of rural women. These organizations are expected to mobilize savings, provide credit, and carry out community development activities. But the program did not continue to meet the national need because of low donor support. PCRW is not primarily a credit program. It is a general development approach for rural women using credit as the entry point to organize rural women in groups.

Micro-credit Project for Women (MCPW)

Micro-credit Project for Women (MCPW) was initiated in 1994 with the support of Asian Development Bank. Micro-credits to women were channeled through Nepal Bank Limited and Rastriya Banijya Bank Ltd. The project aimed to improve the socioeconomic status of women through the provision of financial services using NGOs as intermediaries. The major components of the project are group organization and training, the institutional support of NGOs, and the provision of financial services. Women's Development Division (WDD) and/or the NGOs perform social intermediation including group organization, training, savings mobilization, loan appraisal, recommendation, supervision, and loan collection.

In both programs interest rates are below average commercial lending rates. As delivery cost was very high and recovery rate not high enough, the program has not sustained itself financially. Since MCPW effectively emerged from the PCRW model and has the same vision, there is no sound reason for continuing the two parallel programs. The two programs are funded by different donors, however.

Banking with the Poor Program

Rastriya Banijya Bank has been involved in the Banking with the Poor Program to promote sound NGOs and Self Help Groups (SHGs) for the very poor. The bank has expanded its operations in 18 districts through 32 branches throughout the country. Under this program Self Help Groups are formed, and such groups form associations. The association is linked with a bank branch through an NGO. The district-level association of an SHG assumes the role of a district development bank under the Development Bank Act. This program did not quite take off.

Regional Rural Development Banks (RRDBs)

A major breakthrough in the development of microfinance is the establishment of two RRDBs in 1992—one in the eastern and one in the far western development region—with government and NRB share capital under the Grameen Bank Replication (GBR) model. In this model, RRDBs use a group lending approach focusing on poor women. By 1997 three more government-initiated Regional Rural Development Banks—one for each development region in the country—were established under the Commercial Bank Act of 1984 and the Development Bank Act of 1996. Initially the outreach of the RRDBs was quite encouraging. They were able to reach rural borrowers, and even maintained a 99–100% recovery rate. But recently most of the RRDBs have not been financially sound, and their privatization has come up for discussion.

Micro Finance Development Banks (MFDBs)

Micro Finance Development Banks have been promoted as new approach to microfinance in the private sector. So far six Micro Finance Development Banks have been registered and are in operation. Four of them, Nirdhan, DEPROSC, SBB, and NSCC Development Banks, were former successfully operating NGOs.

Regional Rural Development Banks are allowed to accept fixed and savings deposit from the public and to undertake a wide range of lending activities. They have been categorized into three types: 1) national level, 2) regional level (covering 4 to 10 adjoining districts), and 3) district level (covering 1 to 3 adjoining districts).

Micro Finance Development Banks (MFDBs) can also accept fixed and savings deposit and can undertake poverty-focused group lending only. MFDBs have also been categorized into three types: 1) national level, 2) regional level (except Kathmandu Valley) and 3) local level in terms of their area coverage, based on authorized and paid-up capital. As larger microfinance NGOs have converted into MFDBs, MFDBs todays are active microfinance providers in rural areas. The recent BFA Act of 2004 has designated commercial banks into the A category, finance companies into the B category, Development Bank/Micro Finance Development Banks into the C category, and Financial Intermediary NGOs into the D category of finance institutions; an institution can upgrade from D to C, C to B, and B to A upon fulfillment of criteria and conditions set by NRB.

Savings and Credit Cooperatives (SCC)

Since the enactment of the Cooperative Act of 1992, the number of various cooperatives and SCCs has increased substantially. Out of around 7064 SCLs registered under the Cooperative Act. 1992, only 34 have been authorized by the NRB to undertake limited banking operations. But all SCCs have been collecting savings from and providing loans to their members

At present, there are 7064 registered cooperative societies, of which 2810 are multipurpose cooperative societies, 2264 are savings and credit cooperative societies, 1326 are dairy cooperative societies, 201 are consumer cooperative societies, and the remaining 465 fall under the miscellaneous category. Estimates suggest that many more unregistered cooperatives are also in existence and are functioning in remote rural areas.

Small Farmers Cooperatives Limited (SFCL)

The formation of Small Farmers Cooperatives is being undertaken with the purpose of creating locally managed viable financial cooperatives that can take over the activities of SFDPs on a self-sustaining basis in the long run. SFCLs provide maximum loans of NPR 5,000, and in few cases up to NPR 10,000, in the first year. The loan may be higher in subsequent years. Although group pressure and social compulsion play an important role in repayment, all loans are secured by collateral. In rare cases where members are not in a position to furnish collateral, SFCL accepts guarantees by two other members and/or a citizenship certificate as collateral.

Nongovernmental Organizations (NGOs)

NGOs have come to play a very important role as microfinance providers in Nepal. It has been estimated that more than 18,000 NGOs have been registered under the Society Registration Act of 1978, and there may be many more unregistered NGOs. NRB has so far granted financial intermediary licenses to 44 NGOs. Many donor-funded projects have enabled local NGOs to work as microfinance agencies with their seed funding, and most of the NGOs have savings and credit activities as their major components.

Most RRDBs, MFDBs, and FINGOs can be seen as Grameen Bank Replicator, following the model of Bangladesh's successful project. In this model rural poor women form groupsof five members and elect a leader from among themselves. They undergo compulsory group training, which may last from 9 to 14 days depending on their literacy level. The group is recognized after the members pass the group recognition test (GRT). A group lending approach is adopted. Loans are extended to individual member on group recommendation, and group members act as guarantors of the loan. Peer/group pressure works as collateral and loan security. Failure of a member to pay back loan installments makes all group members ineligible for new loans. Loans are granted on the principle of 2+2+1.

The initial loan granted is generally NPR 5000; the amount gradually increases to NPR 30,000 in subsequent years The loan duration is one year, to be repaid in 50 equal installments with a two-week grace period. The interest rate is 10% to 15% flat or 18% effective. Center meetings for group discussion, loan disbursements and savings collection are held weekly, fortnightly, or monthly; the practice varies from one MFI to another.

MICROFINANCE PRODUCTS

MFIs in Nepal provides various loan products including various micro-loans, varieties of savings schemes, and insurance/protection schemes; they recently have started providing community health, vocational, and marketing training and child education services as new microfinance products.

Loan Products

General Loans

General loans include seasonal and microenterprise loans for agriculture, livestock husbandry, and small businesses like small roadside shops, vending, small-scale agro-product processing, vegetable farming, repair and service shops; they also provide working capital. The individual loan ceiling ranges from NPR 5000 to NPR 30,000 based on the cycles of borrowing; generally the amount is NPR 5000 in the first year with subsequent increases of the same amount for up to five years, by which time the client is supposed to graduate from the poverty level. The repayment period of the loan varies from one MFI to another. While some use a weekly payment system of 50 weeks a year, others request payments every 2 weeks, and some have even started rescheduling repayment on a monthly basis. Similarly, the rate of interest is not the same for all MFIs. While some have a flat 10% interest rate, others have increased their interest rates to a flat 12% to 15%, and still others have started charging 18% to 20 % interest on diminishing loan balances.

Seasonal Loans

Seasonal loans include loans for cash crop production like fruit selling, as well as small working capital loans for seasonal microenterprises and other various income-generating activities, The loan ceiling for seasonal loans is NPR 4000 to 8000 at 10% flat interest, as with general loans, and the repayment period begins at 3 months and does not exceed one year.

Microenterprise Loans

Microenterprise loans are generally provided to clients who have successfully repaid general loans and have entrepreneurial skills and technical know-how for the projects they want to undertake like poultry or pig raising, dairy farming, small service and repair shops, and so on. The loan ceiling is NPR 10,000. Microenterprise loans are scheduled to be repaid in 1 to 5 years.

Loan from Group Saving Centre Fund

This fund is used mainly by members for emergency loans over a very short period. The rate of interest on a group loan is 10% to 20%, and the repayment period, guarantee, and procedure of repayment are determined by the group themselves.

Savings Products

In addition to lending, MFIs have introduced various savings products. Some of the regular saving products are:

Compulsory Group Saving

Group members are required to deposit weekly/fortnightly/monthly a fixed amount of NPR 5 to 10.

Centre Fund

Borrower members set aside 5% of the general loan for five consecutive years.

Voluntary Personal Savings

Members deposit their savings in their individual accounts and are at liberty to withdraw as and when required.

Welfare Fund

Funds are raised by donations, penalties, and other savings among members

In addition to the types listed above, some innovative small saving products have been introduced:

Child Box Saving

This saving is for the welfare of children.

Elder Age Group Saving

Recently introduced as saving product by some MFIs. The product is designed to meet the needs of the elderly for typical unanticipated expenses like pilgrimage tours, religious functions, and contributions to in community works temple construction. The MFI provides 8% interest on the savings. Lending and withdrawal terms and conditions are set by the members of the saving group themselves.

Negotiable Personal Savings

Pewa Savings

Members save a fixed amount monthly with the intention of creating a security fund for themselves, not withdrawable for at least five years.

All these savings products have been designed to attract savings from poor members so that they can be supported in their lean days. MFIs in Nepal have been able to generate considerable funds from these small savings. At present 25% to 30% of the MFI fund has been generated by the savings of the poor themselves. It is a major source of funds for MFIs.

Risk Cover Schemes

Livestock Protection Scheme

This is considered an important complementary service to livestock borrowers. Raising livestock is always risky because of the high rate of animal mortality. This scheme covers animals purchased with MFI loans. The protection fee is from 4% to 6 % of the loan amount. The scheme compensates members up to 80% of the insured amounts in case of the death of the livestock and reimburses 20% of the premium as a bonus if no claim is made.

Member Beneficiary Scheme

This is a kind of life insurance scheme introduced by some MFIs to protect member families in case of unexpected death. A small premium of NPR 100 is charged for members, and an affiliated financial NGO pays NPR 10,000, 5000, and 3000 after the death of the member, a spouse, or child, respectively.

House Protection Scheme

This is to compensate a member for damage to a residential house by flood, fire, and so on. Up to NPR 2000 is paid, for a small of premium of NPR 100 per year.

New Products

Some MFIs have started to offer new products like community health, child education, drinking water and sanitation, and vocational training in their respective areas.

THE MICROFINANCE NETWORK IN NEPAL

The microfinance network is a forum of practitioners, policymakers, regulators, academicians, donors, and researchers who exchange experience, build common performance standards, carry out research on issues affecting their work, develop products, and influence government policy to facilitate the growth of the microfinance sector to fulfill its potential in alleviating poverty and building broad-based economic development. Microfinance networks can be instrumental in accessing, sharing, and disseminating information. Although microfinance is a relatively new intervention in Nepal (since 1990), it is increasingly moving toward maturity. However, new issues, which can be only addressed through the combined and collaborative efforts of concerned stakeholders, are emerging:

- Common microfinance standards are needed for self-regulation and to ensure program quality.
- Traditional products and services may not serve clients in the changing scenario. There is a greater need to design, test, and develop products and services to better serve clients.
- The impact of operational and financial self-sufficiency on poverty reduction needs to be evaluated.

Three microfinance-related networks exist in Nepal:

- Grameen Network Nepal (GNN).
- Microfinance Association of Nepal (MIFAN).
- Nepalese Federation of Savings and Credit Union (NEFSCUN).

Grameen Network Nepal (GNN) was established in April 1996 with several Regional Rural Development Banks as members: Nirdhan Utthan Bank Ltd., Swabalamban Bikas Bank, Women Cooperative Society Ltd. (WCS), and Nepal Rural Development Organization (NERUDO). It was primarily formed for the effective mobilization of funds and capacity building of member organizations. It has its secretariat office at WCS.

Microfinance Association of Nepal (MIFAN) was formed in 1998/99 as a member-based network of all the MFIs and cooperatives. Initially there were 78 members. The annual membership fee is NPR 1000 for member organizations. CECI supported the association in its initial phase. The secretariat of this network is maintained at DEPROSC.

Nepalese Federation of Savings and Credit Unions (NEFSCUN) is a federation of 414 saving and credit cooperatives (SCC). It was registered in 1993. CECI had the support in its initial years of CCA, a Canada-based organization that is still supporting NEFSCUN. NEFSCUN provides capacity building and loan fund support to its members It also has created an interlending fund generated from the contributions of over 150 members. NEFSCUN has also been a member of the Asian Federation of Credit Unions (AFCU) since 1998.

INTEREST RATE REGULATION

Interest rate regulation for the banking sector was abolished in the 1990s as part of financial sector reform, but more specific restrictions were continued; for example, banks and finance companies are not allowed to have more than a 6% spread between deposit and lending rates. Commercial banks are required to publish their interest rates, and variations are permitted to the extent of 1% on deposits and 2% on the lending rates between borrowers for the same purpose. The interest rate controls and restrictions on margins previously used by NRB to influence credit pricing policy have been removed.

However, the new NRB Act reserves the power to control and direct credit and interest rate through directives. It requires the banks to fix rates of interest to be charged on loans and paid on deposits and margins in conformity with arrangements prescribed by NRB from time to time. Similar provisions have been incorporated in the BFI Ac,t giving power to NRB to direct licensed institutions to fix interest rates, margins, and allocation of credit limit. Despite deregulation efforts, interest rate regulation is in practice under the control of NRB so as to check commercial banks from unhealthy competition among them.

The positive effect of deregulation of interest rates on MFIs, is that more commercial banks are competing to fund MFIs under their deprived-sector lending quotas. Commercial banks have been able to lower rates of interest to MFIs on their own. Even the second-tier institution RMDC has lowered its interest rate to 5% and waived its service charge of 0.5%. NRB regulation so far MFIs are concerned has been liberal, as MFIs are still at liberty to charge their own area-specific rate of interest, which is high in comparison to commercial bank lending. MFI service charges have also been considered necessary for the sustainability of MFIs.

This situation has put MFIs in an advantageous position as they can borrow at competitive rates for microfinance and re-lend at higher interest rate along with service charges.

The availability of funds at competitive rates from commercial banks and second-tier institutions has encouraged new MFIs. The growth has been 14 development banks, 4 RRDBs, 6 MFDBs, 44 financial intermediary NGOs, 34 cooperatives, and 147 SFCL cooperatives. The flow of loan funds from commercial banks to MFIs and from second-tier institutions (especially RMDCs) has also increased, and the maximum limit of loans to a single MFI borrower has been upgraded from NPR 60 million to NPR 80 million.

ESTABLISHMENT OF SECOND-TIER REFINANCE INSTITUTIONS

Based on the assumption that most of the rural financial service providers are too small to effectively meet the demand for credit, His Majesty's Government (HMG) initiated support by providing share capital participation and providing soft loans at a 2% interest rate, far below the prevailing rate, to the second-tier institution Rural Microfinance Development Center (RMDC) to provide wholesale loans to MFIs. Other existing second-tier institutions are Rural Self-reliance Fund (RSRF), Small Farmers Development Bank (SFDB), SFDB, and now Poverty Alleviation Fund (PAF). Recently established, PAF will also work as a second-tier institution providing finance to local NGOs, CBOs, and cooperatives as one of the components besides community development and infrastructure development in rural areas. The function, ownership, and coverage of second-tier institutions are as follows:

Rural Self-reliance Fund (RSRF)

His Majesty's Government (HMG) NRB in 1991 created RSRF with NPR 20 million as a refinance window under the Micro Finance Department of NRB. So far it has extended loans to around 200 NGOs, CBOs, and cooperatives at an interest rate of 8% with the added attraction of a 6% rebate after proper loan utilization and timely repayment of the loan. RSRF's wholesale loans and its rebate bring its interest rate below market rate. The rebate can be called a subsidy to the MFIs. RSRF is the first program to use NGOs and CBOs as intermediaries for credit delivery in remote parts of the country.

The NGOs and cooperatives undertaking saving programs regularly for more than one year and having records of rural financing are eligible for RSRF loans. So far the RSRF program has covered 44 districts out of 75 districts in the country and has provided loans to 147 savings and credit cooperatives and 49 NGOs. It has at present loans outstanding of NPR 18.5 million and has been able to maintain a 94.6% recovery rate with cooperatives and an 88% recovery rate with NGOs.

But with the emergence of RMDC, RSRF is slowly being phased out as a financial arm of NRB. NRB from now on will shift to its supervising role rather than providing finance directly. In a country like Nepal, where the physical situation is very difficult, more second-tier institutions will be able to cater widely rather than only one. RSRF has been providing funds to NGOs and cooperatives that had not been able to obtain MFI licenses from NRB itself. The emergence of SFDB (see below) is another case. Even the recently established Poverty Alleviation Fund (PAF) is another version of second-tier institution to finance NGOs and CBOs in rural areas for income generation and community and social development activities. It has recently started some of its own operations on a trial basis in six districts.

Small Farmers Development Bank (SFDB)

Another second-tier institution is Small Farmers Development Bank (SFDB), registered in July 2001 under the Company Act. The bank obtained a financial intermediary license from Nepal Rastra Bank in 2002 and started its lending operation to Small Farmers Cooperative Ltd. The objectives of the SFDB are:

- to act as second-tier finance institution to Small Farmers Cooperatives Limited (SFCLs), and
- to encourage SFCLs to become major shareholders of the bank within a 5–10 year time frame.

Agricultural Development Bank of Nepal (ADB/N) is the main promoter and shareholder of SFDB. Its authorized capital is NPR 240 million and issued capital is NPR 120 million. The total paid-up capital of SFDB at present is NPR 105 million. The major shareholder is ADB/N, with a NPR 70 million share, followed by the Ministry of Finance (NPR 20 million), Nepal Bank Limited (NPR 5 million), NABIL Bank Limited (NPR 2 million), and 99 SFCLs (NPR 8 million). Of seven members of the Board of Directors of SFDB, three are from ADB/N, two from SFCLs, and one each are from MOF and NBL. So far SFDB has disbursed NPR 201 million loans to 147 SCCs.

Rural Microfinance Development Center Ltd. (RMDC)

Rural Microfinance Development Center (RMDC) is emerging as an autonomous wholesale lending organization of microfinance. It was established with the initiative of the Asian Development Bank and the Nepal Rastra Bank in 1998 under the Company Act of 1996 as RMDC. With its substantial resources amounting to U $ 20 million (or NPR 1.5 billion), RMDC is expected to have a significant impact on the MFI scene in coming years.

By the end of July 2004, RMDC has approved loans to 34 MFIs and disbursed loans to 32 MFIs. RMDC has also to date provided training, directly or through MFIs, to a total of 150,000 clients.

RMDC has three major roles: 1) offering wholesale credit to MFIs for on-lending; 2) providing institutional capacity-building support to MFIs; and 3) extending group strengthening and skill development training.

So far, RMDC's lending has been with five public RRDBs and the two private rural microfinance development banks CSD & NIRDHAN. Recently it has been open to a larger clientele after coming into direct competition with priority-sector lending from commercial banks.

Nepal Rastra Bank, 13 commercial banks, five Regional Rural Development Banks, Nirdhan (an NGO), and the Deposit Insurance and Credit Guarantee Corporation (DICGC) are the promoters of RMDC. Of seven members of the board of directors, five are from commercial banks on a rotation basis and two are from Nepal Rastra Bank.

Establishment of second-tier wholesale lending to microfinance institutions is not limited to Nepal. It has been established elsewhere—for example, Palli Karma Sahayak Foundation (PKSF) in Bangladesh and Pakistan Poverty Alleviation Fund (PPAF) in Pakistan—with some modification and broader objectives. The whole idea is to fight the shortage of funds necessary for microfinancing and capacity building of MFIs and poor clients. As more and more governments are relying on microfinance to fight poverty, the need for funding in these nations is ever increasing. Donor support is also on the increase, though it is not yet sufficient. Neither present demand nor potential demand is being met from traditional sources only. So each nation has innovated its own best practices. In Nepal, this is priority-sector lending and deprived-sector lending. The commercial banks have been directed to disburse 0.25–3% of their lending portfolio to this sector; failure in this by commercial banks attracts penalties and bad ratings. Until recently share participation in Micro Finance Development Banks and lending to MFIs have also been regarded as within the purview of deprived-sector lending to commercial banks. This has resulted in the establishment of MFDBs, which today are leading in microfinancing, and their financial help has sustained many NGOs all over the country. So these kinds of second-tier institutions are sources of a funding pool for MFIs. Besides this, their expertise can be used for capacity building of MFIs, through training exposure to best practices and exploring previously neglected areas of microfinance in the hilly and mountainous regions of Nepal where existing MFIs have not dared to venture, by providing soft loans, consultancy services, and supervision. Third, MFIs, in order to receive loans from these second-tier institutions, have to meet the standards set by the second-tier institutions—i.e., receive sound ratings.

By 2007 the mandatory provision that commercial banks finance in deprived sectors will be abolished. The commercial banks' fund pool to MFIs may not be available in the same abundance it is today. Commercial banks may not find it safe to finance NGOs with collateral-less loans. The only source available will have to be second-tier institutions, and thus the importance of second-tier institutions will be even greater. There will always be a shortage of funds in developing nations to finance the poor. So the need for second-tier institutions like RMDC, SFDB, PAF, or others in developing nations will always be present.

THE REGULATORY AND SUPERVISORY ENVIRONMENT FOR MICROFINANCE INSTITUTIONS

Nepal Rastra Bank (NRB), the Central Bank of Nepal, is the ultimate authority to regularize financial activities in the country under the NRB Act of 1955 and the Commercial Bank Act of 1954. NRB has a Banking and Financial Institution Supervision Department to regulate commercial banks, finance companies, national and regional Development Banks, insurance companies, financial intermediaries, and nongovernmental organizations and cooperatives.

- NRB regularizes MFIs by regular monitoring of portfolio status, financial statements, and audit reports, and review of policy documents of MFIs. From this year onward NRB has begun office supervision and field office and client supervision. During inspections NRB comments on MFIs on the following areas of operation:

1. Funds received by MFIs for microfinance should not be used/invested in other MFIs operations.
2. MFIs should prepare annual action plans.
3. Additions to area of operation need prior approval from NRB.
4. Loan classifications should be updated and loan loss provisions should be made accordingly.
5. NRB has advised MFIs to conduct social awareness programs along with credit programs.
6. NRB has been advised to obtain credit information from other MFIs in the operation area.
7. Accounts are to be audited by an approved certified auditor.

- Financial sector reform was initiated in the country in the mid–1980s along with liberalization and in response to financial sector deregulation worldwide. Although NRB policies during the pre-liberalization period could be categorized as emphasizing direct intervention through monetary measures: NRB directed deposit and lending rates, margin rates, refinance rates, cash reserve ratios, statutory liquidity ratios, and credit ceilings. The post-liberalization period witnessed a progressive shift to indirect methods of control and deregulation in the financial system. In order to strengthen the financial sector through a competitive environment, NRB allowed the establishment of joint-venture banks; opened market recourse to contain monetary aggregates to a targeted level; deregulated interest rates; reformed two old and ailing commercial banks; abolished statutory liquidity ratio (SLR) requirements to open secondary markets to facilitate the transaction of short-term treasury bills and development bonds; allowed ADB/N to carry out commercial banking functions; and abolished credit ceilings and margin rates and full convertibility in the current account, along with ceilings on overdraft facilities and market determination of the exchange rate of convertible currencies.
- In addition, NRB focused on development through increasing outreach by branch expansion of commercial banks, supporting priority-sector and deprived-sector lending through establishment of five RRDBs and encouraging RMDC to promote microfinance lending, on the assumption that the overall country's demand for microfinance is huge and need to be addressed as early as possible.
- The establishment of RMDC in 1998 as an entity for wholesale lending to MFIs had the objective of capacity building through training intervention of MFIs. RMDC also monitored and supervised its borrower MFIs and suggested capacity-building "do's" and "un-do's."
- Similarly, Small Farmers Development Bank (SFDB), established with the initiative of ADB/N, NBL, and the Ministry of Finance of HMG/N in 2001, is also a second-tier institution looking after SFDP-converted SFCLs with financial support, capacity building, and training as major components.
- A number of networking institutions involved in microfinance services can be used as second-tier organizations for self-regulation. Grameen Network Association (GNA), Micro Finance Association of Nepal (MIFAN), National Federation of Savings, and Credit Union of Nepal (NEFSCUN) were designed to perform some self-regulation. These institutions are in existence as second-tier institutions but are not having any impact at present on the MFI Environment Scenario as a second-tier organization.
- All MFIs practice self-regulation and supervision, as they are responsible to their executive bodies and general assemblies.

- There are three windows under which MFIs can operate: (i) registration under the Cooperative Act of 1991 and obtaining of a financial intermediary banking license from NRB; (ii) registration under the Society Registration Act of 1977 and obtaining of a microfinance license from NRB under the Financial Intermediary Act of 1998; and (iii) registration as a Microfinance Development Bank under the Development Bank Act of 1995.
- Under the Cooperative Act of 1992 a minimum of 25 persons residing in a locality (specific geographical area—5 wards of a Village Development Committee) with a minimum share capital of NPR 100 each—are able to apply for the registration of a primary society. The Cooperative Act of 1992 helps promote the growth of cooperatives by attracting members. The estimate is that the number of cooperatives may have reached 7064 (it was 4400 in 1976/77). A cooperative of 143 small farmers has been added, and more are in the process of being registered.
- Registration of cooperatives as prescribed by law and regulation is very simple, but as it is necessary to meet various formalities and comply with various bureaucratic procedures, the process generally takes around three months.
- All NGOs are required to register, under the Society Registration Act of 1978, with the Chief District Office (CDO) under the Home Ministry of HMG/N. The status of the NGO has to be renewed every year, and the CDO asks for an audited balance sheet, income tax clearance, a yearly progress report, and the executive members' status before granting renewal. There is also a Social Welfare Council which regulates and supports NGOs that are affiliated with it. It also works as a second-tier institution for all of its member NGOs.
- In order to work in microfinancing, NGOs have to receive a financial intermediary license from NRB. Recently DDC has also started to look after the status of NGOs working in their respective districts to monitor NGO activities. Generally it takes around one month to get an NGO registered with Chief District Office and 3–4 months to get an FI license from NRB.

  The documents required to obtain a financial intermediary license from NRB to conduct microfinance under FIA 1998 are as follows:

  1. Letter of application.
  2. Attested copies of citizenship certificates and photographs of the board members of the organization.
  3. Progress report of the organization at the date of application.
  4. Latest audit report of the organization.
  5. Attested copy of affiliation certificate of Social Welfare Council (if affiliated).
  6. A brief profile of the area in which the organization wants to work (incorporating geographical, demographic, ethnic, occupational, poverty, and unemployment status)
  7. Business/operation plan and projected income and expenditure statement for the next three years.
  8. Attested copies of agreements if the organization has to obtain loans, donations, or grants from national and international organizations.
  9. Commitment letter from the founders confirming their liability in case of liquidation of the organization.

- A Development Bank or Micro Finance Development Bank (MFDB) is required to register as a company at the Company Registrar Office under the Development Bank Act of 1992. On the other hand, the Company Act of 1956 has made it mandatory to obtain prior approval from NRB to register at the Company Registrar Office. In earlier days, registration of Development Banks/Micro Finance Development Banks was a smooth process. Even a few microfinance NGOs had been able to easily promote themselves as MFDBs, with share capital from joint-venture banks and even foreign share investment. But with many more organizations applying for MFDB status, the NRB now seems to be reluctant to provide MFDB licenses. Some applicants have complained that they have not been able to pass NRB scrutiny even after waiting for more than two years, although the stipulated time is only four months. The applicant has to furnish the following documents:

1. Memorandum of understanding and article of association.
1. Internal rules and regulations.
2. Feasibility study report to establish the proposed bank.
3. Business plan of the bank.
4. Personal details of founder members.
5. Letter of commitment of the founder members of the proposed bank, and other documents requested by NRB.

- In addition, the following documents are necessary to register a development bank as a company at the Company Registrar's Office:

1. Application.
2. License from Nepal Rastra Bank.
3. Memorandum of understanding and articles of association.
4. Internal rules and regulations.
5. Deposit receipt of the shares committed by the founder members.
6. Audit report to date.

- There is no capital requirement ceiling for financial intermediary NGOs and cooperatives as such (cooperatives should have a minimum of 25 members' share capital), but for Development Banks and Micro Finance Development Banks operation eligibility limitation is based on the amount of paid-up capital. Regional Rural Development Banks with capitalization of NPR 25 million are allowed to work in one district only; RRDBs and MFDBs with paid-up capital of NPR 50 million are allowed to work in three adjoining districts. Likewise, RRDBs and MFDBs with NPR 1 billion in paid-up capital will be allowed to work in ten adjoining districts, But the ceiling of paid-up capital to operate in the Kathmandu valley has been fixed at NPR 1 billion.
- Ownership ceilings or shareholding limits per person have been fixed at 15% of paid-up capital.
- There is no ownership share in a financial intermediary NGO (FINGO) or NGO.
- Foreign investors are allowed to be shareholders in Development Banks, but the ceiling for foreign investors has not been specified. Grameen Bank of Bangladesh has invested in Nirdhan Utthan Bank as a shareholder. A foreign bank requires prior approval from Nepal Rastra Bank for share participation. In the case of cooperatives and NGOs, foreigners are not allowed to be members; however, they can contribute to the total capital formation in the form of grants, revolving fund contributions, seed money, etc. In the case of cooperatives, a single member can purchase up to 20% of total share distribution.
- The Bank and Financial Institutions Ordinance of 2004 has specified the following qualification to be a member of the Board of Directors of a Development Bank or MFDB: at least two thirds of the Directors must have acquired at least a bachelor's degree in management, economics, accountancy, finance, law, banking, or statistics, and must have at least five years' experience working at the officer level in any

government agency or any agency connected with the banking or financial sector or with any public limited company.

- The same ordinance has stated the following as disqualifications from the position of Director of a DB/MFDB:

1. Anyone who has not attained the age of 21 years.
2. Anyone who is insane or of unsound mind.
3. Anyone who has been declared insolvent.
4. Anyone who has been blacklisted in connection with any transaction with any bank or financial institution (at least three years must have passed since the removal of their names from that list).
5. Anyone working as a director or employee of any bank or financial institution or of any financial institution conducting a business related to insurance, provident funds, or any other kind of deposits; or anyone currently working as an auditor or advisor to any other bank or financial institution.
6. Anyone who is a partner in any kind of contract agreement with the concerned bank or financial institution.
7. Anyone who has acquired the membership in the Stock Exchange in order to work as a security dealer.
8. Anyone who has not subscribed to the minimum number of shares in order to be eligible for appointment as a Director according to the Articles of Association of the bank or financial institution.
9. Anyone who is currently working as employees of His Majesty's Government, the Nepal Rastra Bank, or any bank or financial institution. This provision shall not be applicable to the nomination of any person made by His Majesty's Government as Director of any bank or financial institution whose shares have been purchased by it, or to the nomination of any person made by any bank or financial institution as a Director of any bank or financial institution whose shares have been purchased by it.
10. Any person who has left or retired from the services of the Nepal Rastra Bank after serving in the post of Governor, Deputy Governor, or Special Class employee and have not completed one year from the date of leaving or retiring from that service.
11. Anyone who has liability to pay taxes under current law but has not yet done so.
12. Anyone who has been punished by a court for a criminal offense involving moral turpitude, and five years have not passed since the completion of such punishment.
13. Anyone who has been punished by a court for an offense related to corruption or cheating.
14. Anyone who has yet to complete five years of action by the Nepal Rastra Bank or has been suspended by the Rastra Bank after taking over management under its control.

Some other aspects of MFIs in Nepal are the following:

- The Central Bank, NRB, is the ultimate authority to regulate the interest rate. Banks and financial institutions are allowed to charge a 6% spread between deposits and loans. But commercial banks are obliged to publish their interest rates and variations only to the extent of 1% on deposits and 2% in the lending rate between borrowers for the same purpose. The latter restriction is reported to have been imposed in order to deter banks from engaging in unhealthy competition. But, as part of FSRP, NRB abolished interest rate control regulation in 1989.

- FIA 1998 proposed that MFIs will decide their own lending interest rates, but NRB will have the power to ask the licensed MFIs to revise their interest rates as and when necessary along with credit flow. Thus interest rates will be under the ultimate control of the NRB. The official restriction on interest spread has been removed but continues to be treated as a moral obligation.
- However, NRB has allowed MFIs to charge various fees to their borrowers for the varieties of services rendered to them. The fee charges include registration fees, commitment fees, and various other fees. This provides legal scope to generate funds for MFIs for their operation and sustainability.
- The effective interest rate in most cases varies from 10% to 15% flat, which comes to 19 to 23% on a diminishing balance. Some MFDBs have recently revised their interest rates to 18% on a diminishing balance, and to not above 8% on savings on a six-month average balance.
- It can be assumed that as part of the liberalization of economic policy and financial sector reform in Nepal, the central bank has withdrawn all the impositions and directions in interest rate regulation.
- Interest on deposits and loans is normally guided by the interest rates paid by commercial banks. Further, the interest rates of commercial banks on priority-sector and deprived-sector lending determine the cost of funds to MFIs.
- From the consumer's perspective, interest rate fixing by NRB is not justifiable as clients will have the opportunity to select the best and more cost-effective institution for them.
- NRB, the central bank, through its directives has provided some standards for asset quality. The 2002 directive to MFDB categorizes capital into two types: (i) core capital and (ii) supplementary capital. Core capital consists of paid-up capital, share premiums, general reserves, retained earnings/losses; supplementary capital consists of loan loss provisions, asset revaluation reserves, and other reserves. MFDBs have been directed to maintain risk-weighted assets at 4% of core capital and 8% of total capital by the end of FY 2005/06.

Table 8 shows the weight that has been given to various assets.

Table 8. Weighting of Assets

S.N.	Asset type	Weight
1	Cash balance	0.00
2	Bank balance at NRB	0.00
3	Investment on government debenture	0.00
4	Investment on NRB's bond	0.00
5	Other investments	0.50
6	Deposits in other NRB-authorized institutions	0.20
7	Total loan and advances	1.00
8	Fixed assets	1.00
9	Other assets	1.00

- The central bank through its directives to Micro Finance Development Banks (2002) has redefined previously practiced loan loss provisions, and has now categorized loans into four types and loan loss provisions accordingly, as shown in Table 9.

Table 9. Loan Quality Classification

Classification of loan	Indicator	Loan loss provisioning
Good loan	Loans not delinquent and delinquents up to 3 three months	1% of outstanding loans in this category
Inferior loan	Loan delinquent for 3 to 9 months	2% of outstanding loans in this category
Doubtful loan	Loan delinquent for more than 9 months and less than 2 years	50% of outstanding loans in this category
Bad loan	Loans delinquent for more than 2 years	100% of outstanding loans in this category

- All banks are required to prepare reports twice annually and submit them to the central bank, and to make loan loss provisions.
- In the case of financial intermediary NGOs, classification and provisioning arrangements are as shown in Table 10.

Table 10. Loan Classification and Provisioning

Classification of loan	Indicator	Loan loss provisioning
Good loan	Loan not delinquent	Need no provisioning
Inferior loan	Loan delinquent up to 6 months	10 % of outstanding loans in this category
Doubtful loan	Loan delinquent for 6 months to 1 year	50 % of outstanding loans in this category
Bad loan	Loans delinquent for more than one year	100 % of outstanding loans in this category

- The regulation has directed microfinance practitioners to maintain loan loss provisions strictly so as to lessen business risk. The two standards commonly practiced are to maintain loan loss provision of 3% of total outstanding portfolio at the end of the year or 2% loan loss provision at the time of disbursement.
- Delinquent loans are self-monitored through periodic financial statements and outstanding status.
- The regulation does not insist on any collateral for microfinance loans; however, there is provision to take collateral on microenterprise loans up to NPR 100,000. The regulatory authorities have not challenged microfinance lenders who do not take traditional collateral in the form of real estate or securities. Some commercial banks have recently accepted secondary collateral in the case of financial intermediary NGOs.
- The regulation does not accept group guarantees as a legitimate form of security; nor has it recognized other non-traditional forms of collateral such as joint liability, peer pressure, and third-party guarantees as legitimate forms of security. This is not conducive to microfinance, which has adopted a revolutionary approach by doing away with the old system of collateral-based lending. The result has been quite satisfactory. Collateral-less loans to the poor are repaid regularly and on time, and delinquency rates have been low. The majority of MFIs have been able to obtain a 100% recovery from their members. The legal regulatory system does not approve of MFIs' practice,

and if challenged in court MFIs do not stand on strong legal ground. But it can be said than this is a revolutionary step towards poverty alleviation. It will be interesting to see how the law of the land will react, as the MFIs' form of microfinance is gaining strength and there is no way to avoid it.

- Microfinance practitioners have developed a methodology based on group guarantee/liability/peer pressure as collateral for extending microfinance services.
- The regulation has specified loans of from NPR 5000 (US$ 68) to NPR 30,000 per member as microfinance loans and up to NPR 100,000 per member as microenterprise loans.
- The regulation does not differentiate consumer loans from production loans so far as microfinance is concerned; it is understood that major portion of the loan is for consumption purpose.
- The regulation as such has not specified any criteria or documentation to determine the creditworthiness of microfinance borrowers; these matters are self-regulated and are specified by the MFIs in their business plans, loan policies, and other policy documents.
- Since creditworthiness is the major concern of MFIs, they apply various criteria such as baseline surveys, per-capita income, landholdings, and Casper housing index, and they ask for various documents and commitments from borrowers. The documents are:

    1. Clearance letter from a similar type of microfinancing institution.
    2. Proof of Nepali citizenship.
    3. Permanent citizenship of a particular location,
    4. Group membership.
    5. Indication of trust among group and center members.
    6. Acceptance of group collateral.
    7. Proof that applicant meets the eligibility criteria set by MFIs (participation in CGT, regular saving, and active participation).

- NRB is the supervisory regulatory authority. It reviews and controls through policy documents, business plans, program implementation guidelines for MFIs and periodic (mostly tri-monthly) reviews of progress reports and financial statements. In addition, NRB organizes field inspections and dialogues with clients in fields.
- During supervision the average loan size, initial loan size, maximum loan size, operational self-sufficiency, and financial self-sufficiency are keenly observed.
- Likewise, the same directive has set two types of reserve and liquidity. First, each MFDB has to deposit 0.5% of its total deposit collection and borrowing at the central bank or in another bank authorized by central bank as a compulsory reserve. Second, 2.5% of total individual savings, group savings, and special deposits have to be maintained as liquidity.
- In addition to the standards fixed by regulation for microfinance practitioners, MFIs normally follow the standards practiced in global circles. These include the CAMEL standards.
- Nepal Rastra Bank itself has promoted five Regional Rural Development Banks in the country as microfinance banks, and has set various regulations to support microfinance procedures. Despite conducive policies and strategy development, effective guidance, and effective monitoring and supervision, the total stake of the microfinance sector in the total financial scenario is only 4% in total capital formation, 1% in deposits, and 2% in outstanding loans.

- NRB has a separate department to look after microfinance, deal directly with practitioners, and obtain feedback for formulating conducive policies and effective monitoring mechanisms.
- The Financial Intermediary Act does not allow microfinance NGOs to mobilize savings from the public. They have been given limited access to mobilize savings in specific defined areas, from members and clients only.
- The reason for not allowing NGOs to mobilize public deposits may be that NGOs do not have equity-based capital and members do not have equity ownership. The NGOs in Nepal are primarily established as social intermediation organizations and therefore have memberships but no ownership structure.
- The recent regulation has allowed the transforming of NGOs into formal institutions. Some of the NGOs—particularly the Nirdhan NGO, the Centre for Self-help NGO, Chimek NGO, and DEPROSC NGO—have converted their operations into Microfinance Development Banks.
- An NGO is a non-profit-making, nongovernmental, non-equity-capital-based organization. Sources of funds for NGOs are membership fees, grants, donations, and program overheads, which are not supposed to be owned by any individual. But for banks these resources are converted into forms that go directly to the shareholders in proportion to their equity capital, since the bank is a profit-making, equity-capital-based organization. This form of financial organization has not been regarded favorably by civil society.
- Training is and should be a continuous process for both the supervisors and the practitioners as they work to facilitate and upgrade the microfinance system. In Nepal there is the Bankers Training Institute, run by the central bank, and the Agricultural Credit Training Institute, run by the Agricultural Development Bank Nepal and Rural Micro Finance Development Corporation. RMDC also conducts training for practitioners. But these institutions are mainly established for their cadre development. So the need of MFI training remains. The central bank has proposed the establishment of a Banker's Training Centre and Research Institute to strengthen the operation of MFIs. The training should focus on building rapport with clients and on MFI recordkeeping and efficiency in loan delivery.
- Based on experience, regulators and supervisors may benefit from the following training activities:

    1. Principles and world best practices in microfinance.
    2. Best practices in the Nepalese context.
    3. Product design in microfinance.
    4. Capital composition and fund flow mechanisms of MFIs in the Nepalese context.
    5. Financial and operational viability mechanisms in the smaller MFIs in the Nepalese context.
    6. Financial analysis.
    7. Contribution of microfinance to overall poverty alleviation in Nepal.

- Several special regulatory frameworks have been developed for providing microfinance services. Some of the regulatory frameworks are the Cooperative Act of 1992, the Development Bank Act of 1995, and the Financial Intermediary Act of 1998, with the recent Bank and Financial Institution Ordinance of 2004 as an Umbrella Act.
- Enactment of these Acts has recognized the microfinance sector as one of the primary forces for poverty alleviation in the country.
- Enactment of this legal framework has contributed to the emergence of large numbers of MFIs with the potential to support informal sector financing in rural areas.

CONCLUSION

His Majesty's Government (HMG) of Nepal has taken a lead role since the 1950s in microfinance development to alleviate poverty in the country. It has promoted village block development programs; promoted the cooperative movement; initiated priority-sector and deprived-sector lending programs; established a Rural Self Reliance Fund; launched Small Farmers Development Programs; promoted a Grameen Bank Replicator Program by establishing Regional Rural Development Banks; licensed Micro Finance Development Banks, Financial Intermediary Cooperatives, and Nongovernmental Organizations; and recently initiated second-tier institutions like the Rural Micro Finance Development Centre and the Poverty Alleviation Fund. This all has developed into a sound microfinance constituency in which commercial banks promote microfinance, five RRDBs follow the Grameen Bank model, various MFDBs take the lead in microfinancing, SCFLs have emerged as strong self-sustained microfinancing partners, and NGOs and cooperatives take the initiative in remote parts of the country and encourage many more NGOs to come forward. It is accurate to say that in Nepal, with the government taking the initiative, the private sector has come forward in an aggressive way in microfinancing. It is a public–private partnership mix. But as most of the rural sector is still out of the reach of the MFIs and there is still a vast unmet demand for microfinance services, the government will continue to be looked upon to take the lead role. There is a need for many more government-sponsored programs with the mindset to develop private MFDBs, cooperatives, and NGOs. It seems that the steps taken by HMG/N are in the right direction, but the government still needs to pursue poverty alleviation to its utmost ability. The challenge is not one for Nepal only. Almost all the developing nations have been pursuing the approach pioneered by Grameen Bank in Bangladesh and followed by many. Although Nepal has experimented with various targeted microfinance models, the GBR approach has been seen as the most appropriate model. The country has promulgated a variety of legal and regulatory measures in support of the development of MFIs and the expansion of their coverage and outreach.

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APPENDICES

Appendix 1. Commercial Bank Network in Nepal

Commercial banks	1984	1994	2002	2003	2004
Nepal Bank Ltd.	1	1	1	1	1
Rastriya Banijya Bank	1	1	1	1	1
NABIL Bank Ltd.	1	1	1	1	1
Nepal Indosuez Bank Ltd. (Nepal Investment Bank Ltd.)	–	1	1	1	1
Nepal Grindlays Bank Ltd. (Standard Chartered Bank Nepal Ltd.)	–	1	1	1	1
Himalayan Bank Ltd.	–	1	1	1	1
Nepal SBI Bank Ltd.	–	1	1	1	1
Nepal Bangladesh Bank Ltd.	–	1	1	1	1
Everest Bank Ltd.	–	1	1	1	1
Bank of Kathmandu Ltd.	–	1	1	1	1
Nepal Bank of Ceylon Ltd. (Nepal Credit & Commercial Bank Ltd.)	–	–	1	1	1
Lumbini Bank Ltd.	–	–	1	1	1
Nepal Industrial and Commercial Bank Ltd.	–	–	1	1	1
Machhapuchhre Bank Ltd.	–	–	1	1	1
Kumari Bank Ltd.	–	–	1	1	1
Laxmi Bank Ltd.	–	–	1	1	1
Siddhartha Bank Ltd.	–	–	1	1	1
Total	3	10	17	17	17

Source: NRB, January 2004

Appendix 2. Financial Companies

Nepal Housing Development Finance Co. Ltd.	Lalitpur Finance Co. Ltd.
Nepal Finance and Savings Co. Ltd.	Merchant Finance Co. Ltd.
NIDC Capital Markets Ltd.	Bhajuratna Finance & Saving Co. Ltd.
National Finance Co. Ltd.	General Finance Ltd.
Annapurna Finance Co. Ltd.	Nepal Shreelankha Merchant Bank Ltd.
Nepal Share Markets Ltd.	Alpic Everest Finance Ltd.
People Finance Ltd.	Nepal Merchant Banking & Finance Ltd.
Himalaya Finance & Savings Co. Ltd.	Nava Durga Finance Co. Ltd.
United Finance and Leasing Co.	Pokhara Finance Ltd.
Union Finance Co. Ltd.	Janaki Finance Ltd.
Birgunj Finance Ltd.	Central Finance Co. Ltd.
Mercentile Finance Co. Ltd.	Premier Finance Co. Ltd.
Kathmandu Finance Ltd.	Arun Finance & Saving Co. Ltd.
Inbesta Finance Ltd.	Multipurpose Saving & Investment Finance Co. Ltd.
Narayani Finance Ltd.	Butwal Finance Co. Ltd.
Gorkha Finance Ltd.	Nepal Bangladesh Finance & Leasing Co. Ltd.
Nepal Housing & Merchant Finance Co. Ltd.	Shrijana Finance Ltd.
Pashhimanchal Finance Co. Ltd.	Om Finance Ltd.
Universal Finance & Capital Markets	Cosmic Merchant Banking & Finance Ltd.
Samjhana Finance Co. Ltd.	World Merchant Banking & Finance Ltd.
Goodwill Finance & Investment Co. Ltd.	Capital Merchant Banking & Finance Ltd.
Shree Investment & Finance Co. Ltd.	Crystal Finance Ltd.
Siddhartha Finance Co. Ltd.	Royal Merchant Banking & Finance Ltd.
Lumbini Finance & Leasing Co. Ltd.	Guheswori Merchant Banking & Finance Ltd.
Yeti Finance Co. Ltd.	Patan Finance Ltd.
Standard Finance Ltd.	KIST Merchant Banking and Finance Ltd.
ACE Finance Co. Ltd.	Phewa Finance Co. Ltd.
International Leasing & Finance Co. Ltd.	Everest Finance Ltd.
Mahalaxmi Finance Co. Ltd.	

Appendix 3. Nonbank Financial Institutions

	Head office
Development banks	
Agriculture Development Bank	Kathmandu
Nepal Industrial Development Corporation	Kathmandu
Nepal Development Bank	Kathmandu
Uddyam Development Bank	Tandi, Chitwan
Malika Development Bank	Kailali
Siddhartha Development Bank	Butwal
Development Credit Bank Ltd.	Kathmandu
United Development Bank Ltd.	Bara
Nepal Cottage and Small Ind. Dev. Banks	Kathmandu
Narayani Industrial Dev. Banks	Tandi, Chitwan
Pashimanchal Bikas Bank Ltd.	Butwal
Sahayogi Bikas Bank Ltd.	Janakpur
Pashupati Development Bank Ltd.	Banepa
Rural microfinance development banks (licensed by NRB)	
Purbanchal Grameen Bikas Bank	Biratnagar
Sudur Pashimanchall Grameen Bikas Bank	Dhangadi
Pashimanchall Grameen Bikas Bank	Butwal
Madhya Pashimanchall Grameen Bikas Bank	Nepalgunj
Madhymanchall Grameen Bikas Bank	Janakpur
Nirdhan Uthann Bank	Bhairawa
Rural Microfinance Development Centre	Kathmandu
Deprosc Development	Tandi, Chitwan
Chimek Development Bank	Hetauda
Shawalamban Development Bank Ltd.	Janakpur
Sana Kisan Vikas Bank	Kathmandu
(continued on next page)	

Nongovernmental organizations (NGOs) (licensed by NRB)	
Nepal Grameen Bikas Samaj Kendra	Biratnagar
Nepal Grameen Bikas Sanstha (NERUDO)	Kathmandu
Nepal Sikara rameen Bikas Karyakram	Chitwan
Chartare Yuba Club	Baglung
Mahuli Samudyik Bikas Kendra	Saptari
Samuhik Yuba Club	Bardiya
Samudayik Mahila Biakas Kendra	Saptari
Grameen Samudayoko Lagi Yojana Pratavuti, Nepal	Dhankuta
Grameen Jagaran manch (Program Coordination Office)	baglung
Sarbodaya Grameen Bikas Sangh	Saptari
Jan Jagaran manch	Rasuwa
Rastriya Shaichik Tatha Samajik Bikas Sanstha	Parbat
Dhaulagiri Community Research Dev. Centre	Baglung
Nepal Environment & Pollution Eradication UNESCO Nepal	Gangabu
Society of Local Volunteers Efforts Nepal (Solve)	Dhankuta
Women Enterprises Association of Nepal	Kathmandu
Center for Women's Right and Development	Kathmandu
MANUSHI	Kathmandu
Life Development Society	Morang
Women development and Child care Foundation	Saptari
Mahila Adarsha Sewa Kendra	Kathmandu
Patan Business and Professional Women	Lalitpur
Women Development Centre	Chitwan
Womens Self-reliant Society	Chitwan
Women Development Centre of Nepal	Lalitpur
Bhagwan Youth Club	Kathmandu
Creative Women Environment Development	Kathmandu
Sirjana Samudayik Bikas Kendra	Siraha
Sirjana Bikash Kendra	Pokhara
Sirjana Youth Club	Baglung
Cottage & Small Industry Union	Kathmandu
Rural Area Development & Research Program	Parbat
Adarsha Youth Club	Bhaktapur
Society Welfare Action Nepal	Dang
Social Upgrade in Progress of Educational Region	Dang
Nepal Mahila Samudayik Sewa Kendra	Dang
Gramin Mahila Utsukta Bikas Manch	Sunsari
Gramin Mahila Bikas Sanstha	Dang
Ama Samaj Sangh	Chitwan
Gramin Mahila Utthan Kendra	Dang
Khurkot Youth Club	Parbat
Tharu Tatha Raji Mahila Samaj	Kailali
Nari Abhyudaya Kendra	Narayangadh
Mahila Upkar Manch	Banke

PAKISTAN

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THE COUNTRY'S DEVELOPMENT STRATEGY AND THE ROLE OF MICROFINANCE

Country Profile

Pakistan is a country with a population of 149 million and an average growth rate of 2.69% per annum. Women form 48% of the total population and men form 52%.

According to estimates, 99.12 million people live in rural areas, whereas 49.91 million live in urban areas. The total labor force is estimated at 42.38 million, of which 29.82 million (70.36%) are in rural areas and 12.56 million (29.63%) are in urban areas. Agriculture is the mainstay of the economy, sustaining 48.42% of the employed labor force. The other main sectoral employers are trade (13.50%), manufacturing (11.55%), and other services (15.02%). Per capita income is estimated at US$ 480.

The Present Policy Context

After the relatively difficult phase Pakistan's economy went through during the 1990s, the far-reaching structural reforms initiated and accelerated over the past four years have now started to pay off, and Pakistan has witnessed a modest rebound in growth; its vulnerability to external shocks has been reduced, and its key economic fundamentals have improved. Real gross domestic product grew 5.1% during FY 2002–03 (as against 3.4% in the previous year), and the growth target of 6.0% for FY 2004–05 looks achievable. The government has indicated its willingness to speed up the pace of structural reforms to meet the major challenges of reducing poverty, improving governance and administration, improving the fiscal and balance of payments position, restoring investor confidence, achieving higher growth on a sustainable basis, and improving social indicators.

The government has brought the issue of poverty alleviation to the center of economic policy making, and has put in place a strategy to reduce poverty and improve income distribution. The strategy is based on the premise that sustained economic growth accompanied by macroeconomic stability is the most powerful means of reducing poverty in the medium term.

Poverty in Pakistan

Poverty has many dimensions in Pakistan. The poor in Pakistan not only have low incomes; they also lack access to basic needs such as education, health, clean drinking water, and proper sanitation, which undermines their capabilities, limits their opportunities to secure employment, results in social exclusion, and exposes them to exogenous shocks. The vicious circle of poverty is accentuated when the governance structures exclude the most vulnerable from the decision-making process. Statistics indicate that the share of the highest 20% of households was 49.7%[1] of the national income, while the 20% of the households at the bottom of the pile were receiving only 6.2% of national income.

Based on the requirement of 2150 calories, the government of Pakistan set the official poverty line in at PKR (Pakistan Rupee) 748 per capita per month in 2000–01. According to the calorie-based definition of poverty, 31.8% of the people in Pakistan were below the poverty line in 2003. Poverty in Pakistan is largely a rural phenomenon; the incidence of poverty in rural areas was 38.65% as against 22.39% for the urban population.

[1] Figures are as per the Pakistan Economic Survey for 2002–03, but refer to 1998–99.

Amid growing recognition that the incidence of poverty was increasing in Pakistan, the government adopted a comprehensive multi-pronged strategy in November 2001 to reduce poverty and promote pro-poor economic growth. The policy, articulated in the Interim Poverty Reduction Strategy 2001–04, aims to improve access to basic social services like primary education, primary health care, population welfare services, potable water, sanitation, and microfinance (MF) services. The incidence of poverty is to be reduced from 33% of the population to a target level of 15.2% by the end of 2008.

Unemployment in Pakistan[2]

On the basis of an estimated population of 149 million, the total labor force is 42.75 million. Of this 29.69 million workers are in the rural areas and 13.06 million are in the urban areas. Comparison of rural and urban participation rates reveals that labor force participation rates are higher in rural areas than in urban areas because Pakistan's economy is mainly agrarian and agriculture is the main family profession.

Unemployment is defined as all persons ten years of age and above who during the period under reference were either without paid employment or were available for and seeking work. According to this definition, about 3.34 million persons in the labor force were unemployed in 2003, compared to 3.27 million in 2002. Unemployment increased from 5.89% in 1998 to 7.82% in 2003. Urban unemployment increased from 7.95% in 1999 to 9.92% in 2003, while rural unemployment grew from 4.98% to 6.94% in the same period.

The government has fully acknowledged the prospective repercussions of growing unemployment in the country and has taken several steps to create jobs opportunities as well as self-employment opportunities. In its effort to accelerate the pace of economic development, the government has focused on revitalizing the agricultural sector, development of small and medium enterprises, and growth of the oil and gas sector. Self-employment is an important vehicle for arresting the rise in unemployment. Emphasis is therefore placed on income-generating activities for promotion of self-employment at the grassroots level. The Micro Finance Sector Development Policy (MSDP) supports this emphasis.

Expected Role of Microfinance

While many factors contribute to poverty, its most obvious manifestation is insufficient household income. Poor households are permanently in deficit or in debt. Evidence from many countries has shown that access to and efficient provision of savings and credit facilities, along with social intermediation, enable the poor to stabilize their income and consumption, manage risks better, gradually build assets, develop microenterprises, enhance income-earning capacity, and thus enjoy a relatively better quality of life.

Hence, as part of its poverty reduction strategy, the government of Pakistan with the assistance of the Asian Development Bank announced a comprehensive policy that seeks to broaden and deepen the microfinance sector in order to enhance service outreach and thereby alleviate poverty. This Micro Finance Sector Development Policy (MSDP) seeks to address issues and constraints through:

1. Creating a conducive policy framework.
2. Developing appropriate supervisory and regulatory infrastructure for licensing and regulation of MFIs.
3. Pilot launching a model MFI capable of outreach to the poor.
4. Investments in social intermediation and basic infrastructure.

The objective of the policy is to reduce poverty. The purpose is to develop the MF sector to efficiently provide a range of affordable financial and social services to the poor, especially

[2] Economic Survey of Pakistan 2002–2003.

women who disproportionately bear the burden of poverty. Services provided at affordable prices will have a significant poverty reduction impact and thereby increase incomes of poor households, enhance outreach (especially to women), build social capital, and reduce the risks faced by the poor.

The Microfinance Industry in Pakistan

Clients and Client Characteristics

Pakistan's population is estimated at 149 million. Nearly two thirds of the population live in rural areas. The number of poor people is estimated at 46 million (31% of the population) in 6.6 million households. Of the poor, 33 million, representing 4.7 million households, live in rural areas. All poor households are potential clients for both financial and nonfinancial services. Government considers half the adult poor population (nearly 10 million) as potential MF clients. Among this client base, women, bonded laborers, and artisans, the traditional service providers to the rural community (e.g., blacksmiths, carpenters, weavers, barbers, tailors), are the major constituents.

Demand for Microfinance

The average loan taken by households as microfinance is about US$ 295 (PKR 16,540), at an interest rate of 18–20% per annum. In view of these figures, the estimated potential demand for micro-credit is about US$ 2 billion per annum based on the number of poor households (6.6 million) or about US$ 3 billion based on half the adult poor population (10 million). Similarly, the estimates for deposit possibilities range from US$ 225 million to US$ 350 million per annum. Based on population distribution, two thirds of this demand is considered to emanate from the rural poor. The NGO–MFIs' experience reflects that depositors outnumber borrowers by two to four times. The poor emphasize the safety and accessibility of savings facilities, as in the past many have lost their savings due to failures of cooperatives and finance companies.

Most of the demand for MF in rural areas is for agriculture production (50%) and livestock (25%); the balance is for other household-based income-generating activities (IGAs). In urban areas, most of the demand is for small businesses and self-employment ventures. Clients demand small and frequent loans, flexible terms compatible with the nature of activity, preference for women (due to their restricted mobility), simple and speedy delivery procedures within the community, service proximity, and significant and sustained social preparation to familiarize the poor with managing IGAs.

Interest rate sensitivity is high in rural areas due to the generally low level of economic activity. The fear of becoming indebted, particularly among women, due to failed enterprises (e.g., death of livestock, failure of business, crop failure) is widespread.

Supply for Microfinance

If the supply of MF services were adequate, the MF sector would be the largest sector of the financial system in terms of clientele base. Overall, the MF market is underdeveloped, with an institutional outreach estimated at 200,000 borrowers (60,000 NGOs, 140,000 community-based organizations or CBs) for micro-credit loans. This is about 3% of poor households. The CBs hold about 417,000 savings accounts deposited by NGOs on behalf of their members. Training skills for social intermediation, though developed by NGOs, is grossly underfunded and under capacity.

Suppliers of Microfinance

The suppliers of MF services are: informal reciprocal arrangements; semiformal sources such as NGOs, the Pakistan Poverty Alleviation Fund (a wholesaler), and government-sponsored programs; and formal sources such as Development Financial institutions, commercial banks, and licensed MFIs.

Informal sources account for about 83% of the credit supply. The principal informal sources of credit are commercial creditors linked with marketing intermediaries, commission agents, village traders, and shopkeepers; land-based credit arrangement extended by landlords to farmers for inputs and to meet consumption needs; and socially based arrangements of friends and family (the most numerous). Informal sources, in both rural and urban areas, mainly supply short-term credit on terms that reflect the weak bargaining power of the poor, particularly for land-based credit arrangements. Every village has one or more informal committees that collect regular savings and make loans to members. These operate like rotating savings and credit organizations. Informal credit based on reciprocity and social obligations mainly funds urgent consumption needs without any interest charges. However, these are intermittent and tend to be less than US$ 18 (PKR 1,000).

The semiformal sources of MF are mainly NGOs. The number of registered NGOs is estimated at 12,000 to 20,000, out of which 100 seem to supply some form of microfinance. Their combined outreach is estimated at 107,000 active loans with an aggregate portfolio of US$ 18.3 million (PKR 1.1 billion), and savings of US$ 19.5 million (PKR 1.17 billion). Women borrowers account for 32% of the total. NGOs deliver MF services through group-based methodology, more commonly known as the Grameen Bank model with adaptations to suit the local context). Loans between US$ 45 and 1250 (PKR 2,520–70,000) are given for terms ranging from 3 months to 2 years, and repayments are usually monthly or quarterly. Pricing of loans is in terms of mark-up over the principal at 18–20%. Some NGOs charge up to 48%. Most NGOs are unable to meet their costs, and use grant support to bridge their income gaps. Loan repayment rates are reportedly high (90% to 97%) in most cases. NGOs do not fall within the ambit of any regulator, and hence are not supervised or controlled. They are mainly supported by the donor agencies or through the Pakistan Poverty Alleviation Fund, and are monitored by their respective donors as they apply for further funding.

In the formal sector, operating under the regulatory and supervisory ambit of the central bank, the State Bank of Pakistan, are only two licensed microfinance banks: Khushhali Bank and First Microfinance Bank Limited. Apart from these, Zarai Taraqiati Bank Limited (ZBTL), formerly the Agricultural Development Bank Limited, provides two thirds of the agricultural credit available in the country. One leasing company has started microleasing, and some commercial banks— Bank of Khyber, Bank of Punjab, First Women's Bank, Habib Bank, and Muslim Commercial Bank—have experimented in MF.

Role of the Central Bank

Since 2001, the State Bank of Pakistan (SBP) has been considerably empowered (i.e., strengthened in terms of human resources, systems and procedures to become an effective regulator of the MFI sector) to cover the specific needs of MF, which include:

- Conducive policy to encourage the emergence of MFIs as depository institutions.
- Corresponding creation of a supervisory and regulatory system for orderly sector development and setting up of an independent MF Division to cater to the MF sector.
- Formation of the Consultative Group with a MF professional[3] to develop a regulatory and policy framework for MF and deliberate upon prevailing issues.
- Flexibility to adopt practices and procedures for banking with the poor, such as mobile banking and group collateral.

[3] The Consultative Group comprises officials from the regulated MFIs, SBP, the government, Swiss Development Corporation, and other MF professionals. The group meets on a regular basis to deliberate upon various issues and policies for the improvement of the sector.

- Flexibility on mark-up rates, free limits on accumulating non-collateralized loans.
- Insulation from political interference.

The MF sector can now be expected to seamlessly integrate with the broader financial sector of the country.

THE STRUCTURE OF THE FINANCIAL SYSTEM

Overview of the Structure of the Country's Financial System

The financial sector in Pakistan comprises commercial banks, nonbanking financial institutions (NBFCs), microfinance banks (MFBs), leasing companies, *modarbas*, mutual funds, stock exchanges, and insurance companies. Under the prevalent legislative structure, the regulatory and supervisory responsibilities in the case of banks, Development Finance Institutions, and MFBs fall within the legal ambit of State Bank of Pakistan, while the rest of the financial institutions are monitored by other authorities such as the Securities and Exchange Commission and Controller of Insurance.

Banking Sector

The banking sector comprises 15 private commercial banks, 3 privatized commercial banks, 3 nationalized commercial banks, 4 specialized banks, 2 provincial banks, 2 microfinance banks, and 14 foreign banks; these institutions, along with 6 Development Finance Institutions, are also supervised by the SBP.

Nonbanking Financial Sector

The nonbanking financial sector comprises 29 leasing companies, close-end and open-end mutual funds, 13 investment banks, 3 housing finance companies, 4 discount houses, and 2 venture capital companies. The Securities and Exchange Commission of Pakistan (SEC) now regulates and supervises the nonbanking financial sector, including capital markets and *modarbas*. The nonbanking companies are regulated under the Nonbanking Finance Companies (Establishment and Regulations) Rule, 2003.

Overall Performance of the Banking Institutions in Pakistan[4]

The banking industry in Pakistan remains dominated by 3 nationalized and 3 privatized banks, despite the emergence of private sector competitors following the banking sector liberalization initiated in the early 1990s. These bigger banks, for the last several years, have been confronted with structural drawbacks—especially overstaffing, unprofitable branches, poor customer services, and inept credit discipline. To minimize the organizational weaknesses of nationalized banks and to improve the financial soundness of the overall system, privatization of these units has become inevitable. To facilitate this process, a vigilant restructuring of these institutions has remained on the agenda over the last five years. Two main commercial banks, the Habib Bank Limited and the United Bank Limited, were privatized in the last two years.

Since 1997, SBP has been following a multi-pronged policy in order to manage the burden of nonperforming loan (NPLs) in the banking sector. Major steps include clear guidelines for the classification of NPLs and provisions for handling them; establishment of the Corporate and Industrial Restructuring Corporation (CIRC); Committee for Revival of Sick Industrial Units; and prosecution of defaulted cases under the NAB Ordinance. Additionally, banks were pressured to accelerate recoveries. An important development in FY 2003, in this regard, was the release of new guidelines for the write-off of irrecoverable loans and advances.

[4] Summarized from the Annual Report of the State Bank of Pakistan for FY 2003.

NPLs of the banking sector showed substantial improvement during the year 2003: NPL declined to PKR 227.7 billion by the end of FY2003 with a reduction of PKR 7.0 billion; additions of fresh NPLs to existing stock were PKR 10.1 billion lower during FY 2003 than during the preceding year.

Deposits of the Banking Sector

Despite offering a negative real rate of returns on deposits, the banking sector recorded double-digit deposit growth for the third year in a row, primarily on the back of a continuing improvement in the country's external account. The remarkable 19.5% FY 2003 deposit growth, amounting to PKR 275.1 billion, was primarily driven by exceptional growth in remittances.

Net Credit Expansion by the Banking Sector

The net credit of scheduled banks saw an expansion of PKR 133.2 billion during FY 2003, more than three times the change in net credit expansion recorded in FY 2002. This rise in net credit expansion was backed by an uPKRecedented increase in private-sector credit demand, banks' increased investments in TFCs, and equities, aggressive entry into the consumer finance market, greater participation in foreign currency lending (trade loans), and higher credit demand from the textile sector and loans against National Saving Schemes (NSS) instruments.

Table 1. Net Credit Expansion in PKR in Billion

FIs	FY2001	FY2002	FY2003
PSCBs	20.8	21.0	4.1
DPBs	35.6	18.2	119.3
Foreign	8.8	–5.6	6.3
Specialized	1.7	8.1	3.4
All banks	69.9	41.7	133.2

Source: SBP's Annual Report for FY 2003

New trends in the banking sector like consumer financing (including credit cards, auto loans, housing finance, personal loans, and e-banking) are becoming common in Pakistan. Additionally, credit rating requirements for banks have been made mandatory safeguards in the interest of prospective investors, depositors, and creditors, and necessary amendments have been incorporated in the prudential regulation to promote good corporate governance and to encourage senior management to play an active role in capacity-building of the institutions.

Table 2. Financial Indicators of Scheduled/Commercial Banks in %

	CY97	CY98	CY99	CY00	CY01
Capital adequacy					
Risk-weighted assets to total assets ratio	43.5	42.9	44.5	43.7	42.7
Capital to risk-weighted assets (CRWA) ratio	4.5	10.9	10.9	9.7	8.8
Number of banks below 8% CRWA	7	2	3	5	5
NPLs to risk-based capital	326.2	104.5	148.4	140.4	152.4
Credit risk–asset quality					
Gross NPLs to gross advances ratio	23.5	23.1	25.9	23.5	23.5
Net NPLs to net advances ratio	14.1	11.1	15.3	12.2	11.4
Provisioning held to gross NPLs ratio	46.6	58.6	48.6	55.0	56.2
(continued on next page)					

Earnings and profitability					
Pre-provision profit to average assets ratio	0.6	1.3	1.0	1.1	1.3
Return on assets (ROA)	–1.2	–0.1	–0.2	–0.2	–0.5
Net interest margins (NIM)	2.8	3.7	3.3	3.5	4.3
Liquidity risk					
Liquidity assets to total assets ratio	39.5	39.7	36.8	36.0	38.8
Advances to deposit ratio	57.6	56.6	62.0	66.2	61.7
Liquid assets to borrowing ratio	383.3	366.8	280.0	242.8	283.1

Source: SBP's Annual Report for FY 2002

Type of Clientele, Financial Products, and Collateral

Commercial banks are governed under the Banking Companies Ordinance, 1962. With the recent changes in the universal banking system, the SBP has issued Prudential Regulations for Commercial Banks, covering both consumer and corporate finance, and Prudential Regulations for Small and Medium Enterprises. With the introduction of the Microfinance Bank Ordinance, 2001, the SBP issued Prudential Regulations for Microfinance Institutions.

Table 3. Types of Products Offered by the Banking Sector

Bank	Products	Clientele	Collateral
Commercial banks	Deposits, personal loans, auto loans, consumer products, corporate financing, foreign exchange, trade finance, investment advisories, general banking services	Individuals, corporations, multinationals	Hard collateral such as property, hypothecation, pledge, personal guarantees; liens on bank accounts, savings certificates, other assets
Microfinance banks	Micro-credit, deposits, remittances, insurance	Poor individuals/ groups of people living in rural and urban areas	Peer pressure, personal/ group guarantees
SME Bank	Medium to short-term financing to small and medium enterprises	SMEs	Mortgages, personal guarantees, liens on bank accounts, hypothecation and pledges
Development financial institutions	Project financing (long-term loan, redeemable capital for industrial units)	Medium to large corporations	Mortgage of industrial units (land and other assets)

Overall Performance of the Nonbanking Institutions (with credit as major function)

Leasing Companies

Leasing companies have demonstrated considerable growth despite shrinkage in the spreads due to declining interest rates. The total assets increased by 16% to PKR 51.28 billion. Similarly, the equity base rose to PKR 9.78 billion, indicating an improvement of 24% mainly due to the upward swing of the capital market, which translated into gains on investments in listed securities. Approximately 79% of the assets of leasing companies were dedicated to the principal line of business during the financial year 2003; net lease for the year amounted to PKR 38.527 billion. Certificates of Investment (COIs) remained a significant source of mobilizing short and medium-term funding for leasing companies. As of 30 June 2003, an aggregate amount of PKR 13.87 billion was raised through COIs, which represented 27% of the total assets of leasing companies.

Modarabas

The *modaraba* is an Islamic mode of business in which one party (the *modaraba* company) contributes its skills and efforts while the other (the *modaraba* certificate holder) provides the required funds; the profits earned are shared by the two parties in a pre-specified manner. The *modaraba* may be multi-purpose or specific-purpose, and may be perpetual or floated for a specified period. During the last two decades, *modarabas* have provided attractive investment opportunities based on dividend yield. As of 30 June 2003, there were 38 *modarabas* in existence with an aggregate paid-up capital of PKR 8.31 billion. Total assets of the *modaraba* sector stood atPKR 16.89 billion while the total equity amounted to PKR 8.56 billion.

Investment Banks

The scope of activities of investment banks broadly includes money and capital market operations along with project and corporate finance services. As of 30 June 2003, there were 13 NBFCs undertaking investment finance services, of which one was in voluntary liquidation. These NBFCs were thinly capitalized with a total equity base of PKR 4.10 billion against the total assets of PKR 29.03 billion. A significant source of funding for investment banks has been certificates of deposits that amounted to PKR 10.66 billion, i.e., 37% of total assets, as on 30 June 2003. During the year under review, investment banks mainly focused on capital and money market operations and total investments of PKR 13.4 billion represented 46% of the total assets.

Housing Finance Companies

The House Building Finance Corporation (HBFC) was established under the House Building Finance Corporation Act, 1952 and was the first organization to provide housing finance services in Pakistan. Other than HBFC, three companies have been engaged in providing housing finance services, of which one was in liquidation during the financial year. The housing finance sector is highly concentrated and is dominated by HBFC, which holds more than 90% of total assets, advances, investments, and equity in the sector. Key statistics of HBFC as of 30 June 2003 indicate total investments of PKR 4.34 billion, advances of PKR 10.627 billion, total assets worth PKR 20.974 billion, deposits of PKR 0.035 billion, and total equity amounting to PKR 4.885 billion. Housing finance has been an underdeveloped sector and is yet to take off.

Type of Clientele, Financial Products, and Collateral

Nonbanking finance companies are governed under the Nonbanking Finance Companies (Establishment and Registration) Rule, 2002, and Nonbanking Finance Companies Rule, 2003.

Table 4. Types of Products Offered by the Nonbanking Financial Sector

NBFC	Products	Clientele	Collateral
Leasing companies	Capital leases, including industrial leases, auto leases, asset leases, certificates of investments	Individuals, corporations, multinationals	Asset leased is collateral. Other facilitation: property, hypothecation, bank guarantees
Investment banks	Corporate finance (medium- to long-term), underwriting, investment advisories, portfolio management	Corporations, multinationals	Mortgages, hypothecation pledges, personal guarantees, liens
Housing finance companies	Housing finance	Individuals	Mortgage of the land and house

Role of Informal Lenders in the Credit Markets

As informal lenders have no linkage with the formal financial sector, there are no secondary data available on the extent of penetration of informal lenders in the credit markets of Pakistan. The available information on informal lenders is limited to geographical location and based on word of mouth.

In the northern areas, informal lenders are mainly shopkeepers who use a barter system; they provide foodstuffs and essentials in exchange for handicrafts and other work undertaken by the people. Likewise, a supplier system works in other urban areas, where wholesaler/shopkeeper provide raw material to poor people to manufacture items, and then buy back the products to sell through their own outlets. In some traders' community, entrepreneurs having no access to financing prefer to have a "committee system," under which a group of entrepreneurs contribute a certain sum of money every month to a kitty, and a drawing is held at the monthly meeting to provide the total monthly collection to one of the members of the group. As such, every member gets a one-time lump sum amount to suit his requirements. A portion of mark-up is also built into the system. Informal lending by commercial creditors flourishes since micro, small, and medium entrepreneurs generally are unorganized to access credit from formal financial institutions. Documents and records are not readily available to be provided to banks, nor is collateral. Informal lenders lend money at exorbitant rates ranging from 15–30% a month. Although no collateral is involved, informal lenders put social pressure on the clients to repay on time.

According to information supplied by Khushhali Bank, informal sources account for about 83% of the microfinance credit supply. The principal informal sources of credit are commercial creditors linked with marketing intermediaries, commission agents, village traders, and shopkeepers. Land-based credit is extended by landlords to farmers for purchasing inputs and to meet consumption needs. Socially based arrangements among friends and family are the most common form of microfinance.

Moneylending as a specialized occupation is not significant and is gradually declining. Informal sources, both in rural and urban areas, mainly supply short-term credit on terms that reflect the weak bargaining power of the poor, particularly for land-based credit arrangements. Every village has one or more informal committees that collect regular savings and make loans to members. These operate like rotating savings and credit organizations. Informal credit based on reciprocity and social obligations mainly funds urgent consumption needs without any interest charges. However, these are intermittent and tend to be less than US$ 18 (PKR 1000).

Emergence of Microfinance Institutions in Pakistan

Poverty in Pakistan has increased by 10–12% over the last 15 years, as a result of changing economic policies; the effects of growth and investment did not trickle down to the poor of the country, thus widening the gap between the haves and the have-nots. Hence, in order to address the issues of poverty, sustainable development programs had to be initiated. Recognizing this, the government placed importance on microfinance policy development and deliverable institutions. Although the activities of microfinance existed in NGO circles for quite some time, the development of the microfinance sector was a government initiative in the year 2000. The restructuring of the Small Business Finance Corporation (now the SME Bank) was a first step to address the financing needs of small entrepreneurs, followed by the setting up of the Khushhali Bank in 2000. Later, in 2002, the First Microfinance Bank Limited, the second licensed MFI, commenced its operation.

In contrast, semi-informal sources of microfinance have existed for the last decade; the most important is the AKRSP, which has been in the business of microfinancing for the past 20 years in the northern areas of the country. NGOs have played some role in microfinancing in the past. The estimated number of registered NGOs is between 12,000 and 20,000, of which 100 seem to supply some microfinance. Only half of these have outreach beyond the immediate community. The twelve members of the Microfinance Group (as per the list in Table 6) are considered to have substantive interest in microfinance and are mostly funded by aid agencies. Generally, MF operations of NGOs are sensitive to the demand profile and social needs of the poor and provide services in a participatory manner. The combined outreach of members of the MF Group is estimated at 107,000 active loans with aggregate lending of US$ 18.3 million (PKR 1 .1 billion), and savings of US$ 19.5 million (PKR 1.17 billion). Women borrowers account for 32% of the total.

The government established the Pakistan Poverty Alleviation Fund (PPAF) in 1997, with an endowment of PKR 500 million (US$ 9 million), as an apex institution to help the poor. PPAF plans to provide MF services primarily through NGOs to an estimated 200,000 households over the next four years. The World Bank is sponsoring PPAF with a US$ 90 million loan.

Credit components in other government-sponsored programs are not micro-credit either by size, mode of delivery, or terms of credit. The overall impact has therefore been minimal as the services have been presented, promoted, and delivered in a manner that suggests a politically motivated grant facility and has been so understood by those privileged to have access. The budgetary support for such programs has either been curtailed or discontinued.

Table 5. Structure of Microfinance Institutions in Pakistan

Commercial banks	Development financing institutions	NBFCs
First Women Bank Limited	Zarai Taraqiati Bank	Network Leasing Corporation Ltd.
NGOs	Specialized Banks	Microfinance banks
KASHF, NRSP, PRSP, DAMEN, TARAQEE, etc.	Bank of Khyber	Khushhali Bank First Microfinance Bank Limited

Table 6. Performance of MFIs during Calendar Year 2002

MFI	Loans disbursed in '000	No. of bor-rowers	Portfolio at risk as % of OLP	Return on per-form-ing assets (%)	Finan-cial cost ratio (%)	Operating self-suffi-ciency ratio (%)	Cumu-lative repay-ment rate %	Total no. of active savers
KASHF	196,284	36,103	0.2	16.5	2.0	119.4	99.9	26,791
OPP	26,424	1,617	6.9	19.4	0.2	345.8	96.0	0
SAFWCO	11,677	1,876	8.4	27.2	7.4	44.1	95.6	1,993
SUNGI	5,068	441	24.8	8.2	0.0	23.4	84.8	10,739
TRDP	46,383	4,728	3.7	10.9	5.4	59.8	98.4	44,104
TARAQEE	34,947	3,846	2.0	7.4	3.1	20.2	97.1	9,950
DAMEN	29,860	5,365	3.3	24.6	6.1	92.5	98.0	0
NRSP	586,944	28,768	16.5	13.7	4.2	116.4	94.0	372,640
SRSP	28,008	1,804	59.6	13.3	4.6	51.2	85.1	135,526
AKRSP	175,123	12,232	0.0	15.1	0.5	299.5	99.3	149,175
BOK	84,945	2,166	39.7	13.7	9.0	40.7	87.6	0
PRSP	461,741	42,928	14.6	15.1	4.0	90.9	94.9	164,372

Source: Annual Report of Pakistan Microfinance Network for the year ended 2002

Since the last report of December 2002, the Pakistan Microfinance Network has enhanced the quality of the report to bring it to a par with the international standards. Hence, the performance evaluation conveys new ratios and measures. These are given in Table 7.

MICROFINANCE PRODUCTS AND SERVICES

Types of Microfinance Products

There are two licensed MFIs operating under the Microfinance Ordinance of 2001. Both of these MFIs offer credit facilities—i.e., loans. Additionally, one leasing company, operating under the Nonbanking Finance Companies Ordinance of 2000, provides microlease financing. Two scheduled commercial banks, operating under the Banking Companies Ordinance, also provide micro-credit facilities. However, most of the MFIs operate as nongovernmental organizations, registered under the NGO Societies Registration Act of 1860, the Public and Charitable Trust Act of 1882, the Cooperative Societies Act of 1925, the Voluntary Social Welfare Agencies Registration and Control Ordinance of 1961, and the Companies Ordinance of 1984, and offer micro-credit facilities. Twelve of the main NGOs are members of the Pakistan Microfinance Network (PMN) and are catering to 80% of the present microfinance market. Insurance products, mainly life insurance, are presently offered by two MFIs, but through insurance companies. A brief outline of each product offered by the main MFIs is given below.

Khushhali Bank (KB)

In August 2000, Khushhali Bank was established as part of the Government of Islamic Republic of Pakistan's Poverty Reduction Strategy and MSDP. It is headquartered in Islamabad and operates under the central bank's (State Bank of Pakistan) supervision with 18 FIs as its shareholders. Its mandate is to retail microfinance services and act as a catalyst in stabilizing the country's newly formed microfinance sector.

An amount of US$ 70 million out of the total funding from the Asian Development Bank of US$ 150 million has been allocated to support policy reforms of the microfinance sector in Pakistan. The government has established four endowment funds at the State Bank of Pakistan to support the poor with periodic contributions from both, the government and Khushhali Bank to ensure sustained ownership. These measures are construed as a catalyst for broadening and deepening the country's microfinance market, thus contributing to poverty alleviation in the country on a sustainable basis. They include:

1. **Microfinance Social Development Fund**: US$ 40 million fund supports social mobilization activities within poor communities.
2. **Community Investment Fund:** US$ 20 million fund supports development of community infrastructure such as water channels, link roads, etc., in particular in the under-serviced rural areas.
3. **Risk Mitigation Fund:** US$ 5 million fund provides risk mitigation cover to micro borrowers of the Bank.
4. **Deposit Protection Fund:** US$ 5 million fund provides protection to micro depositors of the Bank.

The Khushhali Bank provides banking services through mobile banking teams/vans or small outlets/service centers in areas/locations where the MFI has a licensed branch within the radius of 50 km. Khushhali Bank presently offers micro-credit loans between PKR 3000 and PKR 30,000 for a period of one year to a group of borrowers, but in an individual capacity. The group members must be in the same area/market area. The bank operates in both rural and urban areas. Peer pressure is the only collateral available to the bank. The current recovery rate is 96%. It has provisioned 2.95% of its credit portfolio against bad debt during the current year.

Table 7. Performance of MFIs during January-December 2003

Year under review	January-December 2003			July 2002-June 2003				January-December 2003			July 2002-June 2003	
MFI/ratios %	BOK	FMFBL	KASHF	NRSP	PRSP	SRSP	TRDP	DAMEN	SUNGI	SAFWCO	Taraqee	OPP
Financing structure												
Equity to asset	–0.33	61.33	40.70	31.97	65.59	–10.16	26.58	23.58	97.41	23.66	11.56	90.04
Commercial liabilities to gross loan portfolio	100	38	0	14.18	30.57	18.72	0	0	0	0	0	18.86
Debt to equity	–30275.23	63.06	145.15	212.80	52.45	–1084.63	276.17	324.08	2.66	322.74	765.12	11.06
Deposits to gross loan portfolio	0	595.87	3.22	0	0	0	0	0	0	0	2.68	0
Deposits to total assets	0	32.96	1.44	0	0	0	0	0	0	0	1.69	0
Gross loan portfolio	100.3	5.53	44.82	64.76	41.57	69.71	72.77	83.52	15.03	53.37	63.25	52.62
Outreach indicators												
Average loan balance per active borrower	28,322	18,492	5,845	8,990	6,572	6,849	6,996	3,479	3,745	3,846	7,062	14,083
Average saving balance per active saver	0	38,622	196	813	432	457	408	0	7,105	188	133	0
Financial performance												
Adjusted return on assets	–15.69	–2.31	2.18	–0.92	–153	–25.33	–10.68	–173	–28.46	–26.74	–24.44	–5.10
Adjusted return on equity	–999.14	–3.24	4.09	–3	–2	0	–39	–9.86	–28.90	–98.02	–190.94	–5.38
Operational self-sufficiency	44.78	105.34	130.07	100.78	105.27	28.96	52.85	94.10	13.90	38.48	36.55	77.38
Financial self-sufficiency	44.78	77.05	115.09	93.82	90.09	28.96	52.14	93.22	12.48	37.99	35.34	55.35
Yield on gross portfolio (real)	8.91	18.94	28.39	13.46	14.12	8.06	9.81	28.24	6.56	22.06	18.31	7.17
Efficiency indicators												
Adjusted cost per borrower	2,518	29,128	1,186	1,442	1,135	1,101	1,301	949	3,532	2,280	4,287	2,012
Productivity indicators												
Borrower per loan staff	270	91	345	158	268	118	343	307	172	270	68	226
Loans per loan officer	270	91	510	158	268	118	343	307	172	270	68	226
Savers per staff	0	83	218	831	572	2,568	2,802	0	1,299	206	88	0
Risk and liquidity indicators												
Portfolio at risk (>90) to gross loan portfolio	32.61	1.6	0.11	6.7	17.30	66.48	2.69	1.50	77.75	4.82	0	2.12
Risk coverage ratio	36.88	43.09	42.12	77.01	76.90	88.89	99.26	25	70.05	65.20	0	35.94
Write-off to average gross loan portfolio	0	0	0	6.43	0.07	14.85	0.02	0	6.97	0	0	2.75

Source: Annual Report of Pakistan Microfinance Network for the year ended 2003

Business Loans

- *Area of operation:* Towns and urban/semi-urban areas/rural areas.
- *Methodology:* Individual loans but to a group of 5–10 entrepreneurs operating in the same vicinity/area. The group has to register as a CO with the bank prior to any loan. Borrowers may be starting a new business or already operating a business. Borrowers have to establish an account with the bank. In rural areas, the group can be of 10 people or more.
- *Purpose:* Agricultural, enterprise development, asset purchase, small seasonal stalls, working capital, and livestock.
- *Amount limit:* PKR 3000 to 30,000; enterprise loan is for PKR 10,000; new entrepreneurs are initially given only PKR 5000.
- *Loan period:* Maximum one year.
- *Repayment:* Monthly installments; agricultural loans are linked to the crop season (6 months); enterprise loans are paid in 12 fixed monthly installments.
- *Service charge:* 20 % per annum (55 paisa per PKR 1000 per day).
- *Application processing time:* 3–4 weeks; no processing fee.
- *Collateral:* Group guarantee (cross-guarantee).

Products for NGOs

Under the Microfinance Sector Development Policy, Khushhali Bank is entrusted to administer the two endowment funds established by the State Bank of Pakistan—the Microfinance Sector Development Fund (MSDP) for US$ 40 million and the Community Infrastructure Fund (CIF) for US$ 20 million, for improvement and development of community organizations (COs). The Khushhali Bank in partnership with any eligible NGO may jointly provide services to the CO to undertake small infrastructure projects under the CIF. Additionally, services such as mobilization of the poor into COs, training and skill development, etc., can be funded with the MSDP funds.

First Micro Finance Bank Limited (FMFB)

The First Micro Finance Bank Ltd (FMFB) originates from the Aga Khan Rural Support Programme (AKRSP), which has been running a successful microfinance and integrated rural development program in the remote and isolated rorthern parts of Pakistan since 1982. AKRSP's positive experience with its program has inspired the creation of many institutions in Pakistan and has also served as a model for others around the world. On the encouragement of the government of Pakistan, which desires to promote the development of an active privately based microfinance industry, First Micro Finance Bank Ltd was established as a non-listed public limited company under the provisions of the Companies Ordinance (1984) in November 2001 and licensed as a Microfinance Institution (MFI) under the provisions of the 2001 Microfinance Institutions Ordinance in January 2002. The principal sponsors and shareholders are Aga Khan Rural Support Programme (AKRSP), Aga Khan Fund for Economic Development (AKFED), and International Finance Corporation (IFC).

The FMFB is the only MFI which offers a range of services, from deposits, remittances, and wire transfers to various credit products, through 21 branches. The products have been developed based on FMBL's long-term research over the last 20 years. Moreover, any new product introduced is a result of a one-year research program and is only launched once the credit officers are properly trained in handling and selling the product. All products are linked to the needs of the potential customers. The average recovery percentage is 98%.

Loans are provided in three different forms: loans under the solidarity group approach (five different loan products), in which the group members cross-guarantee for each other; loans to Village Organizations—20–50 members; individual loans in which the Village Organization guarantees the loan; and loans to individuals who have a past track record of 5–6 years with the bank. The various products' features are given below:

Business Group Loans

- *Area of operation:* Towns and urban/semi-urban areas.
- *Methodology:* Solidarity lending methodology.
- *Purpose:* Loans to microentrepreneurs mainly for working capital.
- *Amount limit:* PKR 5000 to 50,000.
- *Loan period:* One to six months.
- *Repayment:* Monthly installments.
- *Mark-up:* 15% per annum.
- *Loan processing fee:* PKR 100.
- *Collateral:* Group guarantee.

Business Committee Loans

- *Area of operation:* Towns and urban/semi-urban areas.
- *Methodology:* Solidarity lending methodology.
- *Purpose:* Loans to microentrepreneurs mainly for working capital.
- *Amount limit:* PKR 3000 to 50,000.
- *Loan period:* One to six months.
- *Repayment:* Daily/weekly/fortnightly installments.
- *Mark-up:* 12% per annum.
- *Loan processing fee:* PKR 100.
- *Collateral:* Group guarantee.

Individual Loans

- *Area of operation:* Rural areas; members of Village and Women Organizations (VO/WO).
- *Methodology:* Individual lending methodology.
- *Purpose:* Loans to microentrepreneurs mainly for working capital.
- *Amount limit:* PKR 5000 to 100,000.
- *Loan period:* Up to one year.
- *Repayment:* Monthly installments.
- *Mark-up:* 16% per annum.
- *Loan processing fee:* None.
- *Collateral:* Members of the VO/WO stand as informal guarantors.

Group Loans

- *Area of operation:* Rural areas; members of Village and Women Organizations (VO/WOs).
- *Methodology:* Village banking methodology.
- *Purpose:* Availability of a revolving fund.
- *Amount limit:* Equal to the savings of the VO/WO.
- *Loan period:* Up to one year.
- *Repayment:* Lump sum or installments as desired by the VO/WO borrowers.
- *Mark-up:* 15% per annum.
- *Loan processing fee:* None.
- *Collateral:* Equal to the loan amount in Term Deposit Receipts issued by the bank or lien marking of the deposits kept with the bank.

Urban Group Loans

- *Area of operation:* Urban area.
- *Methodology:* Solidarity lending methodology.
- *Purpose:* Loans to microentrepreneurs mainly for working capital.
- *Amount limit:* PKR 3000 to 50,000.
- *Loan period:* One month to six months.
- *Repayment:* Weekly/fortnightly/monthly installments.
- *Mark-up:* 15% per annum.
- *Loan processing fee:* PKR 100.00.
- *Collateral:* Group guarantee.

Other Products

- Housing Improvement Loans of PKR2500 and Low Salary Employees Loans have recently been introduced by the bank.
- The bank also offers a range of deposit and savings products, namely current accounts, profit and loss saving accounts, micro-cash maximizers, and term deposits, at competitive market rates of return.
- Mandatory life insurance is required for all borrowers. An annual fee of PKR 50 for loans up to PKR 50,000 and PKR 100 for loans of more than PKR 50,000 has to be paid by the borrower. The insurance product is offered through an insurance company.
- Other facilities/services offered by FMFB are: Remittances and Collection, Cheque Collection, and Wire Transfer/TT.

KASHF Foundation

KASHF Foundation is one of the major credit-NGOs in the country. Financing is extended to mainly women; however a group of women has to be self-selected by the borrower to in turn guarantee the repayment of the loan. Loans provided are flexible in nature and are linked to the absorptive capacity of the borrower. Credit products are promoted through door-to-door banking in identified areas. KASHF maintains a repayment rate of 100% and its portfolio-at-risk is 1.35%. A life insurance product has been launched through Adamjee Insurance Company to provide life insurance to its borrowers. This product helps the dependents of the borrower to repay outstanding loans to KASHF in case of the borrower's death. The one-time insurance fee is about PKR 100/US$ 1.60, and it also covers the member in the case of an accident.

KASHF Foundation claims to have deviated from the traditional approach of microfinancing and has devised a new approach. Accordingly, products are designed to be pro-poor and to support productive and economic purposes, as well as to meet emergencies. It is thought to be quite systematic and streamlined, with a view to improving overall productivity of the portfolio. Its major products are:

General Loans

- *Methodology:* Customers/women (groups) have to self-select a Center—a group of 20–25 women who will take the responsibility of repayment of the loan.
- *Purpose:* For productive purposes.
- *Amount limit:* PKR 8000–PKR 10,000 (maximum of PKR 35,000).
- *Loan period:* Up to 12 months.
- *Repayment:* 22 equal installments over 12 months.

- *Mark-up:* 20%.
- *Collateral:* Center takes the responsibility of repaying the loan.

Consumption Loans

- *Methodology:* Self-select a Center—a group of 20–25 women.
- *Purpose:* For unforeseen emergencies.
- *Amount limit:* PKR 1800 or US$ 30.
- *Loan period:* Up to 6 months.
- *Repayment:* 12 equal installments over 6 months.
- *Mark-up:* 20%.
- *Collateral:* Center takes the responsibility of repaying the loan.

Deposits

KASHF offers a flexible savings product which provides clients with the opportunity to deposit in multiples of PKR 10 (20 cents) and offers open withdrawal at the Center meetings or, in case of emergencies, at the branch office.

Network Leasing Corporation Limited (NLC)

Microleasing is a new product in Pakistan, and it is different from other loan products in many ways. The clients are given an asset instead of cash, and hence the possibility of misuse of funds is eliminated. The item is used strictly for productive purposes and thus the probability of default is reduced.

NLC microlease is a relatively flexible; a lessee can make partial or substantial payment of the leased amount any time. The lease contract can be structured in order to accommodate seasonal variations and trade cycles, and thus synchronizes payment with income flow. The borrower pays a small down payment and the income from the asset pays for the installment amounts. Microleasing products have been offered in contrast to group lending approach, which is the main methodology adopted by most MFIs.

NLC has its own marketing teams at each branch, which reaches out to the targeted areas and introduces microleasing to the prospective clusters. The applications received are passed on to NLC's Marketing and Evaluation Department, which carries out initial scrutiny of the applications. Subsequently, based on the information from clients, financial statements for the last three years are prepared. This assessment is provided to the Lease Administration Department, which conducts a technical assessment of the proposal, evaluating factors like specification of assets, estimated cost, and estimated incremental revenue, and ensures that all regulatory requirements are duly adhered to. The proposals are then recommended for approval by the Credit Committee. Disbursements are made to suppliers of the asset directly in all cases. For facilitating the repayment of the lease rentals, borrowers are advised to establish a bank account; guidance is provided to the clients on banking services and in the use of post-dated checks. Clients are followed up for payment of rental amounts. The features of the product are:

Microleases

- *Product:* In the form of a productive, income-generating asset. Title to the asset is passed on to the lessee after the expiry of the lease payment.
- *Methodology:* Leasing provided on individual basis, or to a partnership or association.
- *Purpose:* For income-generating and productive purpose; for working capital.
- *Eligibility criteria:* a) The enterprise must be engaged in a productive/income-generating activity; b) Completed application form, together with its attachments; c) Two guarantors from the business vicinity; d) Subject to the requirements of the regulatory bodies.

- *Amount limit:* PKR 1000 /US$ 18 (minimum).
- *Security deposit:* A 10% security deposited is obtained at the time of the disbursement.
- *Lease period:* Three to five years.
- *Repayment:* Monthly installments.
- *Mark-up:* Market-based; 10.50–22% per annum.
- *Collateral:* The asset itself is the collateral.

Insurance Products

1. Life Insurance Product: Under this scheme, all lessees are covered under a "group life policy;" the premium is paid by the company and is recovered through the monthly lease rental. In case of a death, the insurance company will pay the outstanding amount to NLC and the asset will become the property of the lessee's family, with no further payments to make.
2. Residual Value Insurance: A product with an insurance company whereby if the asset is surrendered by the client due to nonpayment of rentals, it will be sold by the insurance company; any shortfall in the outstanding amount due to NLC from the client will be made good by the insurance company.
3. All risks covered: All assets that are financed, irrespective of the amount, are insured under the general insurance policy which covers fire, theft, malicious damage, floods, and civil disturbances.
4. Insurance premia for all insurance products are built into the monthly rental fees; the client makes only one payment which includes the rental as well as the insurance charges.

First Women Bank Limited

The First Women Bank Limited (FWBL) formally launched its micro-credit product in the year 2001. However, prior to this formal introduction, FWBL had been actively involved in providing microfinance to women since its establishment in 1989. Loans were provided to women for businesses, short-term financing needs of salaried women, and car financing. Operating under the Banking Companies Ordinance of 1962, the FWBL has to meet the lending criteria of a commercial bank. Each branch has a team of microfinance credit officers who reach out to customers. Since, as per the Banking Ordinance, there are a considerable number of documents to be furnished, credit officers assist the clients in preparation of the documents. Formal Loan Agreement, Guarantee Documents, Agreement of Hypothecation and Pledge, and Insurance Policy are executed before a loan can be disbursed. The main features of the product are:

- *Area of operation:* Urban area.
- *Methodology:* Single borrower.
- *Purpose:* Loans for business investment.
- *Amount limit:* PKR 1000 to 10,000; can be increased to PKR 25,000.
- *Loan period:* 12 months in new cases; 24 months in repeat cases.
- *Repayment:* Monthly installments.
- *Mark-up:* 16–18% per annum.
- *Application fee:* PKR 2000; to be paid up front.
- *Collateral:* Two personal guarantees—guarantors' monthly salary must be equal to three times the amount of one repayment installment. For financing up to PKR10,000, one guarantee is acceptable.

Zarai Taraqiati Bank Limited (ZBTL)

The ZBTL is the only Development Financial Institution providing loans in the agricultural sector. The present recovery rate of micro-credit is 77.5%. The main features and methodologies of its micro-loan products are:

- *Area of operation:* Rural areas.
- *Methodology:* The MCO (Micro Credit Officer) carries out a complete survey of the area looking for landless poor/tillers/small landowners having land not exceeding 2 acres; the intended borrowers are grouped/classified into skilled, semi-skilled and unskilled. The MCO will also identify the schemes best suited to the area. Both male and female residents will be eligible for loans under this scheme. Loans can be extended to individuals who are members of groups consisting of at least 5 members, separately formed for like-minded men and women, preferably of the same age group. New/fresh borrowers will qualify for the micro-credit provided they have not obtained loans from any other source. However, previous borrowers who have not been defaulters of ZBTL and other banks/ financial institutions, and have shown good repayment behavior in the past, will also be considered for such loans.
- *Purpose:* For agricultural purposes.
- *Amount limit:* Minimum credit limit is PKR 5000 while the maximum limit is PKR 25,000.
- *Saving scheme:* To encourage saving habits among the rural poor special emphasis is placed on opening of savings accounts by the borrowers, who deposit their savings in their accounts regularly. A savings account shall maintain a balance of 5% of the loan amount. In the case of a group loan, the accounts will be operated by 2 members nominated by all the members of the group.
- *Loan period:* 18 months.
- *Repayment:* The repayment period is based on the flow of cash income generated from the loan and the life of assets created out of such loans—monthly and quarterly installments.
- *Mark-up:* 18% rate of mark-up (but for timely repayment a rebate of 2% is given).
- *Collateral:* All loans under the scheme are secured by a bond, with one surety against 50% solvency of the assessed value of the property owned by the guarantor. The guarantor is allowed to stand surety for two persons provided the guarantor is solvent to that extent. The guarantor/surety is preferably from the same village in order to facilitate contact and follow-up for ensuring proper utilization of funds and timely recovery. Necessary entries of bank charges against the surety/guarantor's landed property are made by the MCO personally in the relevant records. Loans could also be advanced against security of tangible properties.

National Rural Support Program (NRSP)

The NRSP extends microfinance facilities in rural areas through community organizations (COs). The COs are primarily responsible for assessing the character of the intended borrower. Therefore, it is the CO that assesses the creditworthiness of the CO members who apply to the CO for loans. The CO submits the loan application to NRSP in the form of a resolution, which is signed by at least 75% of the CO members. The CO undertakes the responsibility of checking proper utilization of the loan and its repayment to NRSP. The eligibility criteria of a borrower are as follows:

- The beneficiary is a member of the CO.
- A majority of the members take responsibility for the loan recovery.
- The credit beneficiary is a small farmer (up to 10 ha of land ownership), a landless farm laborer and sharecropper, a rural laborer, or a woman.
- There is no overdue amount in the case of another loan.

- The borrower is appraised for his/her character, capacity, and capital.

The NRSP social organizer (SO) appraises the credit requests. SOs are trained appropriately in credit appraisal and monitoring. Once the appraisal is complete, the SO prepares a Terms of Partnership (TOP) and an affidavit. The TOP contains terms and conditions of credit while the affidavit contain an undertaking by the borrower for proper utilization and repayment of credit funds. The borrower, CO Manager, President and SO sign the TOP. After the sanctioning, checks are issued in the name of the CO, and the SO obtains acknowledgement of receipt for the same. This program has achieved a recovery rate of 93%. The main features of the product are:

- *Area of operation:* Rural areas—community organizations (COs).
- *Methodology:* Customers are poor individuals belonging to a CO; they have to approach NRSP through the CO.
- *Purpose:* Credit is only provided for productive purposes to community organizations (CO) to utilize natural resources and human capital. Productive activities are: a) agriculture inputs; seeds, fertilizers, pesticides, etc.; b) livestock; c) small business/enterprise; d) lift irrigation, land-leveling and other individual-level productive infrastructure.
- *Amount limit:* PKR 10,000 for the first time borrower; maximum can be PKR 30,000.
- *Compulsory saving requirement:* NRSP encourages COs to generate a matching saving before requesting for a loan. A minimum of 10% as a mandatory saving is required. However, in order to ensure that this does not discourage the poorest CO members, NRSP has set flexible ceilings for such mandatory ceilings.
- *Loan period:* Maturity period of the loan matches the cash flow generation of the economic activities undertaken by the borrower. However, general loan period brackets are: a) agri-inputs—up to 12 months; b) enterprise development (working capital)—up to 18 months; c) livestock—up to 24 months; d) productive infrastructure development—up to 24 months or 60 months in some cases.
- *Repayment:* Repayment schedules match the cash flow generation of the economic activities undertaken by the borrower. However, general repayment criteria are: a) agri inputs—lump sum or monthly installment; b) enterprise development (working capital)—lump sum or monthly installment; c) livestock—lump sum or monthly installment; d) productive infrastructure development—monthly/quarterly/annual installment.
- *Mark-up:* 20% per annum.
- *Collateral:* Each loan request has to be signed by at least 75% of the CO's members; each CO member acts as a guarantor for all other CO members and vice versa.

Urban Poverty Alleviation Project (UPAP)

Under UPAP, credit is disbursed to "solidarity groups" of three or more like-minded women with comparable social and economic conditions, and to individuals. A rotating savings scheme is required to be initiated before any loan disbursement. Each would-be borrower is asked to save the sum of her weekly loan payment (typically about PKR 250). A new three-member group would thus accumulate PKR 750 per week. After three to five weeks, the members draw lots, and one member draws one week's savings. After the group has ensured that this woman has utilized the credit, credit is disbursed to another woman. Usually, in each weekly meeting, credit is disbursed to the next member. An incremental loan plan is designed to ensure that properly functioning enterprises are assured of ongoing credit. There is no limit on the number of times a client can take a loan, so long as it is financially warranted. The program has recorded a recovery rate of 98%.

- *Area of operation:* Urban and semi-urban areas.

- *Methodology:* Solidarity group approach for women.
- *Purpose:* Credit can be used for family enterprises. Men can also use the credit, but their income must come into the hands of the borrowing women.
- *Amount limit:* Depends on the savings of the group. PKR 10,000 for the first-time borrower; In some regions, it can be PKR 30,000.
- *Rotational saving scheme:* NRSP encourages group to generate a saving before requesting for a loan. After five weeks of saving, the savings are given to one member through a draw.
- *Loan period:* 12 months to 18 months.
- *Repayment:* Preferably monthly installments, but can be in one bullet payment.
- *Mark-up:* 20% service charge on declining loan balance; 1% case processing fee: PKR 100.
- *Collateral:* Group guarantee.

Other NGOs Financing under Credit Lines from PPAF

Most of the other NGOs receiving credit lines from PPAF adopt the traditional microfinance products, where financing is extended to a group of borrowers/CO, and each member of the group counter-guarantees the loan for the other members and vice versa. Normally 10% of the loan amount is deducted at the source and deposited in the CO's account maintained at a bank, jointly operated by the CO and the NGO. This is expected to provide for potential defaults by the borrowers. High interest rates, approximately 20% and above, are charged to the borrower.

Collateral Substitutes and Nontraditional Mechanisms to Secure Micro-loans

The most common collateral substitutes and nontraditional mechanisms to secure loans are:

1. Peer pressure and counter-guarantees by members of the group.
2. Third-party guarantees (Center guarantees).
3. Micro-leases providing for the asset to be leased as collateral.
4. Maintenance of equivalent amount as a deposit under lien.
5. Mandatory savings.
6. Security deposit of 10%.

It is generally perceived that the absence of formal physical collateral weakens the recovery powers of the bank. However, microfinance borrowers are not in a position to give physical collateral for the loans. MFIs therefore have to rely on group guarantees and peer pressure as collateral for the loans. In most cases, group lending serves the purpose of recovery since subsequent members of the group become eligible only on the satisfactory repayment performance of the former borrowers. Microfinancing requires constant follow-up and monitoring of loans in order to check proper utilization of funds, income generation, and repayment of loans. Licensed MFIs use a properly executed Financing Agreement, which is enforceable in the banking courts, tribunals, and civil courts. Although the cost of legal counsel and the time involved in settlement of a case may not justify it, facilitation is available to the MFIs. The Microfinance Ordinance of 2001 also provides for financing without traditional collateral. MFIs are permitted to decide on appropriate collateral arrangements.

Table 8. Outreach by MFIs

#	MFI	No. of clients	Loan amount in Pakistan rupees	
1	First Micro Finance Bank Ltd.	3,558 (credit only)	Total:	65,793,905
2	Khushhali Bank (31 December 2002)	56,000	Total: During the period:	475,485,157 365,134,455
3	First Women Bank Limited (31 December 2002)	18,609 clients 38 branches	Total:	605,800,000
4	Network Leasing Corporation Limited (30 June 2003)	Not available	Total:	614,148,000
5	Pakistan Poverty Alleviation Fund (PPAF) (31 December 2002)	224,629 through 30 Partner Organizations	Total (June 2003): During the period*:	1,478,750,000 1,190,000,000
6	Zarai Taraqiati Bank Ltd.	Not available	Total:	82,799,000
7	Bank of Khyber	8,648		245,011,087

	NGOs (Jan–Dec. 2003)	No. of clients served during the period	Amount of loans disbursed during the period
1	OPP	2,481	34,940,550
2	SAFWCO	2,973	11,433,035
3	SUNGI	1,033	3,869,044
4	TRDP	5,488	38,391,595
5	TARAQEE	10,078	71,174,686
6	DAMEN	10,140	35,275,051
7	KASHF	59,389	347,116,339
8	NRSP	70,375	632,654,109
9	SRSP	6,389	43,758,855
10	PRSP	60,464	408,278,630

Source: Annual Audited Accounts for the year ended 31 December 2002 and 30 June 2003; Performance Indicators Report, January–December 2003, of the Pakistan Microfinance Network

* Includes disbursements under other programs also.

LEGAL, POLICY, AND REGULATORY ENVIRONMENT FOR MICROFINANCE

Government Policy and Legal Framework for Microfinance

Microfinance is not widespread in Pakistan. Until the year 2000, less than 5% of nearly 6.5 million[5] poor households in the country had access to affordable microfinance services from institutional sources. The microfinance sector in Pakistan is characterized by a narrow institutional base, limited retail capacity, and little, if any, financial integration. Commercial banks, in general, are neither structured nor geared to extend their microfinance exposure

[5] Taken from the article "The Road Map for Development of Microfinance Sector in Pakistan," available at the Asian Development Bank's website: www.adb.org.

beyond experimental forays, and development finance institutions (DFIs) do not target the assetless poor. Nongovernmental organizations (NGOs) have shown appreciation of the nature of microfinance demand emanating from the poor through effective targeting, participatory approaches, capacity building, and general sensitivity. Yet their microfinance operations are unlikely to attain financial self-sufficiency. Informal sources are often the only window available for the poor. However, informal sources provide services at terms that tend to perpetuate rather than ameliorate poverty. The terms and conditions of informal suppliers are generally very stringent, and credit is available at exorbitantly high rates.

It was, therefore, a matter of urgent priority for the country to establish a pro-poor financial system as a critical element for combating the rising incidence of poverty. The government decided to systematically, proactively, and comprehensively address the underlying issues that have restricted the flow of microfinance services to the poor. Keeping the direction of reforms in perspective, the government formulated a comprehensive Microfinance Sector Development Program (MSDP) with the assistance of the Asian Development Bank (ADB) to broaden and deepen the microfinance sector. This aim will be attained by creating a conducive policy environment, developing appropriate financial infrastructure, promoting and strengthening microfinance institutions (MFIs), developing linkages with NGOs and community organizations, investing in building social capital, mitigating risks of poor households, and institutional development.

The MSDP has drawn up the following map for microfinance sector development in Pakistan:

Step 1: As the first step, and as a matter of urgent priority, the government designed a Microfinance Policy in June 2000 to develop a pro-poor financial system to address the widespread lack of access to affordable microfinance. The Policy recognizes the need to enhance social capital, and considers risk mitigation (refer to Step 6 below) as a necessary safety net measure for the poor; additionally, it encourages public–private partnerships, especially for NGOs, in poverty reduction. The Policy emphasizes sustainable microfinance and encourages private-sector entry into microfinance to ensure innovation and flexibility. Considering microfinance as an integral part of the financial sector, the State Bank of Pakistan (SBP) has taken a proactive role in developing the required financial infrastructure.

Step 2: Maintaining the momentum, the government facilitated the establishment of the first Micro Finance Bank, later renamed the Khushhali Bank (KB), in August 2000 to institutionalize the microfinance policy. The organization and operations of KB have been designed for a sustainable community-based service delivery system.

Step 3: The legal, supervisory, and regulatory arrangements were instituted to mainstream the attributes of the Micro Finance Policy. The design and the financial infrastructure created to support MFB address the following:

- Definition and categorization of MFIs and their licensing procedures.
- Corresponding supervision and regulation standards and systems.
- Disclosure and reporting requirements.
- Appropriate adjustment for entry threshold (i.e., minimum capital requiremenst to establish the bank, as well as other requirements as identified in the "Criteria for Establishing an MFB") prescribed under the banking laws.

This sequencing has twin objectives: first, to enhance the supervisory capacity of SBP to ensure orderly development of the microfinance sector, and second, to protect the financial assets and interests of the poor. State Bank of Pakistan has established a Microfinance Support Division to provide supervisory oversight and developmental support. State Bank of Pakistan and Khushhali Bank have joined hands to establish a Human Development Institute to enhance the supply of skilled human resources for microfinance.

Step 4: As an integral part of the microfinance policy, the importance of building community capacity and providing access to basic infrastructure has been recognized. A Microfinance Social Development Fund of US$ 40 million has been created to ensure sustained and assured investment in building social capital for developing the demand side of the microfinance market. These funds support capacity building of community-based organizations in terms of social awareness and selection and management of income-generating activities, developing community management skills and providing basic literacy training to leaders of community organizations, and providing training to women in rural communities to enhance their leadership skills and participation in social and financial services.

Step 5: A community investment fund of US$ 20 million has been established with the objective of increasing the access of poor communities to infrastructure for improving their livelihood through efficient and productive use of local resources. NGOs are expected to provide these services, and they will be adequately reimbursed for their services. Dedicated initially to KB, support from these funds will also be made available to regulated MFIs as they emerge under the new framework. These funds will also strengthen the NGO sector for other positive externalities, particularly those related to gender.

Step 6: As a pro-poor innovation, a Risk Mitigation Fund of US$ 5 million has been established to reduce the risk aversion of the poor for fear of indebtedness in failed enterprises and to enable poor households to take advantage of potentially viable new techniques, production choices, and income opportunities. The Risk Mitigation Fund will assist the poor in case of loss of income-generating assets due to unforeseen circumstances beyond their control. As a safety net measure, a Deposit Protection Fund of US$ 5 million has also been established to provide a long-term source of funding for social intermediation to expand the microfinance market. The funds initially aimed at Khushhali Bank, will be opened to all licensed microfinance banks.

Step 7: Last, to complement the efforts of the microfinance sector development program, the government has also initiated the restructuring of DFIs, many of whom have a poor governance structure, high levels of nonperforming loans, incapacity to raise resources, and relatively high cost of service delivery. Their performance adversely affects the environment for MSDP.

The government has been instrumental in designing a policy framework, implementing a regulatory system, and strengthening the deliverable institutions of microfinance in the country. The adoption of the Microfinance Sector Development Policy and the establishment of the Khushhali Bank were major steps taken by the government to address this sector. The Microfinance Ordinance of 2001 and the subsequently issued MFI Licensing Rules and Prudential Regulations have been signs of the government's determination to proceed with its developmental plans in this sector. Subsequently a mobile banking facility was also allowed to be licensed as an MFI by the SBP. A special Microfinance Division has been established at the State Bank of Pakistan. Regulatory and supervisory procedures have been developed for MFIs.

Although a number of steps have been taken in the development of microfinance, the programs initiated are still in their infancy. At present there are no other windows for microfinance in other government financial institutions. New products need to be identified, the legal system needs to be further strengthened, and considerable new initiatives still need to be taken to further develop this sector.

Legal Infrastructure Supporting Collection of Loans for MFIs and Protection for Borrowers

The legal credit documents executed by most MFIs are very simple agreements and merely state the resolution of the groups and individual borrowers to repay the loan. These are normally written on plain paper and as such cannot be legally enforced in case of a default. Further, the amounts lent out to borrowers are too small to consider litigation procedures. Despite this limitation, the licensed MFIs have initiated a properly executed Financing Agreement, enforceable in the banking court and tribunals as well as in the civil courts.

The only protection for a borrower in the case of a failure in business is under the Risk Mitigation Fund (RMF). The State Bank of Pakistan is in the process of finalizing the rules and initial guidelines on the use of this fund. Otherwise, there are no bankruptcy laws available in Pakistan at the moment which would protect the interest of the borrowers who fail in their businesses. The government is preparing draft legislation to cover this situation, and it is expected that such laws will be available in the near future.

The Regulatory and Supervisory Environment for MFIs

The financial sector in Pakistan is divided into two main parts: banks and nonbanks. The banking sector, including commercial banks, development financial institutions (DFIs), and microfinance institutions (MFIs), is regulated and supervised by the State Bank of Pakistan (the central bank). The nonbank sector, including nonbanking financial companies (leasing companies, housing finance companies, investment banks, brokerage houses, mutual funds, etc.), is regulated and supervised by the Securities and Exchange Commission of Pakistan (SEC).

The State Bank of Pakistan (SBP), which regulates and supervises the licensed MFIs, has established a separate Microfinance Division in its Banking Supervision Department to exclusively deal with microfinance-related maters and to monitor and supervise licensed MFIs. The regulation of MFIs is in accordance to the Microfinance Ordinance of 2001 and the Microfinance Prudential Regulations. Both off- and onsite surveillance and examination are carried out by the SBP. A Consultative Group of microfinance professionals from MFIs, PMN, SBP, etc., has also been formed at the SBP to deliberate upon the problems of MFIs.

There are only two licensed MFIs in the country, namely Khushhali Bank and First Microfinance Bank Limited. Khushhali Bank was set up with funding from the Asian Development Bank and the government of Pakistan (Ministry of Finance). The First Microfinance Bank was sponsored by the Aga Khan Rural Support Programme (AKRSP), Aga Khan Fund for Economic Development (AKFED) and International Finance Corporation (IFC). At present, SBP does not provide any development financing to these institutions.

Apart from two MFIs, and commercial banks providing MF services, as well as two MF leasing companies regulated by the SEC, all NGO–MFIs are within the ambit of unregulated institutions. The Pakistan Poverty Alleviation Fund (PPAF), being an intermediary institution, has devised appropriate financial, administrative, and accounting procedures for the partner organizations, keeping in view the requirements of the World Bank and the government of Pakistan, to ensure financial discipline. The other donor agencies which fund NGOs independently also have their own systems to monitor the utilization of funds. However, other than these systems for supervision, the NGOs are unregulated.

To provide a basis for self-evaluation, some of the NGO–MFIs are members of the Pakistan Microfinance Network, which provides the service of publishing a Performance Indicators Report (PIR) every six months to promote improvement of microfinance programs, financial transparency, and adoption of best practices. However, PIR figures are not performance ratings for regulatory or supervisory purposes, but are instead efforts by members to improve financial transparency in the microfinance sector.

Specific Regulatory Requirements and Supervisory Practices

The government has clearly spelled out its microfinance policy. A legal framework has been enacted for the establishment of MFIs in the private sector, known as the Microfinance Institutions Ordinance of 2001 (MFIs Ordinance 2001).

MFIs Ordinance 2001 *inter alia* stipulates the functions, capital requirements, ownership structure, terms and conditions for establishing microfinance banks/institutions, audit and disclosure requirements, and winding up procedure. It allows for the establishment of three categories of MFIs: those having operations on the national level, at the Provincial level, or in a specified District. A prospective MFI is required to be incorporated as a Limited Liability Company under the Company Law before applying to the State Bank of Pakistan for an MFI license.

The legal and regulatory systems have been designed for financial intermediaries with substantive long-term interest in microfinance. The framework provides the scope for NGOs to become regulated MFIs provided they meet the requisite criteria. This has been done in order to facilitate NGOs which seek a depository MFI status. The First Microfinance Bank Limited, co-sponsored by a renowned NGO, AKRSP, has already been issued an MFI license. It is expected that a number of mature NGOs and Rural Support Programs presently operating in Pakistan will be licensed as MFIs.

The regulatory framework for the MFIs has been developed through a consultative process with the perception of relatively lenient regulations to enable the MFIs to grow. In the initial phase most of the supervision is offsite, relying on the returns and data received from the MFIs with occasional onsite visits to have a feel of the overall systems and control in place.The regulatory/supervisory framework consists of the following:

a) Criteria and Conditions for Grant of License for Establishing Microfinance Banks/Institutions.
b) Prudential Regulations for Microfinance Banks/Institutions.

Prior to initiation of operations, an MFI registered under the Micro Finance Institutions Ordinance of 2001 has to obtain a license to operate from the State Bank of Pakistan. In order to maintain transparency in the process of granting licenses for establishing a microfinance institution, SBP has developed criteria and conditions. These criteria have been made public after going through the consultative process and with the consensus of MF stakeholders.

It normally takes three months for processing a licensing application and grant of license subject to submission of complete information and details as required under the MFIs Ordinance and licensing criteria.

Minimum Capital Requirements for MFIs and Ownership Structures

Table 9. Minimum Capital Requirements for MFIs

Level of operations	Minimum paid-up capital in Pakistan rupees
Country-wide/national	PKR 500 million
Province-wide	PKR 250 million
District-wide	PKR 100 million

As per the Criteria for Grant of License, clause 3, nongovernmental organizations/projects which have exposure to and understanding of the dynamics of the MF sector may contribute up to 50% of their capital in the form of their existing portfolio of micro-credit and other assets (net of losses) after due diligence by a reputed chartered accountancy firm on the SBP's panel of auditors.

At least 51% of the total paid up capital is required to be subscribed by the promoters or sponsor members of the MFI. The shares subscribed to by the sponsors are required to be in the custody of SBP and are not to be transferred; neither can encumbrance of any kind be placed thereon without prior permission in writing from SBP. A nonprofit organization

(NGO) can also have ownership shares in a MFI. However, there is no upper limit to the shareholdings that an individual or institutional investor/owner can have.

Foreign Investment

Foreign investment in MFIs is allowed in accordance with the government's Foreign Investment Policy. Accordingly, all economic sectors are open to foreign direct investment (FDI). 100% foreign equity is allowed, and equal treatment is given to local and foreign investors. No government sanction is required, and attractive incentive packages are available. Foreign investment is fully protected under the Foreign Private Investment (Promotion and Protection) Act of 1976, Protection of Economic Reforms Act of 1992, and Foreign Currency Accounts (Protection) Ordinance of 2001. Remittance of royalties, technical and franchise fees, capital, profits, and dividends is allowed.

Foreign investment in the service sector is allowed on a repatriable basis. Generally, investors have to simply register their company with the Security Exchange Commission of Pakistan under the Companies Ordinance of 1984, and have to inform the State Bank of Pakistan provided the relevant conditions are fulfilled. The policy allows FDI in the service sector in any activity subject to the condition that services which require prior permission or license from the concerned agencies will continue to get the same treatment until and unless deregulated by such agencies and will be subject to the provisions of the respective sectoral policies. The general conditions specify that the amount of foreign equity investment in the company/project shall be at least US$ 0.3 million. Foreign investors are allowed to hold 100% of the equity subject to the condition that the repatriation of profits will be restricted to a maximum of 60% of total equity or profits and that a minimum of 40% of the equity is held by Pakistani investors (including sale of shares in stock exchange) within five years.

Accordingly, foreign investment in MFI is allowed up to 100% of the total equity. Under the criteria for the grant of license for MFI, foreign investors in MFIs may repatriate dividends with SBP's approval; the repatriation of capital is allowed at interbank exchange rates when shares are sold to acceptable sponsors.

Qualifications of the Members of Boards of MFIs

The qualifications of the members of the Boards of MFIs have been specified in the MFI Ordinance of 2001 and the Prudential Regulations for MFIs. Part IV, Clause 14 of the MFIs Ordinance of 2001 states that members of the Board of Directors of an MFI should be persons of integrity and should have good financial reputations. Clause 26 of the Prudential Regulations for MFIs prohibits the appointment as a director on the Board of any person who:

- has been convicted of an offense involving frauds, breach of trust, or moral turpitude.
- has been adjudged as insolvent, or has suspended payments of his debts, or has compounded with his creditors.
- is a defaulter of any bank or financial institution.
- has been debarred of holding such office under the Companies Ordinance of 1984 or the Banking Companies Ordinance of 1962.
- has been declared to be lacking fiduciary behavior by the court under section 217 of the Companies Ordinance of 1984 at any time during the preceding five years.
- is an office bearer of any political party, or a member of the Senate, Provincial, or National Assembly.

According to the criteria and conditions for grant of license, it is required that the Chief Executive of the MFI should be a professional with sufficient experience as a Microfinance Specialist or Senior Banker; and with no adverse information regarding his/her integrity and performance. The appointment as Chief Executive is also subject to SBP's clearance.

Conformity with the above rules is ensured while processing the licensing application, and no person having any of the above disqualifications will be cleared as director/chief executive of an MFI. Conformity to the rules is also ensured through periodic onsite examination and offsite surveillance, and penal action against non-compliant banks is initiated.

Interest Rate Policy and the Impact on MFIs

The MFIs have been allowed to implement appropriate pricing policies as per Prudential Regulation No. 15, which ensures access of affordable financial services to the poor, as well as ensuring the operational and financial self-sustainability of the MFI. Accordingly, MFIs are free to determine their rates of interest/mark-up on loans made and deposits taken by them. Hence, the MFIs choose their interest rates based on their cost structure, both operating and financial; the level of expected return on investments; and the capacity of the target clients/market to earn sufficient revenues to service the loan.

Capital Adequacy

Capital adequacy requirements are stipulated in Prudential Regulation 4. MFIs are required to maintain equity equivalent to at least 15% of their risk-weighted assets. The risk weights of each class of assets are specified in the Prudential Regulations.

Loan Loss Provisioning

Prudential Regulation No. 12 stipulates the procedure for classification of assets and provisioning requirements.

Loans and Advances

Loans and advances are classified as Nonperforming Loans (NPLs) if payments against the outstanding principal are overdue by 30 days or more. The unrealized interest/profit/mark-up/service charges on such NPLs is required to be suspended and credited to an Interest Suspense Account. Further, the NPLs are to be divided into the following categories:

- OAEM: loans in arrear (payment/installment overdue) for 30 days or more but less than 90 days.
- Substandard: loans in arrears for 90 days or more but less than 180 days.
- Doubtful: loans in arrears for 180 days or more but less than 365 days.
- Loss: loans in arrears for 365 days or more.

Provisioning Requirements

i. *General Provision:* The MFI is required to maintain a general provision equivalent to 2% of the net outstanding advances (advances net of specific provisions).
ii. *Specific Provisions:* In addition to the general provision, the MFI is required to make specific provisions against the NPLs as per the following rates:

   a) OAEM: No provision required.
   b) Substandard: 20% of the outstanding principal net of cash collaterals.
   c) Doubtful: 50% of the outstanding principal net of cash collaterals.
   d) Loss: 100% of the outstanding principal net of cash collaterals.

The MFI can apply more stringent classification and provisioning criteria for NPLs at its discretion.

Investment and Other Assets

Investments are required to be valued on a market-to-market basis. However, in the case of investments and other assets where an active market does not exist, the MFIs are required to make subjective evaluations of the quality, category of classification and provisions required for such investment, keeping in view the risk involved and international accounting practices.

Regulatory Authorities' Means to Measure and Monitor the Risks of a Microfinance Portfolio

The Prudential Regulations evolved for the MFIs address the issue of measuring and monitoring risks of the microfinance portfolio of a bank. MFIs are required to meet liquidity requirements in the forms of reserves to meet the eventual risks of its portfolio.

Under the Prudential Regulations, an MFI's contingent (guarantees, etc.) liabilities are not allowed to exceed three times its equity in the first three years of its operations; and thereafter, they may not exceed five times its equity. The MFI also has to maintain cash reserves equivalent to 5% of its time and demand liabilities in a current account with the SBP. Additionally, liquidity equivalent to at least 10% of its time and demand liabilities has to be maintained in the form of liquid assets—i.e., cash, gold, and unencumbered approved securities. A statutory reserve fund equivalent to the amount of paid-up capital is to be maintained; the MFI is required to credit an amount equal to 20% of its annual after-tax profits to this fund until such time that it equals the amount of paid-up capital. Thereafter, 5% of the annual after-tax profits should be credited to this reserve.

According to Prudential Regulation no.8, MFIs are required to establish and maintain a Depositors' Protection Fund or scheme for the purpose of mitigating the risk of their depositors. MFIs are required to credit at least 5% of their annual profits after taxes to this fund each year. The Khushhali Bank is required to contribute 10% of its annual tax profits to the Microfinance Social Development Fund and 5% to the Depositors Protection Fund each year.

Under Regulation No. 9, restrictions have been imposed on certain types of transactions, e.g., allowing financing for speculative purposes or allowing services whose beneficiaries are the MFI's sponsors, directors, or their families.

Moreover, the maximum loan size for a single borrower is PKR100,000, when the borrower has an established track record of satisfactory payment.

While the Prudential Regulations evolved for the MFIs *inter alia* address the issue of measuring and monitoring risks of the microfinance portfolio of a bank, the central bank monitors and measures the risks as well as the financial health of MFIs through offsite surveillance and onsite examination. Offsite monitoring is primarily based on periodic reports, market information, etc., whereas onsite examination is undertaken normally once a year to ascertain the quality of systems and controls in place, risk identification and management policies, the systems and quality of senior management, and compliance with prudential regulations and other instructions issued by the central bank from time to time. The MFIs submit the following reports to SBP under the Prudential Regulations:

Title of report	Frequency	Time period for the submission
Statement of Affairs	Biweekly—i.e., once every two weeks	Within 7 days of the close of the period to which it relates
Statement of Condition	Quarterly	Within 30 days of the close of the quarter to which it relates

The Statement of Affairs conveys the liabilities and assets of the MFI as well as providing the status of unencumbered approved securities held for liquidity purposes.

The Statement of Condition, which is to be submitted on a quarterly basis, includes a detailed Profit and Loss statement and Balance Sheet together with Notes to the Condition. The Notes include the status of the investments (net of provisions and estimated market value), loan portfolio details including total outstanding portfolio against each loan type (i.e., agri-input, livestock, microenterprise, etc.) as well as its classification according to the four categories. A summary of disbursements and recoveries made during the quarter, including the number of female and male borrowers, and a summary of deposits are to be provided also.

Regulatory Authorities' Means to Assess Credit Quality of Microfinance Loan Portfolio

The Prudential Regulations define the criteria for assessing the portfolio quality and provisions required, if any. The MFIs assess their portfolio quality based on the prudential criteria and report the same to SBP in a quarterly report. The SBP reviews the information and trends in relation both to other MFBs and to the previous quarter. Any concerns are taken up with the bank management to rectify the same. The Banking Inspection Department of the Central Bank makes an independent assessment of the quality of MFBs' credit portfolio during the onsite examination based on the capacity of the bank's information system to generate reliable information about the credit portfolio, the results of test runs of different programs made on the credit portfolio data base and random verification thereof in selected branches and areas, and evaluation of the geographical and sectoral concentration of the credit portfolio.

`The SBP monitors the quality of the credit portfolios of microfinance institutions through the quarterly Report of Condition—a detailed statement comprising a Profit and Loss account, Balance Sheet, and notes explaining various items reflected in the P&L account and Balance Sheet. It includes the following details about the credit portfolio:

Advances
Advances (Net of Provision)
Gross Advances ________________
Less: Provisions held:
Specific
General ________________
Subtotal ________________
Advances (Net of Provision) ________________

Table 10. Breakdown of Current and Nonperforming Loans by Loan Type

Loan type	Total outstanding portfolio	Current	NPLs			
		< 30 days	30 < 90 days	90< 180 days	180<365 days	>365 days
		Current	OAEM	Substandard	Doubtful	Loss
Agri-input						
Livestock						
Microenterprise						
Others						
Total						

Table 11: Summary of Disbursement and Recoveries Made During the Quarter

At the beginning of the quarter			During the quarter			At the quarter's end	
	No. of borrowers	Outstanding advances	Recoverable	Recovery	Disbursement	No. of borrowers	Outstanding advances
Male							
Female							
Total							

Collateral Requirements

The Regulations do not provide for documentation of the traditional collateral (e.g. real estate, securities, etc.) over loan repayment history in assessing the credit quality. The Board of Directors of each MFI is required to define their own operational policies including the credit lending policy, together with collateral and mark-up/interest rates, and provide the same to the State Bank within six months of the commencement of operations.

The Microfinance Ordinance of 2001 (clause 6) states that financing facilities by MFIs can be extended with or without collateral. The bank may accept pledges, mortgages, hypothecation, or assignments to any kind of movable or immovable property for the purpose of securing loans and advances. The Prudential Regulations are silent on traditional collateral. The microfinance loans extended by the MFIs are less than PKR100,000, and the maximum exposure to a single borrower has also been fixed at PKR100,000. Most of the small loans are extended on the basis of group guarantees and peer pressure. The First Micro Finance Bank, however, has one product under which loans are extended against an equivalent amount of deposit maintained at the bank under lien. As such, the regulator accepts nontraditional collateral and group guarantees as a legitimate form of security.

Microfinance Loans—Consumer Loans

Regulations do not classify consumer loans as microfinance; they are dealt with separately under the Banking Companies Ordinance of 1962 and Prudential Regulations for Consumer Financing by Commercial Banks (currently a draft has been prepared). However, no commercial bank except Bank of Khyber and the First Women Bank Limited are offering microfinance services; the Consumer Financing Prudential Regulations, as and when finalized, would be applicable to commercial banks only.

Creditworthiness of Microfinance Borrowers

As the business models and loan products differ from one MFI to another, the MFIs Ordinance of 2001 and Prudential Regulations do not prescribe any document for evaluating the creditworthiness of microfinance borrowers. The Prudential Regulations do however require MFIs to formulate policies for all areas of operations (including credit) which, *inter alia* define the policies, procedures, and documents to appraise the borrowers' capacity to repay. However, at present most micro-credit lending is group-based, and the group verifies and certifies the information provided by the members, which along with group's guarantee to repay the individual members' loan in case of default provides sufficient comfort to MFIs in extending small loans.

Supervision of MFIs

State Bank of Pakistan employs two major supervisory tools—Offsite Surveillance and Onsite Examination—for monitoring and supervision of MFIs. The existing onsite and offsite surveillance systems employ the CAMEL rating system (Uniform Interagency Bank Rating System) to rate and assess the financial health of MFIs.

A separate division has been created in the Banking Supervision Department of State Bank of Pakistan to exclusively deal with microfinance-related maters and to monitor and supervise licensed MFIs. The officers of the division have been provided with training both nationally and internationally to understand the nature, processes, complexities, opportunities, and challenges faced by microfinance institutions in their operations. SBP is one of the few central banks in the world which not only has participated effectively in creating a conducive and enabling MF environment in the country but also is working to build capacity at all levels of management through organizing trainings, visits to Licensed/NGO MFIs, and creating links with national and international MF stakeholders.

Supervisory Tools to Monitor the Quality of Microfinance Loan Portfolios

Prudential Regulation no. 12 prescribes guidelines to assess the portfolio quality and creation of provisions against nonperforming loans. The MFIs assess their portfolio quality based on the guidelines, and report the same to SBP in a Quarterly Report of Condition. During onsite examination an independent assessment of the portfolio quality is made employing different methods as described above.

NGOs

The NGOs cannot mobilize public savings to finance their operations. The commercial banks and the microfinance banks licensed by SBP under the Banking Companies Ordinance and MFIs Ordinance are the only institutions eligible to collect deposits from the general public. In order to mobilize public savings, the NGO–MFIs can opt for conversion into formal microfinance banks and apply for licensure under the Microfinance Institutions Ordinance of 2001. To encourage reputable NGO–MFIs having the requisite capacities to operate as microfinance banks, the licensing criteria allow up to 50% of capital contribution in the form of credit, investments, and other assets in the portfolio. The First Microfinance Bank Limited is in fact a conversion and graduation of an NGO into a microfinance bank.

Micro-insurance

At present, there are no specific regulations or rules in regard to micro-insurance. MFIs offering micro-insurance products have designed their own rules in collaboration with the insurance companies.

Training Needs

The central bank presently has limited MF-related capacity; the bank, conscious of the situation, has developed a comprehensive plan to build MF-related skills and systems in the next three years. The Swiss Agency for Development and Cooperation has committed reasonable financial resources for MF-related capacity building of the central bank. Under the plan a pool of 25 officers has been selected and is being provided extensive training in microfinance, starting from basic concepts and approaches and exposure visits to domestic MFIs to advanced-level trainings with focus on regulatory frameworks, offsite surveillance, and onsite examination.

Practical Implication of the Microfinance Institutions Ordinance of 2001

Since the enactment of the MFI Ordinance in 2001, only one MFI from the private sector has registered. Although it has been learned that there are 2–3 MFIs which intend to register under the Ordinance, primarily to mobilize public saving, at least three major restrictions are prominent under the 2001 MFI Ordinance:

1. The borrower of the MFI can be a person whose total annual income is less than minimum taxable income in a year. At present this amount would be PKR100,000. This condition is restrictive since it would debar an existing client in building up his relationship with the bank, once his annual income increases beyond the minimum taxable income. Moreover, there are a number of poor MFI clients who earn little more, yet their net incomes are small. As such, a major portion of the poor are excluded from this MF sector.
2. The Ordinance allows mobilization of deposits, but has restricted the MFI from becoming a member of the Clearing House system; thus MFIs can not issue checkbooks to its clients or carry out transactions in this regard.
3. MFIs are permitted to invest their surplus funds only in government securities—i.e., Treasury Bills and Pakistan Investment Bonds. Since sustenance through micro-

financing will be possible only after a considerable period of time, (at least 4–5 years), MFIs need to rely on income from investments. However, with this condition, MFIs are restricted from investing in profitable opportunities.

However, since the MFI Ordinance of 2001 and SBP's experience in this regard is still very new and in the infancy stage, it is too early to comment on whether the law has enhanced the efficiency of the MFIs.

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PHILIPPINES

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OVERVIEW OF THE EMERGING MICROFINANCE INDUSTRY

> The Philippines' main problem for the medium term remains to reduce poverty. Poverty is still largely a rural phenomenon. Its causes include high dependence on agriculture where productivity has been declining and per capita economic growth is low; lack of adequate social safety nets, especially for poor women and children.[1]

In 2000, poverty incidence was estimated to be at an alarming 39.5%: 19.9% in urban areas and 46.9% in rural areas.[2] According to the Philippine National Statistical Coordination Board, there were 4.3 million families or roughly 26.5 million Filipinos living below the poverty line the same year.[3] Identified as one of the most fundamental problems of the poor is their lack of access to adequate and appropriate financial services.

In the hopes of addressing this gap, the four-pronged strategy of the Macapagal–Arroyo Administration's Medium-Term Philippine Development Plan included the provision of "employment and livelihood opportunities for the poor and strengthening the capacities of marginalized groups to engage in productive activities."[4]

Mainstream financial institutions, unfortunately, could not extend their services to the marginalized and their communities. The formal banking sector apparently exercises utmost prudence, so much so that the marginalized communities, to a great extent, are deprived of basic financial services. The impoverished, already lacking access to formal banking institutions, are not likely to be approached and extended service by most (if not all) mainstream or formal financial institutions.

The government has also failed to extend financial services to the poor. The bigger and more established borrowers in the countryside consumed most of the supply of credit offered by government lending programs—leaving very little to be shared amongst the smaller, vastly poorer, borrowers. Ironically, but not surprisingly, it is these small borrowers who are supposedly the intended beneficiaries of this intervention.

Specialized programs have taken many forms and have used many methods; they have been initiated by governments and NGOs alike to address the needs of the poor, but the provision of credit for microenterprises is often seen as one of the most potent of poverty alleviation interventions, as it offers the alternative of uplifting poor people's socioeconomic condition in a self-reliant manner (Getubig et al. 1993). Llanto described the constraint to capital access of microenterprises thus:

> Most micro-enterprises do not have access to financial services offered by banks. Microenterprises need timely, small-sized loans whose repayment terms coincide with their

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[1] World Bank, "Improving the Lives of the Poor through Growth and Empowerment. The World Bank Group's Country Assistance Strategy for the Philippines, 2003–2005," p. 9.
[2] International Management and Communication Corp., "Asian Development Bank Microfinance for Rural Development: Final Report," p. 1.
[3] National Statistical Coordination Board, "Poverty Statistics." www.nscb.gov.ph.
[4] World Bank, "Improving the Lives of the Poor, " p. 17.

cash flow. They also have demand for savings services that are not satisfied in view of limited access to banking facilities and the lack of interest of traditional banks in mobilizing small-sized deposits. Micro-enterprises do not have a track record with conventional banks, nor the collateral traditionally demanded by them. These factors contribute to high transaction costs and perceived risks in lending to micro-enterprises. Because traditional banking cannot and did not serve the demand for financial services by low income or small-scale borrowers in many areas, nontraditional and nonconventional approaches emerged in the credit markets.[5]

Economic Indicators

The Asian Development Bank (ADB) reported that for 2002, the Philippines registered 4.6% growth in its gross domestic product, up from 3.2% in 2001. The country's gross national product also expanded 5.2%, the highest since the Asian crisis of 1997. The industry and service sectors grew. Industry output was up 4.1% for 2002 from 1.3% in 2001, and the service sector also grew, by 5.4% in 2002 from 4.4% in 2001. Further, due to lower prices in commodity groups—food, services, housing and energy-related products—inflation slowed down from 6.1% in 2001 to 3.1% in 2002.[6]

However, despite comparable growth among these sectors, the agriculture sector performed dismally. Agricultural output was down 3.5% in 2002 from 3.7% in 2001.[7] A deceleration of 0.2% might seem insignificant; however, considering that the Philippines is primarily an agricultural country and much of the countryside is rural, the effects of the decline are surely substantial and considerable.

Employment

The population of the Philippines is on the rise, and it is increasing at a fast, steady pace. From 2000 to 20002, the population increased consistently at a rate of 2.1% annually. In 2002, the total population was pegged at 81.8 million. Of the total population for the same year, 33,675,000 already belonged to the labor force, of whom 30,252,000 were actually employed.

The total number of unemployed rose to 3,423,000 in 2002, and was pegged at a rate of 10.2%. This was an increase from the unemployment rate registered in 2001, which was 9.8%. In terms of labor force participation, by gender, male participation was significantly higher, at 80.8%, than of women, which registered at 51.7%.[8] Men, it would seem, had more employment opportunities than women. This is actually manifested with greater frequency in rural areas than in urban areas.

Microfinance

The central bank of the Philippines, officially known as the Bangko Sentral ng Pilipinas (BSP), has maintained that it supports the development of microfinance in the country. The BSP developed a framework that encourages microfinance institutions and their activities.

The Monetary Board, the policy-making body of the BSP, has partially lifted the general moratorium on the licensing of new thrift and rural banks to allow and encourage the entry of microfinance-oriented banks on a selective basis. Consequently, microfinance loans extended by rural banks and cooperative rural banks will be eligible for rediscounting with the BSP. This is to encourage rural banks and cooperative rural banks to support and increase

[5] The authors wish to acknowledge the liberal use in this section of Dr. Llanto's research on the Philippines for the Asian Development Bank, "The Role of Central Banks in Microfinance in Asia and the Pacific," pp. 250-73, which formed part of a two-volume country study.
[6] ADB, "Philippines Economic Performance."
[7] Ibid.
[8] ADB, "Country Key Indicators for 2003."

microfinance activities by providing them additional liquidity to fund their lending operations.[9]

Microfinance in the Philippines thrived mainly as the result of the failures of the traditional banking system and the government's directed credit programs (DCPs) to provide small-scale clients access to, and benefits of, loans and other finance services. Credit-granting nongovernmental organizations (NGOs) took it upon themselves to develop, refine and propagate microfinancing techniques that could effectively reach and serve the poor on a sustained basis.[10]

As late as 1997, there were as many as 86 DCPs, most of which were nonperformers. Sadly, in spite of the funds that were at the behest of these government programs, the projects that DCPs funded were mostly money-losing ventures. Even more unfortunate was the fact that only a few of the intended beneficiaries—small farmers, fisherfolk and microentrepreneurs—actually benefited from these credit subsidies.[11]

The government then decided to do away with this approach, seeing that it was costly (with very little return), if not a totally wasteful government intervention. The House of Representatives in 1997 passed a law phasing out all agricultural credit subsidies and install instead a market-oriented credit policy framework for all agricultural lending. This bill was later enacted as the Agriculture and Fisheries Modernization Act (AFMA) or Republic Act (RA) 8435.[12]

Additional government ordinances were later issued to complement RA 8435. Executive Order (EO) 138 ordered directed credit programs to be phased out in other sectors; and, terminated the participation of non-financial government agencies in the implementation of such credit programs.

The rationale for the AFMA and the EO 138 was that market-based policies and mechanisms in the financial markets would give poor households, small and poor farmers, and microentrepreneurs better access to financial services.

The fear that the abolishment of DCPs would leave a vacuum that would further negate the needs of more rural poor people naturally surfaced.

With the intent of addressing this fear, the government, through the National Credit Council of the Department of Finance, drafted and issued the National Strategy for Microfinance. This strategy was actually a policy document that identified and directed the specific roles of the government agencies, state financial institutions, regulatory agencies authorities, and private microfinance institutions such as credit-granting NGOs, rural banks, donors, etc., towards a developed microfinance industry in the country.[13]

This policy opened for the government a new and unique role in the credit markets. Through this national strategy, the state (with regard to its usual finance endeavors) departed from its established identity as a dispenser of loans and transformed itself into a policy-making and regulating agent specifically for microfinance activities in the Philippines. It gained a more authoritative presence in the development of market-oriented financial programs for the poor.

This policy turned out to be instrumental in making government assume a different role in the credit markets. From being a direct provider of subsidized loans, the government has taken, as its duty, a facilitating and coordinating role in creating an environment that will support the development of market-oriented financial programs for the poor, through policies

[9] World Bank, "Improving the Lives of the Poor," p. 122.
[10] Gilberto Llanto, "A Microfinance Promise: To Provide the Poor Access to Finance Services," p. 2.
[11] Ibid.
[12] Ibid.
[13] Ibid.

and regulations.[14] At the same time, Congress issued innovative provisions on microfinance through the revised General Banking Law of 2000 (Republic Act 8791).

To execute these provisions, the Bangko Sentral ng Pilipinas (BSP) issued several circulars and guidelines[15] in support of microfinance development, such as:

- The issuance of clear guidelines on the treatment of microfinance-oriented banks.
- The provision of a rediscounting facility for banks engaged in microfinance.
- The formulation of a supervision format that is appropriate for microfinance operations of these banks.

Meanwhile, the People's Credit and Finance Corporation (PCFC) became the government's lead institution for raising financial resources for microfinance services. With funding sourced through loans from the ADB-IFAD and the World Bank with the Land Bank of the Philippines, the PCFC was able to provide wholesale loans to accredited microfinance institutions which in turn provided loans, through retail outlets, to microfinance clients.

Rationalizing the Role of Government Agencies in Microfinance

In 2002, the National Anti-Poverty Commission (NAPC) met with other government agencies involved in microfinance capacity building and credit delivery. The meeting yielded an assignment of each agency's specific role in ensuring the success of microfinance, as well as the relationship between public and private institutions.

Discussions with government agencies resulted in a differentiation of roles, as follows:

- The PCFC is a wholesaler of loans up to PHP 25,000 per end-client. Its focus is on poor households as specified by the NEDA poverty threshold indicator.
- The Development Bank of the Philippines offers rediscounting of microfinance loans and is a primary wholesaler of small and medium enterprise loans above PHP 150,000 per client.
- The Land Bank of the Philippines (LBP) is a wholesaler of loans for farmers and fisherfolk. It supervises the People's Credit and Finance Corporation (PCFC) and National Livelihood Support Fund (NLSF) funds. It recently approved a microfinance-lending program.
- The National Livelihood Support Fund (NLSF) provides loans to agrarian reform beneficiaries through accredited conduits. It is supervised by the LBP.
- The Small Business Guarantee and Finance Corporation (SBGFC) provides wholesale loans to microfinance institutions (MFIs).

STRUCTURE AND PERFORMANCE OF THE FINANCIAL SYSTEM

The Philippine Financial System

The Philippine financial system consists of formal and informal financial subsystems that are either regulated or non-regulated.

The informal sector is composed of a variety of organized and singular sources of credit, such as relatives, moneylenders, Rotating Savings and Credit Associations (ROSCAs), traders, and suppliers of commodities.

The formal financial subsystem includes banking institutions, which are authorized by the Bangko Sentral ng Pilipinas (central bank) to provide credit and accept deposits from the general public. Also constituting the formal financial subsystem are the nonbank institutions,

[14] Ibid.

[15] These circulars and the specifications of each are discussed below in the section on Specific Regulatory Requirements and Supervisory Practices.

which are authorized to extend loans but are not permitted to accept deposits from the general public.[16]

The banking system consists of the commercial banking system (universal and ordinary commercial banks), the thrift banking system (savings and mortgage banks, private development banks, and stock saving and loans associations), the rural banking system, and government banks.[17]

These different bank categories are authorized to perform different functions.

As of December 2000, the financial institutions in the country had 16,676 offices (head offices, branches, and extension offices). Of this total, some 45% were offices of banking institutions. Over 50% of banking offices of commercial banks were concentrated in Metro Manila and other metropolises, while most banking offices of thrift and rural banks were situated in the countryside. The offices of rural banks are widely dispersed in rural areas.

In terms of assets, the banking system overwhelmingly dominates the financial system with total assets at PHP 3.3 trillion (as of December 2000), which is roughly 82% of the total assets of the financial system. The total assets of the commercial banking system alone stood at PHP 3 trillion, which represented 74% of the total assets of the financial system.

Currently, government-owned banks and financial institutions, such as the Land Bank of the Philippines (LBP), the Development Bank of the Philippines (DBP), and the People's Credit and Finance Corporation (PCFC), have ventured into microfinance on a relatively wider scale (Llanto 1996). These government institutions provide wholesale loans to microfinance institutions, which the latter re-lend to small-scale borrowers, thus developing a network of rural banks, cooperatives, and NGOs that serve as providers of access to wholesale funds.

Between the government, as a wholesaler of loans, and microfinancing institutions, as retailers of loans, the benefits go both ways: the government provides loans without much risks involved; and, MFIs provide micro-credit without having to deal with the high costs of servicing and monitoring small-scale borrowers.[18]

The National Statistics Coordination Board (NSCB) reported in 2002 that the microfinance industry had reached out to an estimated 1 million to 1.2 million poor Filipino households. This figure also indicates that microfinance services were made available to 25% to 28% of the 4.3 million impoverished households in the Philippines.[19] And, according to the Asian Institute of Management, MFIs showed movement towards commercialization.[20]

Assessing the Financial and Operational Status of Microfinance Conduits

Microfinance gained momentum beginning in 1997 and obtained support from beyond the original NGO practitioners to include rural banks and cooperatives. Of the institutions devoted to microfinance, rural banks and cooperatives continued to be the institutional choice, being viewed as having the legal structure and best potential for sustaining the delivery of microfinance in the Philippines. NGOs, on the other hand, were seen to experience constraints in full microfinance service delivery (both credit and savings) since they did not have the legal mandate to provide deposit services. Charitonenko reviewed seven NGOs and expressed concern that, collectively, half of their loans were funded by savings or capital build-up funds from their borrowers. However, NGOs have managed to gain recognition for the cutting-edge technologies they piloted, some of which have been adopted by other MFIs.

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[16] Mario Lamberte, PIDS, 2001.

[17] Credit unions or credit cooperatives are not part of the system described above. Although they mobilize deposits from their members, they are not considered part of the banking system. However, cooperative rural banks are a segment of the rural banking system.

[18] R. Chua et al., "Delivering to the Poor: A Search for Successful Practices in Philippine Microfinance."

[19] Ibid.

[20] Ibid.

The financial and operational performance of the PCFC from 1997 to 2002 provides an overview of the sector's growth in terms of loan portfolio, outreach and conduits.

Loan Portfolio Growth

PCFC estimates that its average annual portfolio grew by 60% from 1997 to 2002. Having begun providing wholesale loans in June 1996, PCFC had an outstanding loan portfolio of PHP 120 million and was reaching 32,210 borrowers by the end of the year. As of January 2003, its outstanding loan portfolio stood at PHP 1.983 billion.

PCFC Conduit Growth

In 1998, the Estrada administration focused on poverty. The head of the Poverty Commission was appointed concurrent chairman and president of PCFC. Growth became the goal of PCFC, as it engaged not only in wholesale lending, but also in setting up retail units in areas where there was minimal MFI activity. In 1999, the sector registered significant growth.

In 1999, as well, PCFC completed negotiations for an additional investment of PHP 900 million in preferred shares, thereby adding to their resources for lending. PCFC saw a 52% growth in conduits, from 94 in 1998 to 143 in 1999. In 2000, conduit growth was 24%, having risen from 143 to 178. The number of conduits in 2001 and 2002 stabilized at 200, while client outreach grew significantly. Whereas the initial conduits of PCFC were NGOs, by 2003 the majority constituted rural banks and cooperatives. As of June 2002, PCFC had 198 conduits, broken down as follows: 32 NGOs, 65 cooperatives, 99 rural banks, 3 thrift banks, 24 cooperative banks, and 2 lending investors.

Client Outreach Growth

Outreach became a major concern of the microfinance sector in 2001. In her June 2001 State of the Nation Address (SONA), President Gloria Macapagal Arroyo identified reaching an additional one million poor women as a primary goal. The progress towards the President's SONA target was tracked by the NAPC, the agency tasked with oversight on microfinance.

The PCFC Conduits' Geographical Dispersion

As of 31 January 2003, PCFC, through its microfinance intermediaries, reported serving microfinance clients in all of the 79 provinces (100%), 113 of 114 cities (99%), and 1083 of 1496 towns (72%). It worked through 77 rural banks, 63 cooperatives, 33 NGOs, 27 cooperative banks, 2 thrift banks, and one lending investor. PCFC's outreach was particularly strong in Regions 1, 2, 3, 4, 5, 6, 7, CARAGA, and NCR. Penetration was weak in the ARMM, Regions 8, 9, 12, and in CAR. PCFC's outstanding loans amounted to PHP 1.983 billion as of January 2003.

Loan Size and Depth of Outreach

The size of the microfinance loan has been used by the sector to estimate the depth of outreach to the poor. The smaller the loan, the poorer the client. Loan size continued to be used as the basis for determining if the MFI programs were truly directed to the poor or if some had lent to non-poor sectors. A 1999 study by Clark Dingcong, a consultant of the Microfinance Standards Coalition, estimated the distribution for various loan sizes. It determined the following:

- Microfinance loans of up to PHP 10,000 comprised 59% of total loans.
- Loans exceeding PHP 10,000 but no more than PHP 20,000 comprised 19%.
- Loans exceeding PHP 20,000 but no more than PHP 50,000 comprised 13%.
- Loans greater than PHP 50,000 comprised 9%.

Different microfinance methods use different amounts of first loans, but loans generally ranged between PHP 3000 and PHP 6000. By April 2003, the maximum loan amount of initial loans extended by large microfinance institutions had increased to PHP 6000.

The PCFC Conduit Profile Based on Outreach and Portfolio Size.

As of December 2002, there were 189 active PCFC conduits, of which only six institutions or 3% served more than 25,000 clients. These institutions were as follows: Negros Women for Tomorrow; Taytay sa Kauswagan; Center for Agricultural Development, Inc., or CARD: CARD Rural Bank: Producers Bank; and the Cooperative Rural Bank of Bulacan. Only 6.3% or 12 conduits served between 10,000 and 25,000 clients, while the majority of PCFC conduits or 90% served fewer than 10,000 clients.

Two-thirds of all PCFC clients were either poised to expand or were just starting out. Thirty-three percent of the conduits had an outreach ranging between 1000 and 3000 clients, which were below the standard set by the NGO Microfinance Council to indicate a serious commitment to microfinance activities and to indicate initial moves toward institutional viability. One-third of PCFC clients reported an outreach of fewer than 1000 clients. It is not clear if these were MFIs that were merely starting out, experimenting, or phasing out their microfinance operations.

Another measurement of improved capacity is an institution's capability to borrow and manage increasing amounts of funds. The PCFC survey data show that the microfinance sector was dominated by "saplings" or small conduits that managed funds ranging from PHP 1 million to 10 million as of the end of 2002. These were primarily rural banks and cooperatives.

There were only eight PCFC partners that managed loan portfolios ranging from PHP 50 million to beyond PHP 100 million. Two were NGOs, while six were rural or cooperative banks. PCFC referred to these institutions as their flagship conduits. As of December 2002, PCFC only had two conduits with outstanding loan portfolios of over PHP 100 million. These were the Negros Women for Tomorrow Foundation and the Producers Bank of San Jose City in Nueva Ecija.

On the other hand, conduits managing loans below PHP 1 million were viewed as no longer interested in pursuing their microfinance programs in partnership with PCFC. They were perceived to simply be paying off their loans.

Microfinance Clients and the Impact of Microfinance

Government's concessions and support for microfinance initially arose because of its promise to help the poor to access credit for various economic opportunities. The 2002 ADB impact survey of 1,200 microfinance clients provided a profile of the microfinance clients being served by the retail conduits of the PCFC.

The MFIs preferred to target the "entrepreneurial poor" or clients who had experience running a microenterprise. This decision was viewed as a cautionary strategy to mitigate default since many of the institutions that had undertaken microfinance were primarily rural banks or cooperatives.

The ADB study also noted that the new MFIs felt they "needed to test the Grameen methodology and gain experience with the enterprising poor first," prior to moving "down the poverty scale." The study also reported that at least 20% of MF clients had over PHP 150,000 in assets when they entered the program, signifying loan leakages to the non-poor. The earlier assumption that only the poor were interested in Grameen products was disproved by the 2002 findings. Whether this adversely affected the poverty goals of MF is debatable. Some argue that poverty is a dynamic concept and should include those hovering above the poverty line as they remain vulnerable to falling below the poverty line.

Seemingly, the current microfinance clients were not the ultra-poor. The study found that less than 15% of the MFIs believed that they served the ultra-poor. The IFAD study in 2002 concludes that microfinance may yet have reached the ultra-poor although the segment may not have been targeted systematically.

The microfinance client was generally female and aged 20 to 70 years for an average age of 44. About 90% were married and had from three to four children, three of whom were likely to still be living with the family. Three fourths of the clients had some education: elementary (33%) or high school (42%). Less than one percent were illiterate. Clients had lived in their communities for a long time.

The enterprises of the microfinance clients were non-agricultural. Of these, 30% were sari-sari stores, while petty trading or vending accounted for 28%. The balance constituted a variety of livelihoods and service activities such as food processing, livestock raising, sewing, hairdressing and manicure services, weaving, and making clay products. The ADB impact study indicated that the poor client was engaged in three or more income-generating activities by the third loan. This tendency was seen as a risk minimization strategy for the household. It contributed to food and livelihood security and allowed households to cope with seasonal fluctuations in income. This study earlier corroborated earlier studies by the National Economic and Development Authority (NEDA) of low-income households engaging in multiple economic activities. Asset accumulation ranged between PHP 100 and PHP 10,000.

The IFAD study observed the following trends:

- Assets were regarded as savings and sold whenever there was a need for households to reduce the variance in their incomes.
- Increases in assets were realized when higher loan amounts were obtained.
- Asset increases were not a direct result of a project.
- Assets were observed to be sold to repay loans.
- Growth and the graduation from microenterprises to small enterprises translated to graduating to individual and larger loans, improved business training, and access to medium-term credit. Microfinance provided only short-term credit.

Ahon sa Hirap and Dungannon Impact Studies

Other studies on the impact of microfinance on the poor have been done. In June 2002, Herrin conducted an impact evaluation on Grameen Bank replicators in Aklan. He found that participation by clients in a microfinance program helped improve their economic welfare in terms of increased per capita household expenditures. Two of the oldest Grameen replicators were Project Dungannon of the Negros Women for Tomorrow Foundation (NWTF) and the Ahon sa Hirap, Inc. (ASHI), which worked with Grameen Trust in 2001 to assess the impact of their operations on poverty. The study found that three quarters of Dungganon's mature clients experienced a significant decline in poverty, while a third were no longer poor after having taken out at least five loans. Over half of ASHI borrowers progressed from very poor to moderately poor, with one fifth having come out of poverty after more than four loan cycles. The studies sampled 152 old clients and 92 new clients in ASHI, and the sample of Project Dungannon of NWTF was composed of 142 old clients (of whom 64 had entry-level data) and 146 non-clients.

The findings showed that the number of NWTF clients who were very poor dropped from 69% to only 5%, while the proportion of ASHI's very poor clients dropped from 76% to only 13%. Researchers pointed out that in the NWTF's Project Dungannon, the factors for poverty elimination were highest in areas of good economic opportunities where the poor people were active as evidenced by their economic activities. The threshold number of loans before significant changes in poverty levels took place was six, whereas the threshold amount of the loan was PHP 54,000. Households that were no longer poor had two or more livelihood activities or sources of income.

As for ASHI, the research identified the following factors as having contributed to poverty elimination using microfinance:

- *Economic activities*: Borrowers who invested in fishing activities were more likely to come out of poverty than those who invested in other economic activities.
- *Loan size*: Clients who had larger loans were less likely to be very poor than those who had smaller loans.
- *Enterprise skills*: Clients who calculated their profits based on records of costs and earnings were twice as likely to have progressed from very poor to moderately poor, but were only half as likely to have come out of poverty.

The ADB study observed that the net effect of the microfinance program on its clients is difficult to measure accurately. To quote: "Any attempt to link the use of financial resources to poverty reduction will face a number of formidable challenges in overcoming statistical problems such as attribution, selectivity bias and fungibility. These problems systematically overestimate the impact of loans on borrower poverty and it cannot be clearly established that poverty has been reduced significantly by the loans granted." It recommended that depth of outreach as measured by loan size be used to understand the poverty situation of the borrower since poor borrowers, who had relatively small cash flows, would need small loans.

Overall, the impact of microfinance has been positive. It has resulted in improvements in borrower incomes, assets, and household expenditures. But clients claimed they needed more than just credit services. They said they also needed savings, health or medical insurance, emergency loans, educational loans, pension plans and death, and disability insurance, as well as housing loans. Some microfinance institutions have ventured toward meeting these expanded needs of low-income clients.

Microfinance Technologies and Services

During the first decade, the industry focused on providing non-collateralized credit to the poor and becoming financially viable. The predominant quest of the sector was to lend to the poor and to ensure that the poor paid back their loans. "Zero tolerance for delinquency" and "credit discipline" were the slogans of many of the new players as the sector grew and learned how credit to the poor should be given. It was only at the end of the decade that attention began to shift to the provision of savings and other financial services such as micro-insurance.

Microfinance in the Philippines started with Grameen Banking, followed by a modified village banking scheme that the APPEND group, particularly the Kabalikat para sa Maunlad na Buhay, Inc. (KMBI), used in largely slum areas. Generally, the microfinance methodologies used in the Philippines were either group lending or individual lending.

Toward the end of the decade, the methods of ASA, Savings and Credit with Education (SCWE) and the Alliance of Philippine Partners for Enterprise Development (APPEND) scale-up model were adopted. In some institutions, two methods were used. Common in the adoption of the Bangladesh-originated method, Grameen Banking, were the experimentation and adjustment processes that the sector ventured into in order to adapt the micro-credit product to local cultures and situations.

The use of a means test was a common feature of early approaches used by the sector. This process appeared to ensure that only the poor would benefit from microfinance loans and leakage would be minimized. But toward the end of the decade, this process seems to have been glossed over or discarded as the sector expanded rapidly and sought viability. PCFC required all its accredited conduits to conduct a means test using the Client Profiling Index to determine eligibility. The criteria were based on the official poverty line set by the government. Three proxy indicators were checked: housing, assets, and income.

Basically, group-based approaches meant extending loans to groups, to individuals within a group, or to a group that re-lent to its members. Group guarantee mechanisms were introduced as a form of alternative collateral. The features of a group-based approach were as follows: short-term loans from one to twelve months; small loan amounts ranging from PHP 1000 to PHP 5000 for the initial loan; repeat loans based on repayment performance of the previous loan; non-collateralized loans or the use of substitute collateral; joint liability to motivate repayment; and the charging of full-cost interest rates and fees to recover the cost of loans.

Individual loans, a method introduced by the Microenterprise Access to Banking Services (MABS) project among rural banks, lent to individuals based on their ability to provide assurance of repayment and some level of security. The approach had the following features: repayments adjusted to a client's cash flow; customization of loan size; term and repayment schedules to suit a client's needs; flexible loan sizes; and the use of movable assets and collateral substitutes such as co-makers.

The IMCC study looked into the financial performance of the approaches to estimate the time it would take for financial and operational viability to be attained. Their projections showed that the Grameen Bank approach, the ASA, and individual approaches could attain operational viability by their second year. The average cost per peso loan was PHP 0.23 for the Grameen approach, PHP 0.22 for ASA, and PHP 0.18 for individual lending methods.

The IMCC review found that all methods were capable of reaching the poor. The Grameen Bank approach was the most widely replicated methodology and had the largest outreach. The other methods showed a certain degree of sustainability given good quality portfolios.

External funding was a driver for the adoption and growth of the methodologies. The modifications in the Grameen methodology showed how Philippine institutions innovated to match their product with the nuances of the market.

Assessing Philippine Microfinance Policies

The operating environment for microfinance in the Philippines has been viewed as supportive and positive for the growth of the private sector. The laws and policies developed were accompanied by financial reforms introduced in the early 1980s. The lifting of restrictions on interest rates and the government's social reform agenda (SRA) merit particular attention. The removal of the cap on interest rates allowed banks to price their products and services taking into consideration the recovery of the full cost. It was not until 1992 that credit became a social reform strategy. This happened when NGOs, private financial institutions, government agencies, and government banks met and discussed their roles and eventually forged a "Social Pact on Credit."

National Strategy and Policy Framework of Microfinance Development

The Social Reform and Poverty Alleviation Act or SRPAA (RA 8425) defines microfinance as

> a credit and savings mobilization program exclusively for the poor to improve the asset base of households and expand the access to savings of the poor. It involves the use of viable alternative credit schemes and savings programs including the extension of small loans, simplified loan application procedures, group character loans, collateral-free arrangements, alternative loan repayments, minimum requirements for savings, and small denominated savers' instruments.

The law sets down an operational framework for a microfinance program. It states that microfinance, or the use of alternative schemes for credit and savings, should exclusively be for the poor, should be accessible. and should improve their household asset base. In Title 2, Section 13, the Law establishes that NAPC should seek to accomplish the following:

1. The development of a policy environment, especially in the area of savings generation, supportive of basic sector initiatives dedicated to serving the needs of the poor in terms of microfinance services.
2. The rationalization of existing government programs for credit and guarantee.
3. The utilization of existing government financial entities for the provision of microfinance products and services to the poor.
4. The promotion of mechanisms necessary to the implementation of microfinance services, including indigenous microfinance practices.

The government framework and policies for microfinance were developed by two agencies, namely, the National Credit Council (NCC) under the Department of Finance (in 1994), and the Presidential Commission to Fight Poverty, which became the NAPC under the Office of the President (in 1992). During a February 2003 *en banc* meeting of NAPC, President Arroyo affirmed that policy oversight for microfinance was the responsibility only of NAPC, while its regulation was the task of the BSP. In June 2001, in her State of the Nation Address (SONA), President Arroyo established microfinance as a cornerstone strategy of the government's fight against poverty. She committed to reach out and help one million women through microfinance. The SONA target, broken down into annual outreach of 300,000 new women borrowers, is being vigorously pursued by the PCFC and its progress tracked by the NAPC.

The National Credit Council

From 1998 onwards, the most active policy advocacy was undertaken by a project within the Department of Finance through the NCC. The Credit Policy Improvement Project, which received significant funding from the United States Agency for International Development (USAID), undertook policy studies and advocacy. A major initiative of the NCC was to lobby and secure approval for Executive Order 138, which directed government entities involved in the implementation of credit programs to adopt the credit policy guidelines formulated by the NCC. Through EO 138, the NCC laid out the national policy whereby government agencies could assist the basic sectors in gaining access to financial services.

The NCC promoted four principles that have influenced the sector's development. These principles were as follows: (1) the conferment of a bigger role to the private sector in the provision of financial services to the basic sector; (2) the adoption of market-oriented financial and credit policies, e.g., market-oriented interest rates on loans and deposits; (3) the government's providing an enabling policy environment, critical support services, and capability building services that facilitate the increased participation of the private sector in the delivery of credit services; and (4) the non-participation of government non-financial agencies and government-owned and controlled corporations in the implementation of credit programs.

A significant feature of Executive Order 138 was the dismantling of directed-credit programs managed by government line agencies. These credit programs amounted to PHP 30 billion in 1995.

The NCC believed that the "emerging environment for microfinance was anchored on the government's objective to alleviate poverty within a framework of viable and sustainable financial institutions." Government had failed by relying on supply-led approaches. Because of the failure of subsidized, directed credit programs to reach the target clientele and achieve operational viability, the government needed to shift to providing the appropriate policy and regulatory framework for the efficient functioning of financial markets, and to use the private sector to provide financial services at the prevailing market rates.

The National Strategy for Microfinance

The results of consultations with the private sector are embodied in a strategy paper released by the National Credit Council in 1999 and supported by the Bangko Sentral and the NGO private-sector Microfinance Council. The proposed vision under the NCC strategy was to have a viable and sustainable private (micro) financial market to be achieved in a liberalized and market-oriented economy where the private sector played the major role and government provided the enabling environment (through the appropriate policy and institutional framework) for the efficient functioning of markets. The strategy identified a specific objective: to provide low-income households and microenterprises access to financial services. The target group identified consisted of those who lived below the poverty line and were engaged in some form of business or economic activity, but who did not have access to or were inadequately served by the formal financial sector.

Operational Policy and Regulatory Environment

In 1996, microfinance was defined as "the provision of financial services to small borrowers and savers, particularly among the poor." In 1999, microfinance took on a dual vision that merged social and commercial interests. The 1999 vision was crafted by the NGO Coalition for Microfinance Standards, a group of microfinance practitioners and government officials, during an August 1999 workshop. The workshop participants formulated a policy statement to the effect that microfinance should be recognized as a vital part of the financial system, with laws and regulations appropriate for the sector. The same policy statement signified that microfinance should also be recognized as an effective means to reduce poverty.

The practitioners' view was not one immediately shared by commercial banks nor by many in the formal financial sector, who continued to shy away from microbanking, citing high transaction costs and microenterprise lending risk. Their attitude was transformed only when BSP acknowledged and actively promoted microfinance with the passage of a new banking law in 2000.

The small borrowers and savers were the ones who benefited the most from the emergence of Philippine microfinance and microfinance institutions, with their unique products and services. It has been pointed out that the rise of nonbank financial institutions proved beneficial to their many small-scale clients who traditionally relied on informal lenders to meet their consumption and production goals.

The NCC issued a regulatory framework in 2002 for microfinance institutions and proposed to assess institutions based on the following minimum set of parameters: portfolio quality (portfolio at risk, past due ratio, provision for loan losses); efficiency indicators (administrative efficiency, operational self-sufficiency and financial self-sufficiency); stability indicators (liquidity and net institutional capital); and outreach indicators (growth of number of clients, of the microfinance loan portfolio, and of savings).

In 1998, microfinance was acknowledged as a poverty alleviation strategy with the passage of the SRPAA. The Philippine Banking Act of 2000 also recognized microfinance, but this time as part of the formal financial sector.

The Bangko Sentral ng Pilipinas and Microfinance

The newly passed General Banking Act of 2000 tried to establish a balance between the objectives of tightening prudential regulations and ensuring the flow of financial services to microenterprises, small enterprises, and poor households. The Act had provisions devoted to microfinance, particularly issues regarding collateral-based lending, unsecured loans, and interest due to microfinance borrowers and loan amortizations.

The new law encouraged banks to demand statements of assets and liabilities, and of income and expenditures, as well as other information from their credit applicants. Microfinance borrowers, however, could not meet such requirements.

For this reason, the law exempted microfinance borrowers from this regulation and instead encouraged banks to lend to them, not on the basis of the collateral they could present, but on the basis of their cash flows. As regards interest rates, the Central Bank circular clearly spelled out the policy that the "interest rate shall not be lower than the prevailing market rates to enable the lending institution to recover the financial and operational costs incidental to this type of microfinance lending." This ran counter to the previous government policy that promoted below-market interest rates for loans to microenterprises and poor households.

Structure of the Microfinance Sector

The Philippines has a relatively wider range of formal, semiformal, and informal institutions[21] that provide microfinance services than in other countries. The financial intermediation and credit activities provided by these institutions are regulated and supervised by the *Bangko Sentral ng Pilipinas*.

The BSP employs a regulatory framework, which is included in the General Banking Law of 2000 (which repealed the General Banking Act of 1949). Along with this framework are a number of parallel laws governing specialized banks that brought forth a tiered structure of licensed financial intermediaries and of financial regulations.[22]

Table 1 on the following pages shows a matrix of the different MFIs in the Philippines and their respective frameworks.

Performance of MFIs in the Philippines

Data released by the Microfinance Council of the Philippines (shown in Table 2) seem to indicate that the MFIs' twin objectives are being met. These objectives are serving a greater number of poor clients while simultaneously ensuring the sustainability of the financial institutions that serve them.

Table 2. Performance of Microfinance Institutions in the Philippines 2001–2002

Indicator	Aggregate data of 15 MFIs (as of Dec. 31, 2002)	Aggregate data of 12 MFIs (as of Dec. 31, 2001)
Number of branches	172	121
Number of staff	2,324	1,475
Number of field staff	1,881	1,177
Number of borrowers and savers	382,672	251,211
Value of outstanding loans (in RP peso)	1,566,435,367	1,050,458,155
Value of clients' savings deposits (in RP pesos)	638,511,066	402,633,016

Source: Gilberto M. Llanto, "A Microfinance Promise: To Provide the Poor Access to Finance Services," PIDS Policy Notes, July 2003. In this table, Llanto is citing the findings of the Microfinance Council of the Philippines.

[21] Joselito Gallardo compares the status of the Philippines in this respect with that of Ghana in the World Bank study "A Framework for Regulating Microfinance Institutions: The Experience in Ghana and the Philippines," p. 16.

[22] Ibid.

Table 1. Microfinance Institutions and Regulatory Framework in the Philippines

Type of MFI	Ownership	Legal basis	Organized as	Fund source	Authorized activities	Agency jurisdiction	Agency supervision	Target market
Commercial banks in microfinance	Private or government shareholders	General Banking Law; Law on Corporations	Limited Liability Company	Equity capital; commercial funds; deposits	Full service bank	Central Bank; Deposit Insurance Company	Central Bank; Deposit Insurance Company	Bank/nonbank MFIs (RBs, CB, NBFCs)
People's Credit and Finance Corporation	Land Bank of the Philippines	Finance Company Act	Limited Liability Company	Capital/loan funds from government and international agencies	Apex organization	Central Bank; Land Bank of the Philippines	None	Cooperative banks; NGO-MFIs
Thrift banks	Private investors	Thrift Banks Act; Law on Corporations	Limited Liability Company	Equity capital; commercial funds; deposits	Savings deposits and loans	Central Bank; Deposit Insurance Company	Central Bank; Deposit Insurance Company	Microenterprises; small businesses; general public
Rural banks	Private investors	Rural Banks Act; Law on Corporations	Limited Liability Company	Equity capital; commercial funds; deposits	Savings deposits and loans	Central Bank; Deposit Insurance Company	Central Bank; Deposit Insurance Company	Microenterprises; small businesses; general public
Cooperative banks	Cooperative societies	Rural Banks Act; Cooperatives Code	Limited Liability Company	Equity capital; commercial funds; deposits	Savings deposits and micro-loans	Central Bank; Deposit Insurance Company	Central Bank; Deposit Insurance Company	Microenterprises; small businesses; cooperatives
Nonbank finance companies	Private investors	General Banking Law; Law on Corporations	Limited Liability Company	Equity capital; commercial funds	Wholesale deposits and microloans	Central Bank	Central Bank	Microenterprises; small businesses
Pawnshops	Private investors	General Banking Law	Limited Liability Company; Sole Proprietor, Partnership	Equity capital; commercial funds	Pawn loans	Central Bank; SEC	None	Individuals
(continued on next page)								

2nd/3rd–tier federations of credit unions or savings and credit cooperatives	Primary-level cooperative societies	Cooperatives Code	Cooperative Association	Members' equity capital; commercial funds, deposits	Management/ finance services plus liquidity facility to member cooperatives	Cooperatives Development Authority	None	Savings and credit cooperatives; credit unions
Credit unions and savings and credit cooperative associations	Individual members (natural persons)	Cooperatives Code	Cooperative Association	Capital; plus deposits from members	Savings deposits from members and micro-loans to members	Cooperatives Development Authority	None	Individual members
NGO–MFIs	Private trustees	Law on Trusts and Non-Profit Foundations	Nonprofit foundations; private lending investors	Grants, donations, commercial loans	Microfinance loans to individuals and groups	Annual reports to SEC and the Central Bank	None	Individuals and groups
NGOs	Private parties	Law on Trusts and Non-Profit foundations	Non-profit foundations	Grants, donations, commercial loans	Microfinance loans to individuals and groups	Annual reports to SEC and BIR	None	Individuals and groups

Source: Joselito Gallardo, *A Framework for Regulating Microfinance Institutions: The Experience in Ghana and the Philippines*, The World Bank Financial Sector Development Department, November 2001, p. 17

The implication is that the government has found microfinance to be a very good substitute for directed credit programs (DCPs). On the one hand, the poor are now gaining access to sustainable finance services without creating a fiscal and institutional burden for the government. On the other, private microfinance institutions (MFIs) are doing good business.

A separate study conducted by the International Fund for Agricultural Development in 2002 revealed the following profile of microfinance clients in the Philippines[23]:

- Female, with an average age of 44 (ages ranged from 20 to 70).
- 90% were married, having 3 to 4 children.
- 42% had secondary school education, 32% had at least elementary education, less than 1% were illiterate.
- Most microfinance clients engaged in non-agricultural enterprises.

Microfinance services primarily targeted the entrepreneurial poor, comprised of mainly household-based entrepreneurs, and the like.[24] Citing an ADB study, AIM also revealed that microfinance services are not deliberately designed for the ultra-poor, or those situated at the lowest poverty levels.[25] Microfinancing activities for the ultra-poor sector have been very limited: only 15% of MFIs surveyed declared that they served the ultra-poor.[26] For instance, the perennial clamor for deposit services for the poor has remained an unmet demand; reference is more widely made to credit services than to savings services.[27]

There is also a preference among MFIs to service those who have had experience or know-how in managing small businesses. Apparently because of the belief in microfinance that the poor have the capacity to repay loans and build savings, MFIs have focused their attention on those who they perceive as having legitimate capacity to repay, save, and sustain their enterprises.

Notwithstanding, the demand for microfinance loans expressed by the entrepreneurial poor has grown tremendously in the past 5 years and is expected to grow at a high rate for another 5 years. The International Management and Communications Corporation (IMCC) estimated the entrepreneurial poor families' total demand for microfinance loans for 2002 to be at PHP 62.04 billion, and the figure is projected to jump to PHP 110.31billion by 2007.

In a survey on gender and its relevance in microfinance during the first half of 2002, Rebecca Coke found that resources loaned to clients are indeed used to generate income for the borrowers. It generally had positive effects on the beneficiaries. However, it was found out that these income-generating endeavors were not collectively sustained in the long-term.[28] It did not make "entrepreneurs" out of the borrowers nor did the microfinance loans fund "growth projects." According to Coke:

> Given the social context in which borrowers make business decisions, the Philippine microfinance programs are not properly designed to meet the overarching policy goal of economic growth. The programs are alleviating poverty, but (are) not encouraging long-term development. This can be primarily attributed to an over-reliance on credit as the sole method for promoting entrepreneurship.[29]

[23] This was part of the result of a study conducted by the International Fund for Agricultural Development cited by Marcia Feria-Miranda of the Asian Institute of Management in her article "The First Decade of Microfinance: 1992-2002," written for UNDP under the supervision of Prof. Rolando T. Chua..
[24] Jimenez, "Understanding Microfinance."
[25] Chua et al., p. 6.
[26] Feria-Miranda, "The First Decade of Microfinance: 1992-2002."
[27] Nimal A. Fernando, p. 8.
[28] Rebecca N. Coke, "Gender and Microfinance Business Choice: Evidence from the Philippines."
[29] Ibid.

This echoes the concern about the prevalence of expanding credit loans given to clients. Credit alone cannot jumpstart development; it must be combined with larger, holistic initiatives targeting individuals within communities.[30]

These findings suggest that the needs of the poor are not homogeneous and that, therefore, if the industry is to respond to the needs of the poor, the provision of other financial services such as savings and insurance must be encouraged.

The IMCC ADB report identified the lack of institutional capital or equity as one area of weakness among Philippine MFIs, particularly among NGOs. The lack of capital prevents MFIs from setting up facilities and branches to further expand outreach. Cooperatives found it very difficult to raise capital due to the fact that their members are mainly from low-income sectors. Among NGOs, funding from donors is drying up. In addition, the UNDP Microfinance Support Project Evaluation identified the following issues as contributing to a successful microfinance operations: governance and leadership; strategic planning; staff development; MIS; and accounting and auditing systems.

With the continuous increase in competition as well as the growing complexity of clients' evolving needs, the need for microfinance education and capacity building also increases. *There is a need to move from an experimental mode of learning to a more structured methodology focused on management and financial principles*.[31] The Asian Institute of Management maintains that funding agencies are now more inclined to finance capacity-building endeavors than operations due to the conviction that running the institutions must simply be the role of the MFIs themselves.[32] Table 3 summarizes the performance issues identified by each sector, which also indicates the capacity-building needs of each sector.

Needless to say, mainstream banking institutions, or commercial banks, will have the lion's share of financial resources and control, given its mandated clientele. However, as conventional banking institutions thrive in their adherence to traditional banking methods, microfinance institutions have transcended the limits that have deprived the poor of much-needed financial services.

Microfinance Providers and Support Institutions

Direct microfinance providers in the Philippines include rural banks, credit-granting nongovernmental organizations (NGOs), and credit unions/cooperatives. Agabin (1998) pegged the outreach of these MFIs in 1995 at 656,500 individuals (a very rough estimate). This gives the overall impression that microfinance in the Philippines has not expanded very much and is, in concept, quite limited.

Agabin also reported that the assets of these MFIs in 1996 was PHP 77.1 billion, which was equivalent to only 4% of the resources of the commercial banking system. However, the combined number of MFI offices was 7,855 outlets, or more than double the number of commercial bank offices. In addition, commercial bank offices are concentrated in the National Capital Region, making banking services less accessible to those in less developed regions.

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[30] Ibid.
[31] Ibid., p. 39.
[32] Ibid.

Table 3. Performance Issues by Sector

<table>
<tr><th>NGOs</th><th>Cooperatives</th><th>Rural banks</th><th>Cooperative rural banks</th></tr>
<tr><td>Basic technical skills training or the "how-to" of management and supervision, financial mgt., audit and control system, basic banking skills, simple accounting and financial analysis, MIS (Agabin 1999)</td><td>Membership policies, low investment in human resource development, not guided by accurate and timely information, manualization of operations, strategic/financial business plan (PLBS 1999)</td><td>Management, asset/liquidity management, product packaging, risk management, proper pricing of financial products, sector-specific information tools and appraisal systems (PLBS 1999)</td><td>Poor repayment, mounting arrearages, weak extension support and to some extent, management-related problems, declining membership support, inadequate capital, limited resources and lack of management capability (Lamberte 2001)</td></tr>
<tr><td>Repayment performance was generally poor. Poor monitoring, accounting and recordkeeping practices or weak information management (Dingcong 1999)</td><td>Loan delinquency control and collection strategies, accounting basics (Punla 2000) Competition, leadership (ADB 2002)</td><td>Delinquency management, risk management, financial management and funds sourcing, internal control, cash flow projection, HRD, client development, product development and marketing (ADB 2002)</td><td rowspan="2"></td></tr>
<tr><td colspan="3">Governance and leadership, strategic planning or objectives, staff development, products and services delivery including MF policies, MIS, accounting and auditing systems (MSP 2002)</td></tr>
<tr><td colspan="4">Absence of strategic plans, manualization of procedures and policies, need for continuous staff development, operational issues in delinquency management, financial management, management information, central management in group lending methodology and resource mobilization (ADB 2002)</td></tr>
</table>

Source: AIM, "The First Decade of Philippine Microfinance, 1992–2002"

There are several types of microfinance institutions in the Philippines. The following is a profiling of these institutions:

Rural Banks

Rural banks used to be categorized under the traditional regulated banks, with their services focused on clients in the agricultural sector. In recent years, however, they have started to venture into microfinance after realizing the potential for profit in the sector. The Bangko Sentral ng Pilipinas reported that in mid–2003 there were 119 rural banks already involved in the microfinance industry with 363 branches, reaching 394,613 clients with outstanding loans amounting to PHP 2.2 billion.[33] In terms of loan size, rural banks provided an average of PHP 69,200 per borrower. Rural banks are owned and governed by private owners whose interests are represented by a governing board.

[33] Feria-Miranda, p. 5.

More recent data revealed that as of September 2003, the assets of 66 rural banks, 4 microfinance-oriented rural and thrift banks, and 25 cooperative banks amounted to PHP 1.9 billion exclusively yielded, with a total outreach of 342,547 clients.[34]

Credit-granting Non-government Organizations (NGOs)

In 1996 there were 600 NGOs involved in microfinance, with combined total assets of some PHP 4.5 billion. The loan portfolio was about PHP 920 million, with average loans outstanding of PHP 5,687. Volunteer individuals who do not own the institutions govern them. Members of the boards are selected by, and often serve upon the invitation of, the founding members, usually being chosen for their reputation and expertise. Credit NGOs register with the Securities and Exchange Commission (SEC) as nonprofit, non-stock corporate entities, but are practically left unregulated.

In 1998, the Coalition for Microfinance Standards described the financial situation of credit NGOs in the Philippines as follows:

Capital Was Sourced Primarily from Donations

Microcredit NGOs financed most of their operations with funds coming from donations from foreign donors, philanthropic organizations, or foundations set up by corporations.

Limited Borrowing from Commercial Sources

Since microcredit NGOs have no clear ownership as non-stock, nonprofit organizations, and are usually faced with issues of governance and accountability, these pose a difficulty when securing loans from commercial sources. In many cases, the members of the board are asked to assume personal liability for a loan to the NGO by signing a document expressing that they are jointly and severally liable for the repayment of the loan. Some board members have expressed reluctance to do so; thus, most NGO borrowings have been sourced from donors and are priced at concessional rates.

Limited Reliance on Savings for Cheap Source of Lendable Funds

Microcredit NGOs are not legally allowed to gather deposits from the public, hence the compulsory savings of their members are booked as capital build-up.

Innovative Lending Techniques Are Employed

Fifty-six credit programs of NGOs reported the following loan features: i) the majority of the microcredit programs charge interest rates of 24–39% per annum; ii) at least 18 programs compute interest rates on a flat basis (in contrast to bank practice of computing interest rates on a declining balance basis); iii) some require hard collateral such as real estate mortgages but also accept post-dated checks, group guarantees, co-makers, character, and assignment of receivables as alternatives; and iv) a good number of programs adopt weekly and daily loan amortization.

In his review of MFIs, Llanto concluded that the credit NGOs are not viable and sustainable: “While credit NGOs effectively target and reach poor clientele, they are neither effective nor efficient credit intermediaries because of their weak institutional capacity and financial position. These institutions seem capable of delivering financial services to the poor only because of their access to grants and concessional loans.”

Credit Unions/Cooperatives

Cooperatives are owned and governed by their members, who number approximately 200,000. Credit cooperatives are regulated by the Cooperative Development Authority (CDA).

[34] Jimenez, “Understanding Microfinance.”

Wholesale Fund Providers

Aside from these direct providers, there also exist 3 wholesale fund providers: the People's Credit and Finance Corporation, the Land Bank of the Philippines and some commercial banks. These institutions are involved in wholesale lending to MFIs for on-lending to small-scale borrowers. In the process, they are able to develop a network of rural banks, cooperatives, and NGOs that serve as their conduits, allowing them to go into micro-lending without fully taking the risks involved and avoiding the high costs of the servicing and monitoring small-scale borrowers. However, although the current macroeconomic and financial environments favor bank entry into the microfinance market, banks, particularly commercial banks, remain averse to doing business with small-scale borrowers. The lack of appropriate information on, and exposure to, microfinance, and differences between micro-finance and regular banking technology mitigate the desire to have microfinance as part of the banks' regular financial products. Among the reasons posited is that existing central bank policies and regulations make bank entry into microfinance difficult, if not unprofitable (Llanto 2000).

Support Organizations

Support organizations include the National Credit Council, the Microfinance Council of the Philippines and the National Anti-Poverty Commission. The National Credit Council (NCC) was created in 1993 to "provide a market-oriented financial and credit policy environment, to promote efficient financial markets, and help private microfinance institutions broaden and deepen their microfinancial services."[35]

According to the *Bangko Sentral ng Pilipinas*, their vigorous and active initiatives in support of microfinance in the Philippines have resulted in the following developments countrywide:

1. There are now six microfinance-oriented banks licensed under BSP Circular 273 (February 2001). There are also 115 rural and cooperative banks with 379 branches with some level of microfinance operations. Combined outstanding loans of these banks have reached PHP 2.58 billion spread across 432,475 micro-borrowers.
2. The BSP has granted rediscounting facilities to ten banks with outstanding loans totaling PHP 20.1 million involving 23,353 micro-borrowers.[36]
3. There are now 65 provinces in the Philippines that are served by banks with micro-finance operations.[37]

The *Bangko Sentral* Governor also reported that as of October 2003, some 122 banks had engaged in microfinance activities along with two microfinance-oriented thrift banks, three microfinance rural banks, and 122 rural and cooperative banks.[38]

In March 2004, the *Bangko Sentral* reported significant growth in microfinance activities among Philippine banks. Microfinance beneficiaries have reached close to a half million individuals. Loans to these beneficiaries have reached PHP 2.5 billion.[39]

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[35] Philippine National Strategy for Microfinance.
[36] Espenilla, "Regulating and Supervising Microfinance in the Philippines."
[37] Ibid.
[38] Ibid.
[39] BSP. "The Good News: Microfinancing Loans Hit PhP2.5 Billion—BSP."

Table 4. Philippine Microfinance Methodologies

Methodology	Key features	Average loan size	Replicators
Grameen Bank approach	• Exclusive focus and direct delivery of service to the poor • Small loan amounts that increase gradually from one cycle to the next • Weekly loan repayments • Mandatory weekly center meetings where educational inputs are often provided • The formation of homogenous groups that the borrowers form themselves. • Close monitoring and supervision of borrowers • Non-collateral loans secured though mutual (group) guarantees • Staggered loan releases to group members, depending on the repayment performance of the first two borrowers • Compulsory weekly savings	PHP 3501	PHILNET (13 MFIs), PCFC GBA Replicators (198 MFIs)
ASA[40] model	• Formation of homogenous groups for credit and CBU collection • Simple and standardized cost-effective structure with only one branch manager and four loan officers • Simple bookkeeping system and MIS • Simple loan and savings products • Loans paid on a weekly basis • Delinquency controlled by the sit-down or doorstep technique • No group liability on loans; past dues considered individual obligations	PHP 2282	MSP Partners (16 MFIs)
	• Increased loan amounts in succeeding cycles depending on repayment performanceFast expansion through cost minimized operations		
MABS[41] approach for rural banks	• Cash flow-based lending to individuals without collaterals • Loan amount based on capacity to pay • Zero tolerance on delinquent borrowers • Technical assistance to rural banks on best practices	PHP 6008	Rural Banks (81)

(continued on next page)

[40] Association for Social Advancement (ASA) Bangladesh Model.
[41] Microenterprise Access to Banking Services (MABS).

CUES[42]–SCWE	• Focus on economically disadvantaged women • Formation of savings and credit associations • Financial services with education on topics such as health nutrition and better business development • Non-collateral lending with group guarantees • Regular weekly meetings • Mandatory and voluntary savings	PHP 2732	Cooperatives (18)
Solidarity	• Group formation where members self-select • The amount of loan determined based on how much each member needs • An on-time repayment requirement • Borrower and lender accountability and mutual respect • Savings for emergency needs	n.a.	NGOs (4)
APPEND[43] scale-up model	• Targets economically active but poor women • Self-selection of group members • Weekly meetings where social, economic and spiritual goals are pursued • Simultaneous release of loans • Weekly loan payments • Uncollateralized lending; members co-guarantee all loans • The training of member clients to be ready to assume management functions at the centers	PHP 4005	NGOs (10), bank/s (1)

Source: R. Chua et al, eds., *Delivering to the Poor: A Search for Successful Practices in Philippine Microfinance* (2003), p. 9

MFI Products and Services[44]

Tables 5–8 profile four of the many successful microfinance institutions in the Philippines. These are used in this survey to provide a snapshot of how MFIs thrive in the country. Profiled in the tables are a mix of micro-loan products and micro-insurance products of different and diverse MFIs.

[42] Credit Union Empowerment and Strengthening (CUES).
[43] Alliance of Philippine Partners in Enterprise Development (APPEND).
[44] These are MFIs studied by Clarence G. Dingcong, as reported in “Documentation of Product Development Processes in Selected MFIs.” The rationale for using these cases is that these have been documented and the validity of the findings has been established.

Table 5. United Sugarcane Planters of Davao Savings and Credit Cooperative (USPD–SCC)

UPSD-SCWE: Savings and Credit Cooperation is a microfinance methodology introduced by the CUES project. It is a microfinance program designed especially to meet the needs of the very poor rural women in the communities of credit unions. Along with savings and lending services clients are also provided education on topics such as health, nutrition, etc.		
Product/s	Profile	Description
Micro-credit	Methodology	Savings and Credit Association (SCA) of 5–6 solidarity groups are formed. Solidarity groups are composed of about 25–36 women.
	Amount limit	PHP 1500–PHP 20,000. Loan amount may increase 150% on the next loan application depending on the repayment performance of the borrower.
	Loan period	4 months per loan cycle
	Repayment	Weekly, during meetings. These weekly meetings are venues to make savings and loans repayments and also serve as learning sessions on "high impact" topics.
	Mark-up	15% for four (4) months
	Loan application	The loan application of a member is reviewed and approved first by the solidarity group then by the SCA. All approved loans are added together and submitted to the cooperative as one loan application.
	Collateral	Amortization can be charged from the savings accumulated by a member. In case of a loan default of a member, payment will be charged against the group's contribution.
Micro-insurance	Methodology	All SCWE are automatically covered with insurance Insurance coverage is mandatory.
	Purpose	To insure the member on risks against death (of the borrower member). A member is indemnified of her liability in case of death.
	Premium	PHP 1.25 per PHP 1,000 loan availment
Mandatory savings	Methodology	Every week, each SCA member must make a deposit of at least P10. A member can only make withdrawals during the weekly SCA meetings. Members can only can withdraw the entire amounts they have saved if and when they decide to exit the program. USPD SCC retains 5% of the loan on top of the mandatory PHP 10 weekly savings as the member' deposit made to the cooperative.
(continued on next page)		

	Purpose	These mandatory savings will be for the personal use of the member, or, as collateral, if a member cannot pay the amortization for the week.
Other details	Performance (of each member) is evaluated after each loan cycle. Non-payment of loans for three (3) successive weeks may be sanctioned by expulsion from the program upon the decision of the cooperative's management. Other indicators for good performance are rate of the member's attendance in meetings and making deposits and maintenance of savings A flat late payment penalty fee is imposed against the unpaid balance of the borrower. 1% for the 1st week, 10% for the 2nd week, 20% for the 3rd week and every week thereafter.	

Table 6. Tubao Credit Cooperative, Incorporated (TCCI)

Credit cooperative establishd by Belgian Missionary Fr. Jaime Quatannens (CICM) in the municipality of Tubao, La Union; in operation since 1966		
Product(s)	Profile	Description
Petty cash loan	Purpose	Can be utilized either as providential loan or as productive loan
	Amount limit	The amount of loan that a member can avail of is equal to the amount of deposits made by the member.
	Repayment	The loan is payable in one year (max). Repayment modes are flexible. Members may choose to between installment or lump sum modes of payment. For repayments made in installments, interest are computed based on the diminishing balance of the unpaid principal. Pledges are imposed. In case a payment is not made on schedule, the member is required to make a personal appearance the loan officer and make the necessary representations on why the payment was not made. If the loan officer decides n favor of the erring member, then an extension on repayment is granted. A promissory note will be issued y the erring member.
	Mark-up	16.6% per annum
	Loan application	A member may only avail of loan if he/she is an investor or a member shareholder. For repayments made in installments, interest are computed based on the diminishing balance of the unpaid principal.
(continued on next page)		

	Collateral	The Saranay Aid System serves as a collateral substitute.
	Methodology	A member borrows against is/her share capital and against the share capital of the guarantor. The Co-maker makes a guarantee of only PHP 1000. Through this scheme the borrower is able to avail him- or herself of a loan double the fixed deposit.
Co-makership loan	Purpose	Can be utilized either as providential loan or as productive loan
	Amount limit	The amount of loan that a member can avail of is equal to the amount of deposits made by the member.
	Repayment	The loan is payable in one year (max.) (see above)
	Mark-up	16.6% per annum
	Loan application	(see above)
	Collateral	A member's placement in fixed deposits and time deposits serve as collateral substitutes.
	Methodology	Mandatory savings program for members who wish to avail themselves of loans from the TCCI. A requirement for membership is a deposit account with a corresponding maintaining balance. The amount of contributions is specified per member depending on the member-contributor's age. Benefits are given directly to the beneficiary (to the family thereof) in cash.
Saranay Aid System	Purpose	Serves as a mortuary assistance and credit insurance program.
(continued on next page)		

	Amount of benefit	The mortuary benefit may is estimated to amount to PHP 22,000 per beneficiary member. The amount of the benefit is also based on the size of membership and the amount of the accumulated deductions from the savings account of the members. TCCI charges an administrative fee of 5% of the total contribution
Other details	TCCI's operating self-sufficiency ratio 138% and its financial self-sufficiency ratio was at 117% (in 2000). This marks the high level of sustainability of operations. Income ratio was pegged at 29% for 2000. Return on equity was pegged at 8% for 2000.	

Table 7. Rural Bank of Sto. Tomas (RBST)

Established in 1973, in Sto. Tomas, Davao Province, RBST has become a model for successful microfinance implementation in the southern region of the Philippines. RBST also represented MFIs in the Philippines with the sharing of its experience in microfinance in the Global Summit of Women in Hongkong in 2001. It was awarded the "AA" rating by MABS in 2003.		
Product/s	Profile	Description
SUKI Loan	Methodology	Follows the MABS' cash-flow based individual lending. Credit risk is reduced and tailoring loan-size and terms and repayment schemes to the client's needs is a way of providing customized service.
	Amount limit	Initial loan shall not exceed PHP 15,000 per borrower
	Repayment	Loam terms and repayments depend on the expense requirements and income stream of clients' enterprise/s. Repayment schedule is timed based on the client's cash flow and its respective schedule. For the initial loan of availment of the SUKI Loan, the loan should be paid within 6 months. An increment (step-up) of up to 20% (the step-up shall not exceed 20%) of the original loan amount will be given to subsequent loans. Repayments can be made on a daily, weekly, bi-monthly and monthly basis depending on the borrowers cash-flow. This approach is sensitive to the borrower's cash-flow and capacity to pay.
(continued on next page)		

	Mark-up	All SUKI loans carry a flat, add-on interest rate of 2.5%. A service charge of 2.5% is deducted from the loan proceeds Other charges include: documentary stamps—collected from 0.15% of the loan amount availed of; and late penalty fees are charged at a 2% rate based on the outstanding principal balance of the loan.
	Collateral	The collateral requirement is based on the loan amount availed of. For a loan ranging from PHP 3000–P4,999, the collateral requirements or the Guarantee is shared by two (2) co-makers. For a loan ranging from PHP 5000–P30,000, the guarantee is shared by the two (2) co-makers and it carries a Security Agreement in the form of household appliances, etc.). For loans ranging from PHP 30,001 to P100,000, this carries REM, Chattel and/or other forms of hard collateral based on the evaluation of the bank.
	Incentives	If clients make payments that are made in full and on schedule, on a consistent basis, they are awarded an incentive equivalent to 0.5% per month. The amount of this rebate is credited to the account of the borrower at the end of the loan repayment term when all amortization charges have been paid in full.
Savings contributions	Methodology	Al borrowers with approved loans are mandated to open a savings account with RBST. This is not a requirement nor is a payment for loan availment.
	Purpose	To build the asset base of the client.
	Initial deposit	Before loans are released, a borrower has to open a savings account with a minimum initial deposit of PHP 100.
	Subsequent Deposits	Deposits are made on days of the scheduled repayment of loans. Savings deposits are made part of the loan amortization. The amount of deposits depends on the amortization to be paid by the client. The deposit should be equivalent to a balancing figure so as to make the loan payment a round figure.[45]
(continued on next page)		

[45] The example presented by Dingcong is: "If the client is supposed to pay PHP 178 as loan payment every week, he/she will be required to deposit an additional PHP 22 on top of the loan payment to make the total collection PHP 200."

	Savings Withdrawals	Withdrawals can only be made once the loan availed of by the client has been fully paid.
SUKI Savers Club	Methodology	Provides clients with regular savings services without the traditional banking requirements such as minimum deposits, etc.
	Purpose	The SUKI Savers Club was designed to mobilize savings from clients who have never had savings deposits with any bank caused by fear that their deposits might be rejected by the bank.
	Initial deposit	Any amount is welcomed as initial deposit in the SUKI Savers Club Program.
	Interest rate	The interest rate is pegged at 4 per annum For the savings to earn interest, the savings account must have an average daily balance of PHP 1000.
Ganansya Box and Ganansya Raffle Bonanza	Methodology	Important parts of the SUKI Savers Club program. The Ganansya Box is a savings box, complete with lock and key to ensure the security of its contents, which clients purchase from the RBST offices. The keys of the Ganansya box are left in the custody of the bank for safekeeping. The client takes home the Ganansya Box wherein he/she makes preliminary deposits until the client/holder decides to deposit the saved sum in the bank.
	Purpose	Affords for the client an important confidential and discreet mechanism of making small deposits. Through this system, information on client's savings is kept confidential. The Ganansya Raffle Bonanza is a monthly promo, wherein the bank will match the value of the savings account picked through deposit slips drawn monthly.
Other details	As of the end of February 2003, the UKI portfolio reached an aggregate of PHP 5.328 million with 642 active accounts, 8255 micro-depositors, PHP 7.497 million in deposits and (relatively low) portfolio-at-risk ration of 4.52%.	

Table 8. Center for Agriculture and Rural Development–Mutual Benefit Association, Inc. (CARD–MBA)

<table>
<tr><td colspan="3">Innovative microfinance product that complements the operations of CARD Bank and CARD NGO. It is registered with the Insurance Commission and it is a very popular intervention that brought clients to CARD's lending operations. CARD-MBA holds its base in San Pablo, in the province of Laguna, and is a non-stock, non-profit entity wherein ownership resides in the members who also serves as its managers. It was an offshoot of the Members' Mutual Fund (MMF) which was established in 1994 to provide for debt redemption and burial expenses in case of a member's death or of her immediate family member. It now also provides Pension Plan/Emergency Medical Assistance for members who are isolated from engaging in productive entrepreneurial activities due to old age, or debilitating medical and physical conditions.</td></tr>
<tr><th>Product/s</th><th>Profile</th><th>Description</th></tr>
<tr><td rowspan="4">Life insurance</td><td>Premium</td><td>Premiums are weekly contributions of PHP 5 per week.</td></tr>
<tr><td>Coverage</td><td>The insurance policy covers the member, her spouse, all single and minor children.</td></tr>
<tr><td>Benefit/yield</td><td>PHP 3000 for members and PHP 3000 for her dependents (these are for members with less than two (2) years as members). PHP 16,600 for members and PHP 6000 for her dependents (these are for members with 2 years and more as members). The coverage of the legal spouse and of the dependents are co-terminus with the member's participation in the association.</td></tr>
<tr><td>Policy coverage</td><td>Covers death, medical reimbursement for dreaded diseases and permanent disability.[46]</td></tr>
<tr><td>All Loans Insurance Package (ALIP)</td><td colspan="2">The ALIP is a modified reinsurance scheme of the regular Loan Redemption Fund (LRF) that gives full protection to the member-borrowers of CARD, Inc. and CARD Bank becoming members of CARD-MBA and to protect the lending institutions by ensuring 100% collection of loans extended to the members.</td></tr>
<tr><td colspan="3">(continued on next page)</td></tr>
</table>

[46] Daryll Jane Delgado, "An MFI Story of Motivation and Innovation: A Case Study on CARD Rural Bank, Inc."

	Methodology	CARD–MBA charges a loan redemption fee equivalent to 1.5% of the loan amount availed of (regardless of the size of the loan).
	Purpose	In the unfortunate event of death to a member, CARD–MBA will pay to the lending institution the outstanding balance of the loan at the time of death and will also pay to the beneficiary the paid portion of the loan at the time of death. This package is on top of the Life Insurance Benefit of the MBA program.
Provident Fund (retirement savings)	Methodology	Members make a weekly contribution of P5 to CARD–MBA administered provident fund. The member receives her share of the fund upon reaching the age of 65. The fund is deposited in a bank wherein there is guaranteed annual interest income. After three (3) full years of continuous patronage, the member will be entitled to an equity value equivalent to 100% of the total contributions upon termination of her membership from CARD–MBA, whether she voluntarily resigned or was forced out by her center.
Other details	CARD's outreach in 2002, peaked at 66,223, the highest among MFIs in the Philippines. In December of 2002, CARD had served 68,978 clients through 44 branches. CARD had an average loan portfolio (per technical officer—TO) of PHP 2.5 million, with outstanding loans of PHP 532 million. The repayment rate was at 100%, with an operational sustainability rating of 150.6% and a financial self-sufficiency rating of 125.6%. CARD is well on its way to serve one million clients by 2010.	

GOVERNMENT POLICY AND LEGAL FRAMEWORK

Microfinance has always had a place in the Philippines' financial structure. The Philippine government had to find a fitting regulatory mechanism that would effectively supervise microfinance activities in the Philippines.[47]

To achieve that goal, microfinance practitioners and regulators in the Philippines opened the avenues of communication for mutual education and sharing of best practices.

The Magna Carta for Small Enterprises. This law was passed in July of 1991; it mandated that all financial lending institutions must allocate 5 to 10% of their total loan portfolio for availability to small enterprises.

Many commercial financial institutions found this revolting. Banks were generally unappreciative of the law since it compelled them to extend a substantial portion of their loan services to the "unbankable sector." Needless to say, there was even stronger bias against providing credit to microcredit clients with microenterprises.[48]

Fortunately, there were a few positive outcomes of this law. A few banks opened foundations that provided credit lines to NGOs, who in turn, retailed these funds to micro- credit clients.[49] This encouraged the movement of funds from commercial banks to NGOs with microfinancing activities.

NGOs with microfinance operations are not covered by any legislation of the *Bangko Sentral ng Pilipinas*. On the other hand, credit cooperatives, institutions that provide loans exclusively to their members, are licensed and regulated by the Cooperative Development Authority (CDA). The CDA is an entity separate and independent of the *Bangko Sentral*.[50]

Microfinance NGOs are registered with the Securities and Exchange Commission as non-stock and non-profit establishments. NGOs operate outside the formal financial system; hence they are not regulated or licensed by the *Bangko Sentral*. As a result, NGO–MFIs do not have the permission to mobilize deposits from their clients, thus limiting their resource base. Because of this very same reason, NGO–MFIs are also restricted from supplying and providing important financial services to their target clientele.

President Ramos in 1996 signed the establishment of the Peoples' Credit and Finance Corporation (PCFC). PCFC essentially functions as the government's arm that extends wholesale credit to NGOs, cooperatives, and rural banks, which in turn retail it to micro-entrepreneurs.[51]

In 1997, the National Strategy for Microfinance was approved with a vision to have a viable and sustainable microfinance market and to provide poor households and microentrepreneurs greater access to microfinancial services. The National Credit Council (NCC), an interagency body that includes the *Bangko Sentral ng Pilipinas*, was also created to provide a market-oriented financial and credit policy environment that will encourage private microfinance institutions to broaden and deepen their services.[52]

The Credit Policy and Improvement Program (CPIP), a bilateral donor-assisted program, is providing technical assistance to NCC.

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[47] Eduardo C. Luang and Malena Vasquez authored the chapter on the Philippines (pp. 35-42) as part of a compendium of microfinance case studies in Craig Churchill, ed., "Regulation and Supervision of Microfinance Institutions (Case Studies)."

[48] Ibid.

[49] Llanto et al. (1996a) reported that the Bankers' Association of the Philippines (BAP), Credit Guaranty Corporation, and the Bank of the Philippine Islands Foundation have also extended credit lines to NGOs. However, these are not banks but subsidiaries of banks. The former is owned by a group of banks in the country.

[50] Ibid.

[51] Ibid.

[52] The National Strategy for Microfinance, National Credit Council. Quoted by Espenilla in "Regulating and Supervising Microfinance in the Philippines," p. 2.

The National Strategy for Microfinance features the following principles:

1. Greater role of the microfinance institutions in the provision of financial services.
2. An enabling policy environment that will facilitate the increased participation of the private sector in microfinance.
3. Market-oriented financial and credit policies (e.g., market-based interest rates on loans and deposits).
4. Non-participation of government line agencies in the implementation of credit and guarantee programs.

Guided by these principles, the following laws and measures have been passed and enacted to support the strategy[53]:

1. The Social Reform and Poverty Alleviation Act (1997)—rationalized (phased out) direct credit programs and emphasized savings mobilization, with government funds to focus on capacity building.
2. Agriculture and Fisheries Modernization Act (1999)—government financial institutions are to act as wholesaler of funds with private microfinance institutions to serve as conduits, or retailer of funds.
3. Executive Order 138 (1999)—transfer of directed credit programs from government line agencies to government financial institutions; discontinuance of interest rate subsidies; private microfinance institutions identified as vehicles for delivery of retail financial services.
4. The General Banking Act of 2000 (2000)—recognition of the peculiar characteristics of microfinance in the Philippines; the BSP mandated to establish rules and regulations for its practice within the banking sector.
5. The Barangay Micro Business Enterprises Act (2002)—government financial institutions are to set up special wholesale windows for accredited microfinancial institutions.

Because of these developments, there has been a great increase in the number of microfinance institutions in the country.

Legal Support and Safeguards

The General Banking Act of 2000 also attempted to establish a balance between the objectives of tightening prudential regulations and ensuring the flow of financial services to microenterprises, small enterprises, and poor households. The Act has provisions devoted to microfinance, particularly issues regarding collateral-based lending, unsecured loans, and interest due to microfinance borrowers and loan amortizations.[54]

The new law encouraged banks to demand statements of assets and liabilities, and of income and expenditures, as well as other information from their credit applicants. Microfinance borrowers, however, could not meet such requirements.

For this reason, the law exempted microfinance borrowers from this regulation; instead banks to lend to them, not on the basis of the collateral they can present, but on the basis of their cash flows. On the issue of interest rates, the act clearly spelled out the policy that "interest rates shall not be lower than the prevailing market rates to enable the lending institution to recover the financial and operational costs incidental to this type of microfinance lending."[55] This ran counter to the previous government policy that promoted below-market interest rates for loans to microenterprises and poor households.

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[53] Espenilla, p. 2.
[54] Chua et al., p. 13.
[55] Ibid.

Banks normally required payments on their loans on a monthly, quarterly, or annual basis. In the microfinance market, however, clients borrowed small amounts and were given a more flexible amortization schedule that reflected their cash flow. The law thus gave the BSP the authority to formulate more flexible guidelines insofar as loan amortizations were concerned. The new guidelines issued by the BSP allowed microfinance loans to be amortized on a daily, weekly, bimonthly, or monthly basis, depending on the cash flow situation of the borrowers.[56] The BSP's Notes on Microfinance guides banks in implementing the new policies on microfinance.

BSP Notes on Microfinance for BSP Examiners

The Definition of Microfinance

Microfinance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance products to the poor and low-income households, for their micro enterprises and small businesses, to enable them to raise their income levels and improve their living standards.

Core Principles of Microfinance

- The poor need access to appropriate financial services.
- The poor have the capacity to repay loans, pay the real cost of loans and generate savings.
- Microfinance is an effective tool for microfinancing.
- Microfinance institutions must aim to provide financial services to an increasing number of disadvantaged people.
- Microfinance can and should be undertaken on a sustainable basis.
- Microfinance NGOs and programs must develop performance standards that will help define the microfinance industry and move it toward greater outreach and sustainability.

On Interest Rates

There are no interest rate restrictions applying to MFIs, which leaves them free to set their own interest rates.

THE REGULATORY AND SUPERVISORY ENVIRONMENT FOR MICROFINANCE INSTITUTIONS

The Rationale for the Regulatory and Supervisory Framework

With the increase in number of formal institutions involved in providing microfinance services and given the policy thrust of expanding their outreach further, an appropriate regulatory and supervisory framework is of paramount importance in order to preserve the sustainability of the whole system. It is necessary that regulators and supervisors increase their understanding of microfinance in order to be able to uphold prudential regulation standards and discipline while allowing flexibility and keeping an open mind to the uniqueness of microfinance. Examination procedures must be attuned to the methodologies, peculiarities, and risks involved in microfinance operations to ensure that risks associated with microfinance are appropriately managed by the concerned microfinance institutions. The end goals are primarily to protect the financial system from unsafe and unsound practices and to protect the depositors of deposit-taking microfinance institutions.[57]

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[56] Ibid.

[57] Espenilla, p. 4.

The National Credit Council (NCC) approved a Regulatory Framework for Microfinance in 2002. The framework covers only institutions taking deposits from the general public and/or from its members, specifically banks and cooperatives, and are subject to prudential regulation and supervision. These institutions include banks and cooperatives. Since microfinance NGOs are not allowed to take deposits from the public, they are generally not covered by prudential regulations.

Banks

The Bangko Sentral ng Pilipinas is the regulatory authority over all banking institutions including those engaged in the provision of microfinance services. The BSP issues the necessary rules and regulations for the safe and prudent operations of banks. As part of its regulatory mandate over banks, the BSP supervises and conducts regular examination of banks. The BSP examiners check for compliance with banking laws, rules, and regulations, as well as for soundness of risk management systems, particularly systems for managing credit risk, and the overall quality of loan portfolios.[58]

Cooperatives

The Cooperative Development Authority (CDA) is mandated to provide oversight functions for all types of cooperatives. However, the CDA has tended to focus on development activities, which is also mandated by their charter. This has distracted them from more effectively implementing their regulatory and supervisory mandate. In 1998, the NCC, in coordination with the CDA and the cooperatives sector, developed a Standard Chart of Accounts (SCA) for credit cooperatives and other types of cooperatives with credit services. A set of financial performance standards was also established. The SCA and the financial performance standards could be used as a management as well as a regulatory tool. Work is also in progress to strengthen the CDA's regulatory and supervisory capacity.[59]

Nongovernmental Organizations (NGOs)

At present, microfinance NGOs are not regulated. Microfinance NGOs only register with the Securities and Exchange Commission (SEC) as non-stock, non-profit organizations. Almost all microfinance NGOs collect forced savings[60] (usually referred to as capital build-up) from their borrower-clients that are in the nature of compensating balances. In view of this, the BSP, which is mandated by law to regulate deposit-taking activity from the public, has taken a tolerant view of the practice provided that forced savings do not exceed the amount of loans per client. Forced savings do not fall under the ambit of prudential regulations of the BSP. To better ensure that microfinance NGOs are operating in accordance with sound practices, their activities and financial performance are now being monitored. The Microfinance Council of the Philippines (MCP), an association of microfinance practitioners, has set out to collect information and recommend performance standards for microfinance NGOs.[61] However, this is observed by only a handful of NGOs under MCP; the remaining credit-granting NGOs are not yet compliant.

[58] Ibid, p. 5.
[59] Ibid.
[60] Members contribute a fixed amount at regular intervals to a Center Fund. A member's forced savings can be withdrawn only when the member resigns from the program or the whole center opts to dissolve itself and leave the program. If this happens, the member or the center receives the whole amount deposited plus the interest, net of the payments for unpaid amortization.
[61] Ibid.

SPECIFIC REGULATORY REQUIREMENTS AND SUPERVISORY PRACTICES

In 2000, the Bangko Sentral ng Pilipinas declared that microfinance would be its flagship program for poverty alleviation. The initiatives and programs of the BSP have been in the areas of:

- Policy and regulatory environment.
- Training and capacity building within BSP and the banking sector.
- Promotion and advocacy.[62]

Enabling Policy and Regulatory Framework

First and foremost, an enabling policy and regulatory environment is integral in the creation of sustainable microfinance institutions. Towards this end, the BSP has issued a number of circulars:

1. Circular 272 (2001)—This circular defines microfinance loans as small loans granted to the basic sectors, the poor, and low-income households for microenterprises and small businesses. The basic characteristics of microfinance loans are:
   - 1.1. Basis for Credit—borrower's projected cash flow; borrower's reputation
   - 1.2. Amortization—may be daily, weekly, bimonthly, or monthly, depending on the borrower's cash flow conditions
   - 1.3. Amount—maximum of PHP 150,000.00
   - 1.4. Security—typically unsecured; usually with joint and several guarantees
   - 1.5. Interest—market-based; should be able to cover administration costs, provisions for loan losses, intermediation/funding costs[63]
2. Circular 273 (2001)—Allows the establishment of new microfinance-oriented banks to be licensed as either thrift banks or rural banks, through the partial lifting of the general moratorium on the opening of new banks. Microfinance-oriented banks are required to maintain the majority of their business in microfinance. In addition to standard requirements, the requirements for licensing are:
   - 2.1. Form—thrift or rural bank
   - 2.2. Ownership—private persons, multilateral entities, or both
   - 2.3. Capitalization
     - 2.3.1. For thrift banks—PHP 52 million to PHP 325 million
     - 2.3.2. For rural banks—PHP 5 million or existing requirement, whichever is higher
     - 2.3.3. Organizers must have the capacity to engage in microfinancing as shown by the following:
       - 2.3.3.1. At least 20% of total capital is owned by persons with track records in microfinance
       - 2.3.3.2. The majority of members of the Board of Directors have microfinance experience, with at least one member having actual banking experience
       - 2.3.3.3. Presence of an efficient loan tracking system
     - 2.3.4. Documentary requirements—vision and mission statements, manual of operations
     - 2.3.5. Disposition of funds—at least 50% of the gross loan portfolio shall consist of microfinance loans[64]

[62] Ibid., p. 6.
[63] Ibid.
[64] Ibid.

2.3.6. Qualification of officers—the President/General Manager/Chief Operations Officer must be a college graduate with two years of experience in banking/finance/microfinance[65]

3. Circular 282 (2001) and Circular 324 (2002)—These two circulars provide for the guidelines governing the BSP rediscounting facility to provide supplemental liquidity to microfinance loan portfolios of qualified rural and thrift banks. To be able to avail itself of the rediscounting facility, the bank should have at least one year's track record in microfinance; have at least 500 microfinance borrowers; have a past-due loans ratio of not more than 5% and a repayment rate of not less than 95%; and be compliant with the prescribed financial ratios and regulations.
4. Circular 340 (2002), Circular 365 (2003), and Circular 369 (2003)—all provide for the rules and regulations for the establishment of branches and/or loan collection and disbursement points (LCDPs) of microfinance-oriented banks and microfinance-oriented branches of regular banks, as an exception to the general moratorium on bank branching in areas with existing banking offices.
   4.1. The application shall be signed by the President and/or officer of equivalent rank and shall be accompanied by prescribed documents/information. The incremental capital requirements per new branch are as shown in Table 9.

Table 9. Capital Requirements Imposed by the BSP on Banks

Type of bank	Incremental capital requirement
Universal and commercial banks	PHP 20 million
Thrift banks and national cooperative banks	PHP 5 million
Rural banks and local cooperative banks	PHP 2.5 million

However, the incremental capital requirement is only a notional charge against total capital. No new capital need be infused provided that the capital adequacy ratio (CAR) does not fall below 10% after the notional charge.

   4.2. Capital adequacy ratio (CAR) at the time of filing of the application is not lower than 12%.
   4.3. Rural or local cooperative banks with unimpaired capital accounts of less than PHP 10 million are not allowed to establish any branch or LCDPs.[66]

5. Circular Letter (2003)—prescribes more detailed reporting on microfinance operations (i.e., levels, provisions for probable losses, status, and classification—e.g. portfolio at risk)
6. Circular 409 (2003)—provides a formal minimum credit risk management guideline including the measurement of a portfolio-at-risk (PAR), and appropriate provisioning standards for microfinance loan portfolios.

As a regulator and supervisor of the banking system, the BSP is continually looking, reviewing, and if necessary, amending its existing and regulatory guidelines that are relevant to the growing needs of the microfinance sector. In this regard, ongoing initiatives of the BSP are described below.

Training and Capacity Building

To augment the aforementioned efforts, the BSP believes that capacity building is essential. The BSP is committed to increase the capacity and skills of specialist BSP ex-

[65] Ibid., pp. 7–8.
[66] Ibid.

aminers, through a comprehensive and focused training program. A core group of microfinance examiners has been formed to handle the supervision of all banks with significant microfinance activity. The BSP also offers exposure seminars to provide better appreciation of microfinance within BSP in general. Moreover, the Basic Rural and Thrift Banking Courses for banks' representatives now include a session on microfinance prudential operations.

A Microfinance Committee and a Microfinance Unit have been created within the BSP to ensure continuity and coherence of its programs and projects. The Microfinance Committee provides overall direction of BSP's microfinance initiatives; the Microfinance Unit coordinates and monitors the implementation of its various activities including advocacy.[67]

Promotion and Advocacy

To the Bangko Sentral's credit, it launched a microfinance regional advocacy program in 2003. To date, its crusade has reached eight regions, and it planned to cover more areas in 2004.[68] The goal is to conduct microfinance seminars in strategic regions of the country to encourage potential practitioners of sustainable microfinance, especially from among microfinance NGOs and regular banks, to bring microfinance services to a much larger and eagerly waiting potential clientele. Another focus of this effort is to build working ties with other institutions for a broader, more accessible microfinance network. Intended partners include large corporations and private foundations seen as potential collaborators on microfinance initiatives.[69]

The process of commercialization is taking place particularly as private banks and other deposit-taking institutions are assuming an increasingly greater role in the delivery of microfinance services. In this model, funding is principally sourced from deposit mobilization, including from the ultra-poor themselves, rather than from donor funds or even concessional bilateral or multilateral loan funds. These funds are lent to microentrepreneurs at risk-adjusted market rates, but credit access is also not supply-constrained. This works well for the ultra-poor and is consistent with research findings showing that access to credit is far more critical than the price of credit for microentrepreneurs.

The rural banking system and, to some extent, the thrift banking system—a network consisting of almost 3,200 banking offices all over the Philippines and with a capital base of almost PHP 55 billion—are proving to be ideal delivery vehicles for microfinance considering their community-based roots. It is critical, however, that the regulatory and supervisory frameworks keep pace with developments to ensure the safety and soundness of the participating banks.

To accommodate microfinance activities, the Bangko Sentral did not create any new special bank category. Instead, the BSP simply recognizes microfinance-oriented banks that are licensed as normal thrift or rural banks, adding additional requirements in keeping with their microfinance focus. As a consequence, these entities need to meet higher entry standards in return for exemption from the general moratorium on the establishment of new banks except in "unbanked" areas. No licensing concessions are given, but entry is freely open to those that meet the requirements including the standard minimum capital requirement. As full-fledged banks, they are also expected to meet the standard annual supervision fee assessment, which is a function of the net asset base.

Microfinance portfolios of banks are also subject to portfolio-at-risk measurement and tougher provisioning standards that lead to full provisioning after 90 days of being past due or

[67] Ibid., p. 9.

[68] BSP, "The Good News: Microfinancing Loans Hit PhP2.5 Billion—BSP."

[69] Espenilla, p. 9.

upon twice restructuring. This aggressive provisioning requirement is necessary in view of the unsecured nature of microfinance lending and minimal documentation requirements.

The BSP also recognizes the special requirements of microfinance operations for the conduct of bank supervision. This challenge is being met by setting a core of especially trained examiners.

With respect to cooperatives, the approach to prudential regulation and supervision is essentially the same as for banks since co-ops are considered deposit-taking entities, although the service is limited to their membership. However, the key challenge at present is developing the regulatory and supervisory capacity of the Cooperative Development Authority (CDA). This is a work-in-progress and the BSP is being tapped to assist in this undertaking.

Microfinance NGOs, as non-deposit-taking entities, are not subject to prudential regulation but are subject to increasing market discipline through enhanced disclosure and requirements for reports to be submitted to the Microfinance Council. Their performance is measured against a common set of performance standards, equally applicable to the other microfinance players.[70] The performance indicators for microfinance are focused on portfolio quality, efficiency, sustainability, outreach, and savings generation. These could be the basis for evaluation by donor agencies and other interested parties. Microfinance NGOs, to be recognized, likewise need to allow independent external audit.

The BSP and the National Credit Council (NCC) have supported the creation of a credit bureau which can help reduce credit pollution, promote greater borrower discipline, and lower credit risk especially on unsecured lending. Vogel and Llanto (2005) observe that the NCC and BSP have clearly recognized the need to take the initiative in the expansion of credit bureau databases to increase their effectiveness. The BSP is currently investigating the legal and operational requirements for making all regulated lenders supply information on all loans and for sharing this information with credit bureau databases in the private sector.[71] The availability of such information would increase the ease of assessing the creditworthiness of borrowers and should thereby greatly reduce the costs of lending to smaller borrowers in rural areas. Moreover, with the mass of information thereby available, non-regulated lenders (e.g., credit cooperatives and NGO micro-lenders) should not only find it not only very attractive to participate voluntarily, but also see the value of a reciprocal requirement to submit information to the database in order to have access.

NGO Transformation

As of August 1999, only one NGO had transformed into a formal financial intermediary. This is the Center for Agriculture and Rural Development (CARD). In 1990, CARD was serving 307 clients. In 1995, its client base had grown significantly, to 4,240. It was this point that CARD's Board of Directors considered the prospect of fully transforming the NGO into a regulated bank, as this was also the natural extension of CARD's original vision.[72] This strategy would provide the legal basis for mobilizing deposits from the public and enable the organization to tap commercial sources of funds. The Board sought a rural bank license because of the low capital entry requirements and the rural focus. CARD Rural Bank was registered with the Securities and Exchange Commission in May 1997. In August 1997, the Bangko Sentral ng Pilipinas authorized CARD to start bank operations with initial capital of PHP 5 million.[73] By the end of 1997, its active clients numbered 10,868.[74]

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[70] Ibid.

[71] According to the NCC, both houses of Congress are currently deliberating a bill creating a credit bureau. Meanwhile, the Monetary Board of the BSP is inclined to set up an interim bureau pending passage of the bill.

[72] Arelis Gomez et.al., "Regulations and Supervisions of MFI Activities: The Philippines Case Study" 19.

[73] At the prevailing exchange rate of US$1 = PHP 39.74 in August 1999, it had in capital US$167,000.00.

[74] Gomez et al., p. 20.

CARD Rural Bank has gone a long way from its NGO precursor and initial inception as a formal financial institution. In terms of outreach alone, CARD has reached a formidable status. Its outreach of 28,531 in 1999 rose to 35,704 in 2000 and 49,887 in 2001, and soared further to 69,223 in 2002.[75] By January 2003, CARD had reached out to 70,000 clients.

With the success of CARD Bank, other NGOs in the Philippines are seeking transformation to regulated bank status as well. In 2000, Alalay sa Kaunlaran sa Gitnang Luzon Inc. (ASKI) had announced its plans for transformation. As of February 2003, Tulay sa Pag-Unlad (in Metro Manila) and the Negros Women for Tomorrow Foundation (in Negros) were reportedly in the process of establishing themselves as a rural bank. Tulay sa Pag-Unlad had an outreach of 57,000 while Negros Women for Tomorrow Foundation had an outreach of 45,000.[76]

CARD is a pioneer in its field. Because of its success, it has shared its methodology with many other MFIs wanting to expand their outreach, increase repayment rates, and learn about NGO-to-bank transformation, all which were milestone events in the success of CARD. In a large way it has been spreading the word that microfinance interventions work in the Philippines, and they work in a big way.

Recommendations to Improve Regulation and Supervision of MFIs

Before indicating specific measures to improve microfinance in the country, there is a need to address the challenges of the macro environment. In this regard, Llanto (1998) put forward the following recommendations:

(1) The central bank should act as an advocate for sustainable microfinance. BSP should maintain its public support for the policies of the National Strategy for Microfinance and, in particular, the need to provide an enabling environment so that the private sector might participate in the provision of microfinance services.

(2) BSP should continue to promote market-driven interest rate and credit policies. BSP should continue to promote the market orientation of interest rate and credit policies and should resist very effort of certain sectors—for example, legislators—to put a cap or ceiling on interest rates for any class of lending, including poverty alleviation lending.

(3) Government initiatives to terminate subsidized credit programs and programs requiring direct government involvement in retail microfinance are worthy of BSP's support. BSP should support the government's continued implementation of Executive Order No. 138 that terminates subsidized credit programs and transfers the loan funds to government financial institutions for wholesale lending to private MFIs.

(4) The BSP should continue to play an active role to facilitate the engagement of banks in microfinance. This study has pointed out specific regulatory and supervisory practices which can either encourage or inhibit the involvement of regulated banks in microfinance. BSP should, therefore, review those regulations and practices with the objective of establishing a regulatory framework that is appropriate for microfinance banks or microfinance operations. At the same time, that framework should ensure the protection of depositors. BSP should continue its active role in the National Credit Council (NCC), lending its expertise to NCC efforts to improve the regulatory environment for banks to facilitate their engagement with microfinance.

BSP works with NCC on the creation of a favorable microeconomic environment for microfinance through appropriate regulation and supervision of MFIs. It is also responsible for the macroeconomic environment in which microfinance is conducted, by virtue of its overriding concern for price stability. This is the primary concern of most contemporary central banks and also one of the most important, if indirect, forms of support for microfinance that a central bank can provide (Llanto 1998).

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[75] Delgado, "An MFI Story of Motivation and Innovation: A Case Study on CARD Rural Bank, Inc."

[76] Chua et al., p. 23.

However, there could be unconscious regulatory discrimination against microfinance arising from the innate conservatism of bank examiners and a lack of understanding of the nature of microfinance. It is, therefore, important to review some of the factors that discriminate may against microfinance.

The Seeming Preference for Fewer, Bigger, Banks

The scarcity of regulatory resources might tempt central banks to have a preference for fewer and bigger banks. This view could also stem from the belief that bigger banks are more viable and sustainable. We submit that what is needed is a competitive financial market that motivates banks to become more efficient. A few big banks might use their dominant position in the market to their advantage and at a cost to clients. Bigger banks are not necessarily more viable than smaller banks. Apart from adherence to capital adequacy requirements, banks should be assessed for their ability to deal with and manage risks. It is important for banks to have in place policies and procedures that would enable them to handle their unique operating environments, and to have highly qualified management and technical personnel to deal with competitive financial markets.

Some Attitudes and Practices of Bank Examiners

While there seems to be nothing in BSP regulation that prohibits banks from providing unsecured loans, including small clean loans, conservatism and bias against microfinance constrain it. The collateral and documentation expectations of bank examiners may discourage banks from going into micro-lending. Interviews with banks indicated that (i) examiners do not look favorably upon business loans not supported by audited financial statements and (ii) bank supervisors take a dim view of unsecured lending.

Limits Imposed on Unsecured Lending

BSP wants to make sure that commercial and thrift banks' unsecured loans do not exceed 30% of their loan portfolio. BSP uses moral suasion to keep rural banks' unsecured loans under the same ceiling. Clearly, given the nature of microfinance loans, this regulation would necessarily limit rural banks' micro-lending activities. The point, however, is whether rural banks or any bank providing unsecured microloans have the capacity to handle those loans—that is, whether there is adequate capital and the necessary policies, procedures, and technical expertise to manage risks.

Prohibition of Deposit Pick-up Services.

In 1999, the BSP passed Circular No. 118, which prohibits house-to-house visits to pick up deposits, because of concerns about the security of deposits. It has been observed that small depositors are reluctant to go to banks if their homes or business sites are too far away, thus increasing their transaction cost. To entice savers, some rural banks have offered pick-up services to regular depositors. The prohibition could therefore adversely affect the rural banks' deposit mobilization performance. It is a challenge to find a middle way that will address both savings mobilization performance and the security of deposits.

Restrictions on Physical Facilities and Location of Branches

In the aftermath of the Asian currency crisis as well as the closure of some rural and thrift banks, the BSP in 1999 suspended bank branching and opening of new banks. The suspension works to the disadvantage of rural banks that seek to diversify their portfolios. BSP lifted the moratorium on the licensing of new thrift and rural banks in 2002 so that microfinance-oriented banks could be established in areas where they are most needed. However, BSP Circular 340 (July 2002) imposes high minimum equity requirements for geographical coverage and branching, and it allows an MFI branch to be set up only in areas not served by existing MF banking offices. BSP also imposes certain standards on the branches' physical structures to ensure security. The downside is that this may unnecessarily increase the cost of establishing new branches. It may benefit the development of microfinance to review these requirements.

Ceilings on Fixed Assets

Banks' investments in fixed assets were limited by BSP to 50% of net worth. Inasmuch as the success of a microfinance program relies heavily on the ability of the institution to track loan quality and other performance indicators, including computer equipment in the ceiling would discourage rural banks, especially those with small capitalization, from automating their operations. Efficiency would be hampered.

On the other hand, credit cooperatives represent a potentially strong sector for microfinance. The successful credit cooperatives have provided many poor members access to deposit-taking facilities. They have also provided micro-loans to their members. The strongest feature of credit cooperatives is their efficiency in mobilizing members and their deposits, thereby creating accessible deposit facilities and providing for small borrowers a good alternative to informal moneylenders in various communities. The main gap is the absence of a credible regulatory institution for credit cooperatives. However, a prior requirement would be the availability of a transparent and reliable data base on credit cooperatives. In this regard, the efforts of NCC to convince credit cooperatives to embrace the standard chart of accounts and performance indicators developed (by NCC) should be supported and promoted among credit cooperatives. Effective regulation and supervision will depend on transparent and reliable data, an updated registry, and the adoption of performance standards on portfolio quality, outreach, efficiency, and sustainable transparency.

Nongovernmental organizations (NGOs) are not subject to any prudential regulation. The present stance of NCC and BSP is to allow credit-granting NGOs to collect savings from their member clients without being subject to any prudential regulation provided that the collected savings do not exceed their total loan portfolio. Those that collect savings in excess of their loan exposures shall be required to transform into a regulated entity, that is, either as a bank or as a credit cooperative.[77] The current attitude of the regulatory authorities is to enjoin those NGOs to adhere to the performance standards developed by the Microfinance Council of the Philippines for the sake of market discipline and greater transparency.

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[77] Ibid., p. 5.

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SRI LANKA

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INTRODUCTION

In Sri Lanka, microfinance (MF) emerged more than ninety years ago with the launch of the cooperative societies.[1] Since the late 1980s, the MF industry has grown rapidly as the government has used micro-credit as a major instrument for poverty reduction. Apart from government agencies, a large number of local NGOs, foreign donor agencies, and several banks and other financial institutions have been involved in providing microfinance facilities throughout the country. As the traditional banking system has failed to provide financial facilities to the poorer segments of the population for reasons such as collateral requirements and various other stringent terms and conditions, microfinance has become popular, particularly among the poor, as a more flexible and customer-friendly financing source. While the microfinance industry has expanded rapidly, there are concerns about the long-term sustainability and effectiveness of microfinance institutions (MFIs). At present, no regulatory or supervisory framework is available for MFIs in Sri Lanka, except for banks and cooperatives.

This study will focus on the policy, legal, and regulatory environment for microfinance in Sri Lanka. It forms a component of the Survey on Microfinancing in selected Asian countries sponsored by the Asian Productivity Organization. The objectives of the survey are (a) to establish the status of microfinancing, and the legal and regulatory framework for microfinance in the countries to be surveyed, (b) to determine the impact of the legal and regulatory framework on MFIs, and (c) to recommend measures that will improve the legal and regulatory environment so that MFI productivity may be raised. In conducting the survey on microfinance in Sri Lanka, the survey instrument developed by the team of national experts headed by the chief expert was used to collect information and data from various organizations including government bodies, the Central Bank of Sri Lanka, commercial and specialized banks, and MFIs.

We have used the standard definitions of microfinance in conducting this country study. According to the Asian Development Bank (2000), microfinance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to the poor and low-income households and their microenterprises. In the context of Sri Lanka, micro-credit generally refers to loans up to SLR 40,000 (about US$ 400)—although the industry's average micro-credit amount is much lower, at around SLR 10,000 (US$ 100)—and other similar small-scale financial services (Charitonenko and de Silva 2002).

This report is organized as follows. The second section presents an overview of the economic achievements and government policy in Sri Lanka. As a background to the study, the third section gives a description of the financial system. The fourth section focuses on MF products and services. The fifth section analyzes government policy and the legal framework. The regulatory and supervisory environment for MFIs is explained in the sixth section. Specific regulatory requirements and supervisory practices are focused on in the seventh section. The final section of the report presents concluding remarks.

[1] The Thirft and Credit Co-operative Societies (TCCS) were set up in 1911.

ECONOMIC BACKGROUND AND GOVERNMENT POLICY

Socioeconomic Achievements and Policy Reforms

With an average per-capita GNP of around US$ 1025 (in 2004), Sri Lanka belongs to the lower middle-income category of countries, in terms of the World Bank atlas method. This per-capita income level is higher than those of the other South Asian countries, except for the Maldives, but is much low compared with many Southeast Asian countries. Nevertheless, Sri Lanka enjoys fairly impressive human development conditions, equivalent to some fast-growing countries in Southeast Asia and even to some developed countries, due to the widespread welfare programs adopted by the successive governments since independence. The score of 0.740 on the UNDP Human Development Index achieved by Sri Lanka in 2002 is much higher than the scores of many other developing countries, and the country's rank is 96 among a total of 177 countries in terms of this index.

Sri Lanka has completed more than 25 years of economic liberalization. In 1977, the then government embarked on a liberalization path by removing an array of administrative controls so as to create a market-friendly economic atmosphere conducive to the private sector, which was to be the engine of economic growth. The underlying objective of that reform package was to shift the policy focus from an inward-looking import substitution strategy to an outward-looking and export-led growth strategy. The initial policy package included the first generation of economic reforms like relaxation of import controls, reduction of tariffs, adoption of a flexible exchange rate system, removal of price controls, liberalization of the financial sector, and granting of incentives to foreign investors. All successive governments have pursued these economic liberalization policies continuously during the last two and a half decades. It is interesting to note here that Sri Lanka launched its liberalization policies much earlier than other South Asian countries. By the early 1980s, Sri Lanka became the most open economy in South Asia. The country's foreign trade grew faster than its output, reflecting greater openness; foreign trade as a ratio of GDP rose from 40% in 1977 to nearly 70% by 2004.

The liberalization process has had far-reaching socioeconomic implications in Sri Lanka. On the positive side, the liberalization has fostered a certain degree of export diversification, employment creation, output growth, and poverty reduction. Liberalization also helped the country to graduate from the low-income to the lower middle-income country group category by 1996. Income growth was associated with certain improvements in socioeconomic conditions, including health, education and housing.

But the actual production and income growth realized through liberalization is far below expectations. The growth momentum that was gained immediately after the liberalization diminished after a few years, and, alarmingly, Sri Lanka has now settled down to a low GDP growth trajectory of 3–4% a year. The successive governments have been attempting to deal with these problems by reviving the economic reforms consisting of structural adjustments and stabilization policies. These policy strategies are reiterated in the economic policy document (Ministry of Finance 2004) of the current government, which came into power in April 2004 after the general elections. Until then, the economic policies had been based on the policy document titled *Regaining Sri Lanka* of the previous short-lived government (Government of Sri Lanka 2003).

A major hindrance to economic growth has been the unstable macroeconomic setting characterized by high fiscal deficits, rapid money growth, high rates of inflation, and unwarranted balance of payments deficits. Factors such as political instability, contradictory economic policies, the war in the North East, low savings and investment levels, deficiencies in human capital, inadequate technological progress, weakened export competitiveness, low productivity, and poor infrastructure have jeopardized the growth efforts. Improper sequencing and frequent disruptions of the economic reforms also retard the growth process. Although the government initiated the first wave of economic reforms nearly three decades ago, the second wave of reforms relating to financial sector, taxation, privatization, and the labor market are yet to be implemented. As a result of the depressed economic growth, poverty and unemployment have remained acute in Sri Lanka.

Poverty and Income Inequality

Poverty is commonly defined as inadequacy of meeting basic needs for physical survival. The basic needs include food, clothing, and shelter. The poor can be identified as those persons who are so deprived that their physical survival is threatened due to insufficient meeting of these basic needs. Poverty is associated with low income levels. The magnitude of poverty is generally estimated by using a poverty line, which can be defined in terms of a cut-off per-capita income required to meet the basic needs, mainly the minimum calorie intake. Based on different definitions, cut-off points, and methodologies, various researchers have derived different poverty lines for Sri Lanka. We use here the poverty indicators derived by the Department of Census and Statistics.

As shown in Table 1, nearly one fourth of the households are poor. Also, more than one fourth of the population lives below the poverty line, as indicated by the Headcount Index. The incidence of poverty varies significantly across provincial and district boundaries. Larger proportions of the households in rural and estate sectors are poor, compared with the urban sector. Poverty is distinctly a rural phenomenon in Sri Lanka, because nearly 90% of the total poor live in rural areas.

Table 1. Poverty Indicators*

Area	Percentage of poor households			Head count index (%)	Poverty gap index (%)
	1990/91	1995/96	2002	2002	2002
Sri Lanka	30.4	26.7	23.9	27.9	23.6
Sector					
Urban	18.2	13.4	7.9	9.7	21.1
Rural	34.7	28.7	26.4	31.0	24.2
Estate	20.5	26.1	22.1	27.9	15.5
Province					
Western	20.1	12.2	12.2	14.3	20.4
Central	33.5	35.4	25.6	30.3	21.7
Southern	32.6	32.5	26.2	30.6	26.7
North Western	33.6	30.4	28.3	34.9	22.3
North Central	39.0	26.1	29.3	33.8	25.5
Uva	38.1	33.9	36.4	41.4	25.8
Sabaragamuwa	36.7	40.0	34.7	40.6	24.7
District					
Colombo	16.4	9.0	5.9	6.9	16.7
Gampaha	17.9	11.4	13.8	16.6	21.3
Kalutara	31.2	20.3	21.8	24.4	21.2
Kandy	37.4	36.3	25.7	29.9	21.1
(continued on next page)					

Matale	36.6	45.7	31.1	37.0	26.0
Nuwara Eliya	22.6	28.7	21.7	27.0	19.1
Galle	30.7	32.1	17.8	21.6	25.8
Matara	32.2	34.8	29.5	33.9	25.9
Hambantota	36.8	30.3	37.8	42.9	28.4
Kurnegala	35.3	29.5	30.5	36.6	23.3
Puttalam	29.2	32.5	23.6	31.4	20.0
Anuradhapura	41.1	25.6	29.5	34.3	26.5
Polonnaruwa	34.1	27.3	29.0	32.8	23.5
Badulla	38.8	27.1	37.7	43.6	25.6
Moneragala	36.5	47.7	33.8	37.1	26.2
Ratnapura	31.6	44.1	37.4	43.3	23.0
Kegalle	42.2	35.5	31.5	37.1	27.2
*Excluding the North and East					

Source: Department of Census and Statistics, "Household Income and Expenditure Survey," 1990/91, 1995/96, and 2000

There seems to be an inverse relationship between the poverty level and urbanization. Western and Southern Provinces, which are the most urbanized, have the lowest poverty levels. Conversely, Uva and North Western Provinces, which are the least urbanized, have the highest poverty levels. Poverty is acute in a large number of districts including Badulla, Hambantota, Matale, Kurunegala, and Ratnapura.

As indicated by the Gini Coefficients in Table 2, there has been no marked change in income distribution over the last two decades. The percentage of the total income shared by the poorest households declined from 15.2% in 1995/96 to 13.8% in 2002. This is reflected in an increase in the Gini Coefficient in 2002. The richest 20% of the households shared as much as 53.7% of the total income. The slow economic growth and the failure to trickle down the growth effects to lower income groups have aggravated income inequality in the country.

Table 2. Gini Coefficients for Households

Sector	1980/81	1985/86	1990/91	1995/96	2002
Urban	0.44	0.48	0.62	0.47	0.51
Rural	0.38	0.43	0.42	0.46	0.46
Estate	0.27	0.31	0.25	0.34	0.32
All Island	0.43	0.46	0.47	0.46	0.48

Source: Department of Census and Statistics, "Household and Expenditure Surveys"

Unemployment

As shown in Table 3, the unemployment rate has been on a declining trend in Sri Lanka since 1990. The high economic growth, averaging 5.4% per year, in the 1990s helped to bring down the unemployment from 15.9% in 1990 to 8.6% by 2000. The migration of a large number of workers to other countries, mainly to the Middle East, in the last two decades also has helped to ease the unemployment problem. The declining trend of the unemployment rate reversed to a certain extent in the last three years following the negative economic growth experienced in 2001,

Table 3. Economic Growth and Unemployment

Year	Real GDP growth (%)	Unemployment rate (%)
1990	6.2	15.9
1991	4.6	14.7
1992	4.3	14.6
1993	6.9	13.8
1994	5.6	13.1
1995	5.5	12.3
1996	3.8	11.3
1997	6.3	10.5
1998	4.7	9.2
1999	4.3	8.9
2000	6.0	7.6
2001	–1.5	7.9
2002	4.0	8.8
2003	5.9	8.4
2004	6.0	8.4

Source: Central Bank of Sri Lanka, Department of Census and Statistics

At present, around 700,000 persons are unemployed. Despite the declining trend of the overall unemployment rate, the unemployment problem is acute among the young. In 2004, the rate of unemployment was 30% in the age group of 15–19 years and 20% in the age group of 20–29 years. Another alarming feature is the high unemployment rate among the educated. In 2004, the rate of unemployment among those who have GCE (AL) or higher qualifications was as high as 17%.

The unemployment rate among women has continued to remain relatively high since the late 1970s, mainly as a result of the increasing trend of female labor force participation. In 2004, the female unemployment rate was as high as 13.2% as against the male unemployment rate of 6.3%. On the demand side, the range of vocations available for women was rather limited compared with that available for men due to physical reasons and social factors. Less mobility of female workers to locations away from their homes also restricted their job opportunities.

Development Strategies and Policies

The successive governments have pursued open and free-market-oriented economic policy strategies since 1977, as mentioned earlier. The present government, which took office in 2004, has pledged to continue the open economy policies while setting new directions to the growth and poverty reduction programs with a greater focus on regional balanced growth as well as rural and small and medium enterprise development. Structural reforms are being continued further as laid down in the Economic Policy Framework released by the government in July 2004. The government's policy statement and the Medium-Term Macroeconomic Framework (MTMF) announced with Budget 2005 has set out broad strategies to achieve macroeconomic stability and regional balanced growth over the medium term. The tsunami disaster of 26 December 2004 changed the macroeconomic outlook drastically and posed new challenges for economic development.

Policy Stance of the Government vis-à-vis Microfinance

Sri Lanka has had a long tradition of adopting social welfare policies to protect the poor. Since independence, the successive governments have provided various forms of welfare measures. The food subsidy program had been an important component of such facilities. Free provision of public health and education facilities are the other key components of the welfare programs. A main shortcoming of those programs was that food and other consumer subsidies were provided universally without targeting the poor. Those subsidies were withdrawn to a large extent in 1977 with the launch of economic reforms that aimed at uplifting the standards of living mainly by means of faster economic growth. In 1978, the government introduced a food stamp scheme targeting low-income groups, and abandoned the universal food subsidy program.

In the late 1980s, the government adopted a major reform with regard to its social welfare policy following a youth insurrection in 1987–88. In 1989, it launched a pioneering poverty alleviation program called "*Janasaviya.*"[2] It sought to improve the living conditions of the poor, for the first time, by promoting self-help income-generating activities through income support. For this purpose, it had a microfinance component. In 1991, the government established the National Development Trust Fund (NDTF) as a second-tier microfinance institution replacing the *Janasaviya* Trust Fund (JTF). The main function of the NDTF was to manage a credit fund for channeling credit through microfinance institutions (including NGOs, Rural Development Banks, commercial banks, and Cooperative Rural Banks) to partner organizations and to final borrowers for income-generating self-employment projects. The government that took office in 1994 discontinued the *Janasaviya* program and introduced the *Samurdhi* Program. The main objective of this program was to bring all major welfare programs under its umbrella.[3] The *Janasaviya* beneficiaries covered under the first four rounds were also absorbed into the *Samurdhi* Program.

An Overview of the Microfinance Industry

A large number of microfinance institutions dealing with small-scale financial services have emerged in Sri Lanka during the last two and a half decades. They provide a variety of products and services such as savings, loans, insurance, and business guidance. These services are not normally provided by commercial banks and other formal financial institutions due to high administrative costs and lack of skilled personnel to handle microfinance. The MFIs have adopted innovative policies and procedures in order to maximize the number of borrowers while keeping the cost of funds low. In addition to the MFIs, several commercial banks have also entered the MF field to offer such services on a commercial basis through different programs. These programs rely heavily on participatory approaches involving Community Based Organizations (CBOs) and Self-Help Groups (SHGs) for minimizing transaction costs and for effective supervision and recovery of loans.

On the basis of the purpose of MF, the organizations that provide microfinance can be classified into four broad categories (Table 4). First, various government agencies use MF as a poverty reduction strategy. The micro-loans provided by various poverty reduction schemes of the government account for more one third of the total number of outstanding micro-loans. They are highly subsidized loans characterized by political interests and high default rates. Second, banks and several other financial institutions provide microfinance for commercial

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[2] It targeted groups of poor people from among the food stamp recipients. Under that program, a monthly allowance of SLR 2500 was allocated to each family, comprising a food grant of SLR 1458 and a compulsory saving component of SLR. 1042. The program was scheduled to be implemented in 11 rounds in the selected Assistant Government Agent (AGA) Divisions, and priority was given to those divisions having the highest percentage of low-income people. The first five rounds were implemented during 1989–94.

[3] The quantum of benefit was divided into four levels; SLR 100, SLR 200, SLR 500 and SLR 1000 per family. The payment is based on the family income level.

purposes. Third, many NGOs and other organizations provide MF for social or cultural purposes. Finally, the government, international agencies, and NGOs are involved in MF activities in the North and East, which are affected by the ethnic conflict.

Table 4. Classification of Microfinance Activity

Microfinance purpose	Organization
Government policy tool for poverty alleviation at the national, regional, and local level	Central Bank, Ministry of Planning, *Samurdhi* Authority, NDTF, multilateral and bilateral agencies, Ministry of Regional Development and Plan Implementation, Ministry of External Resources
Commercial for-profit activity	Bank of Ceylon, DFCC, Hatton National Bank, National Savings Bank, People's Bank, Seylan Bank, small private organizations
Not-for-profit social or cultural development tool	National, regional, and local NGOs such as SEEDS, Agromart, Social Mobilization Foundation, CRBs, TCCS, Multilateral agencies and INGOs
Intervention tool in areas affected by conflict	Multilateral and bilateral agencies, INGOs, Government, local, and regional NGOs

Source: Richard Gant et al., *National Microfinance Study of Sri Lanka: Survey of Practices and Policies*, 2002

Microfinance providers can also be classified on the basis of their types (Table 5). A large number of bilateral and multilateral agencies provide MF funds as lenders/granters. Some organizations including certain government departments, Central Bank and foreign agencies act as funders/practitioners. There are also practitioners and facilitators of MF.

Table 5. Typology of Microfinance Actors

Actor Type	Organizations in Sri Lanka
Funding organizations	
Granters	AusAID, CIDA, DFID, HIVOS, ICCO, NORAD, SIDA, SLCDF, UNICEF, UNCHR, USAID
Lenders	DFCC, NDTF
Granter–lender	ADB, JBIC, NOVIB, World Bank
Funder–practitioners	
Granter practitioners	
International	CARE, DRC, FORUT, GTZ, Oxfam, SCN, UNDP, WVL, ZOA
National	Ministry of Plan Implementation
Lender–practioners	CBSL, RDBs, SANASA, commercial banks
Practitioners	
National level	*Samurdhi* Authority
Regional level	*Agromart*, *Arthachariya* Foundation, *Samatha Lanka Praja Sanwardena Mandalya*, *Sarvodaya*, *Sewa Lanka*, South Asia Partnership
Local level	CRBs, CBOs, TCCS, Local NGOs, GOSL, Private companies
Facilitators	
National level	The Microfinance Network, ICRTL
Local level	Microfinance Coordination Groups

Source: Gant et al.

THE FINANCIAL SYSTEM

Structure of the Financial System

Currently, the value added generated by the financial sector accounts for about 8% of GDP, and the sector's annual average growth rate in the last decade was around 7%. As one of the earliest sectors that was deregulated, the financial sector benefited from the liberalization policies and expanded considerably in the last 25 years. Sri Lanka's financial system mainly consists of the following institutions:

- Central Bank of Sri Lanka (CBSL), which is the monetary authority, plays the regulatory and supervisory roles in the financial sector.
- 23 licensed commercial banks; of them, 2 are state-owned, 9 are domestic private and the remaining 12 are foreign banks. There are 1003 bank branches spread throughout the country.
- 14 licensed specialized banks including long-term lending development banks, savings banks, and Regional Development Banks.
- 25 registered finance companies engaged in hire-purchase, leasing, and real estate business.
- 8 primary dealers engaged in dealing in government securities.
- 5 leasing companies.
- 10 merchant banks and investment banks engaged in a variety of financial services.
- Savings and loan associations such as Cooperative Rural Banks (CRBs) and various microfinance institutions. They collect savings from members and lend exclusively to members.
- Contractual savings institutions functioning in the forms of insurance establishments, Employees Provident Fund, Employees' Trust Fund, other provident funds and insurance companies.
- Other specialized financial institutions including 7 venture capital companies, 12 unit trusts, and the Housing Development Finance Corporation.
- Numerous individual money savers and lenders in the informal sector.

Central Bank of Sri Lanka

The Central Bank of Sri Lanka was established under the Monetary Law Act No. 58 of 1947. Its main functions include regulating and supervising licensed commercial banks, licensed specialized banks, registered finance companies, primary dealers, leasing establishments, and Employees' Provident Funds. The Central Bank's Department of Bank Supervision, which was established in 1951, supervises the commercial banks. The Department of Supervision of Non-Bank Financial Institutions was set up in 1988 to regulate and supervise the finance companies. The Central Bank's supervision, based on the Basel Accord, ranges from the examination of information collected from institutions for offsite surveillance of their performance to onsite examination of books and accounts. In order to ensure prudential standards, the Central Bank has required the institutions to disclose to the public timely financial information through newspapers. Further, banks and registered finance companies are required to display their annual financial statements at their head offices and branches for the information of the public. They are also advised to seek a credit rating from the rating agencies.

Commercial Banks

The banking sector is the largest segment in the financial sector. The entry of foreign banks and domestic private banks has helped to improve efficiency and dynamism in the banking sector. However, the financial sector continues to be dominated by the two state-owned banks, the Bank of Ceylon and People's Bank, which together account for more than half of the deposit base and credit disbursements of the banking system. The government has taken certain steps to restructure the state banks since the early 1990s, as a major component of the financial sector reforms. The government has used the two banks extensively to channel microfinance facilities to the poor over the last several decades.

The banking sector provides the following services.

- Domestic banking: savings, loans and advances, financial advice, payments advice, money transfers, standing orders, trustee/administrative services, legal services, electronic fund transfers, guarantees, corporate services.
- International banking: foreign savings, loans in foreign currency, foreign trade financing, mail/telegraphic transfers, inward remittances, guarantees, and status reports.

In general, commercial banks, by their very nature, are conservative in making decisions on credit delivery, and tend to attach greater importance to the collateral offered by borrowers. This has acted as a major deterrent towards expanding the volume of credit, especially to low-income entrepreneurs. The outstanding loans and advances of commercial banks amounted to SLR 529 billion or US$ 5.3 billion (24% of GDP) as of the end of 2004. Credit is mainly disbursed for trade (39%), manufacturing (10%), services (10%), housing (14%), and consumption (12%).

The financial performance of the banking sector has weakened considerably over the years mainly owing to substantial nonperforming loans. The ratio of nonperforming loans to total advances is high for all categories of banks; the state banks are the worst off with a ratio of 19%, followed by the private sector banks with a ratio of 16% and foreign banks with a ratio of 13%.

Nonbank Financial Institutions

- Finance companies have expanded rapidly since the liberalization of the economy. They usually offer higher returns to depositors than do commercial banks. The fixed deposits are the main source of funding for finance companies. The outstanding amount of such deposits stood at SLR 38 billion (US$ 0.38 billion) at the end of 2004. The total assets of finance companies amounted to SLR 66 billion; of them, loans and vances accounted for 70%. They provide loans mainly for leasing and hire purchasing of motor vehicles, land, and housing. The companies accept such assets as collateral in disbursing the loans.
- A large number of pawnbrokers are operating all over the island. But there is no mechanism to gather information on such activities.
- Cooperatives have an extensive network of societies covering the entire island.
- Various types of other specialized financial institutions are in operation. They include merchant banks, leasing companies, venture capital companies, insurance companies, and primary (government security) dealers.

Informal Lenders

Historically, poor households have extensively resorted to borrowings from non-institutional sources such as moneylenders, friends, and relatives, as access to banks and other formal financial institutions is difficult for various reasons such as collateral requirements, paperwork, and loan processing delays. The informal moneylenders usually charge high interest rates varying from 5% to 20% per month. Despite the high cost of funds, borrowers rely on the moneylenders for reasons such as easy accessibility, lending without collateral, and low transaction costs. Moneylenders select borrowers on the basis of trust and control. Therefore, the default rate for informal lending is usually very low.

With the expansion of financial institutions, a decline in the dependence on such lenders is evident in recent years. Nevertheless, non-institutional sources still meet about one-third of household borrowing needs.

Emergence of Microfinance Institutions

In Sri Lanka, the origin of microfinancing can be traced back to the early 1900s. In 1911, the British government passed legislation to set up credit cooperatives in Sri Lanka. However, the government did not interfere with the activities of the cooperatives in the initial phase up to 1942. Village superiors like landlords and village headmen dominated the cooperative societies. These societies did not show much growth during the initial phase.

Following the food shortages emanating from the Second World War, the government became involved in cooperatives in the second phase that began in 1942. The government initiated the formation of Cooperative Agriculture Production and Sales Societies (CAPS), and provided credit facilities to them. The number of CAPS rose from 26 societies with 8694 members in 1947 to 994 societies with 247,000 members in 1957.

In the post-independence period, the government largely concentrated on agriculture credit, particularly for paddy cultivation. These credit facilities were granted mainly through the two state-owned banks, the Bank of Ceylon and People's Bank. Under various rural credit schemes, the Central Bank provided funds to the two banks at subsidized interest rates. These cultivation loans were written off in many instances due to political pressures, and such actions led to moral hazard. In 1964 the government established the Cooperative Rural Banks (CRBs). This was a major contribution in the field of microfinance.

Although microfinance has a long history in Sri Lanka, its growth accelerated only in the late 1980s when the government began to use microfinance as a major instrument for employment generation and poverty reduction. During 1986–1991, the government initiated an array of policy measures to expand credit facilities to the poor under its poverty alleviation strategy. The *Janasaviya* program was the major instrument of the government's poverty alleviation strategy. The government established the *Janasaviya* Trust Fund in 1990. In the meantime, the Central Bank established the Regional Rural Development Banks (RRDBs) in 1986. It also launched the Small Farmers and Landless Credit Project (SFLCP) in 1991. Various microfinance programs launched by local NGOs, foreign NGOs, and international donor agencies supplemented the initiatives of the government and the Central Bank. Some of the major microfinance institutions and programs in operation are described below:

- ***Samurdhi* Development Credit Scheme or SASANA Scheme:** The government inaugurated this scheme in 1996 in order to promote income-generating self-employment opportunities among the poor so as to raise their income levels, thereby making them self-reliant and self-supporting. Under this scheme, the *Samurdhi* beneficiaries are eligible to obtain loans of up to SLR 10,000 for undertaking new income-generating activities or expanding an existing business. As part of the *Samurdhi* movement, *Samurdhi* Bank Societies (SBS) were set up throughout the country to promote savings and to disburse credit. In 1997, the government established the *Samurdhi* Authority and its microfinance scheme. The government heavily subsidizes this scheme, which does not operate on a sustainable footing. The capital provided by the government was lent through the state commercial banks to final borrowers at highly concessionary interest rates. In addition, the administrative costs associated with village task forces are borne by the government. There are no proper estimates of costs. The government's transfers to the scheme amounted to

SLR 8.5 billion (0.4% of GDP) in 2004. This estimate, however, does not include indirect costs borne by various ministries and government agencies.

- **Regional Development Banks:** the government established the Regional Rural Development Banks (RRDBs) in 1985.[4] A major objective of setting up the RRDBs was to provide credit to remote and unbanked areas in the rural sector. The RRDBs introduced innovative lending methodologies in order to make institutional credit more accessible to the poor. As the poor are unable to furnish the collateral usually required by commercial banks, they are excluded from the formal financial sector. To overcome this problem, the RRDBs motivated their field officers to develop a close relationship with the clients and allowed them to offer loans without collateral on the basis of the reliability of clients and the viability of the projects to be financed. The RRDBs also popularized the concept of *inter se* guarantee, which means groups of individuals guaranteeing of each other's loans. In addition the RRDBs introduced group loans enabling the borrowers to achieve economies of scale in resource use and cost effectiveness. Thus, setting up the RRDBs was a major breakthrough in the microfinance industry in the country. 1997, the government restructured the RRDBs and set up province-based Regional Development Banks (RDBs). This reform was expected to re-capitalize RRDBs, expand their resource and operational bases, strengthen internal control systems, inculcate professionalism, and broaden the ownership base. Under the reform, the ownership and control of the Central Bank was reduced. Now, the Bank of Ceylon, People's Bank, Employees' Provident Fund, and Central Bank share ownership of the RDBs.
- **Self-employment Promotion through Microenterprise Credit (*Surathura* Scheme):** The government launched this scheme in 1996, aiming at providing microfinance to the educated unemployed for undertaking self-employment income-generating activities. A sum of SLR 350 million was allocated by the government for refinancing the *Surathura* loans granted by the three participating credit institutions, viz. Bank of Ceylon, People's Bank, and Hatton National Bank. The scheme is operated throughout the island. Following the success of the scheme, in terms of outreach and loan recovery, the government introduced Phase II of the scheme in 1997. In line with the government's policy of converting the state-funding schemes to self-funding ones, this phase is funded by the three participating credit institutions.
- **Sarvodaya Economic Enterprise Development Services (SEEDS):** Reflecting the onset of NGO involvement in microfinance, *Sarvodaya Shramadana Sangamaya* (SSS), the largest NGO in the country launched a microfinance division called the Sarvodaya Economic Enterprise Development Services [Guarantee] Ltd. (SEEDS) in 1986. The mission of SEEDS is to alleviate poverty among the rural poor in Sri Lanka by raising the economic conditions and income levels of the membership of SSS; to strengthen each SSS to become a self-reliant, self-funding and self-managing institution; and to ensure their sustainability as alternative development institutions. This program, operated in 18 districts, has 2770 societies. SEEDS also functions as a link institutions in the credit schemes implemented by the Central Bank, National Development Trust Fund (NDTF) and the National Development Bank (NDB).
- ***Gami Pubuduwa* Scheme**: The Hatton National Bank (HNB), a private commercial bank, experimented with a hybrid of linkage banking by inaugurating its *Gami Pubuduwa* Scheme (GPS) in 1989. Under this scheme, HNB has successfully established partnership with a number of NGOs and Self-Help Groups (SHGs). These

[4] Enacted under the RRDB Act of 1985.

NGOs and SHGs introduce potential borrowers to the bank, monitor loans, and take follow up action and help the bank to recover loans. The GPS is operated and directed by specially trained permanent officers attached to the relevant branch of the bank.

- **Thrift and Credit Cooperative Societies (TCCSs) Credit Scheme—SANASA**: TCCS, popularly known as SANASA Societies, perform a useful role in the rural sector by mobilising rural savings and extending micro and small loans to members. It also functions as a linkage agency in rural lending by establishing partnership with a number of national and regional credit schemes. The SANASA activities culminated in 1997 when the SANASA Savings and Development Bank was set up as a specialized banking institution.
- ***Janasakthi* Banking Societies in Hambantota**: The Women's Development Federation (WDF) in Hambantota set up the Janasakthi Banking Societies (JBSs) in 1989. The objective of this imitative was to empower the women in poor families in the area to become both socially and economically self-reliant.
- **Social Mobilization Foundation (SMF) in Hambantota:** In 1986, the government's Hambantota Integrated Rural Development Program launched a Social Mobilization Program. This program enabled the establishment of an organizational structure consisting of small producer groups, self-banking societies, and the SMF. The program has evolved in a three-tier organizational structure: small groups at the neighborhood level, Self-Bank Societies (SBS) at the village level, and Joint Bank Societies at the divisional level.

MICROFINANCE PRODUCTS AND SERVICES

The MFIs provide a variety of services including savings mobilization, micro-lending, insurance, training, technical know-how, and market guidance. These MF services are available in most parts of the country. The supply of MF is high relative to the population. Supply is higher in the Southern Province and the districts of Kurunegala, Polonnaruwa, and Puttalam, and lower in the North and East. Savings mobilization and loan disbursements are the major microfinance activities, as shown in Table 6.

Types of Microfinance Products and Services

Mobilization of Savings

A large number of MFIs provide savings facilities to their members, although deposit mobilization is restricted to banks and other specified financial institutions under the Banking Act. The savings schemes operated by selected MFIs/schemes are described below:

- Voluntary savings banking facilities under the *Samurdhi* scheme: These facilities are aimed at inculcating the savings habit among the poor so as to reduce their vulnerability. Accordingly, beneficiaries form groups of five, and leave a small amount of their *Samurdhi* receipts weekly or fortnightly to build up a group fund. The money is collected by an appointed treasurer, who may deposit it in a *Samurdhi* bank. These are a special kind of bank set up for the scheme, and they are not regulated or supervised by the Central Bank. The money so collected may be lent to a member of at a low interest rate in a case of emergency or may be invested by the group itself, in rare instances, towards a common project. The program encourages small group savings among *Samurdhi* recipients. The Niyamakas help to organize the groups. *Samurdhi* banks are established as cooperatives. A *Samurdhi* beneficiary can become a member of such a bank by purchasing a share of SLR 500. There are different types of deposits including group savings deposits, mothers' deposits, and children's de-

Table 6: Savings Mobilization and Loan Disbursements of Selected MFIs, 2002

	Cooperative Rural Banks (CRBs)	Regional Development Banks RDBs)	SANASA	SEEDS	Janasasthi Bank	SANASA Development Bank	Total	Percentage
Total savings	18,688	6,344	4,902	n.a.	65	1,490	31,489	100.0
Savings	13,477	4,102	1,385	n.a.	28	380	19,372	61.5
Special savings	5,211	0	1,899	n.a.	17	6	7,133	22.7
Fixed deposits	0	2,242	741	n.a.	1	943	3,927	12.5
Shares		0	877	n.a.	19	161	1,057	3.4
Total loans granted	3,327	6,345	3,176	1,039	367	646	14,900	100.0
Agriculture	850	497	573	103	308	7	2,338	15.7
Animal husbandry	101	64	165	29	0	0	359	2.4
Fisheries	33	47	0	18	0	0	98	0.7
Small industries	280	340	62	157	29	12	880	5.9
Building construction etc.	185	0	1,233	0	0	56	1,474	9.9
Projects/commerce	226	499	288	564	0	209	1,786	12.0
Other	1,652	4,898	855	168	30	362	7,965	53.5

Source: Central Bank of Sri Lanka

posits. Small group savings account for most of the deposits. The *Samurdhi* implements a variety of credit and development schemes to promote microenterprise development. The program has developed its own banking network. These banks are managed by the *Samurdhi* managers. Under this scheme, the members of the savings groups become shareholders of a bank, enabling them to deposit a part or all of their savings in the bank and withdraw it if needed. A single member in a group can withdraw money from the group account on the approval of the group and the zonal committee. Loans are given for cultivation, self-employment, consumption, emergencies, and fisheries. The recovery rate is found to be very high mainly as a result of peer-pressure to repay the loans.

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- SEEDS encourages its society members to save using several different schemes:
  · Ordinary savings: to save any amount whenever possible.
  · Compulsory savings: to save an agreed amount monthly.
  · Children's savings.
  · Fixed deposits: to deposit a fixed amount of SLR 500 or above for a period of one year or more.
- *Janshakthi* Banks: The WDF has evolved a credit culture by promoting savings habits among small groups of five members. There are different types of savings including shares, associate deposits, children's savings, elders' savings, fixed deposits, common funds, *Amma*, *Devi*, and *Sisusaviya*. :

- Regional Development Banks: There are specific saving schemes for children, women, government servants and plantation workers. There are three types of deposits: fixed deposits, savings deposits, and development certificates.
- TCCS and *Sanasa* Development Bank: the savings schemes include fixed deposits, compulsory savings, and non-member deposits.

Disbursement of Microcredit

Disbursement of microcredit to the poor is a major function of most MFIs. Various types of loans are available for the borrowers. Loans are given for cultivation, small businesses, consumption, emergencies, and fisheries. The recovery rates for these loans are fairly high as the loans are based on the group lending method. Some of the loan schemes are described below:

- *Samurdhi* banks offer loans to members, mainly for agricultural and self-employment activities. Repayment begins from the date of loan disbursement. Income generating loans are usually available at an interest rate of 3% per month. Consumption loans are offered at a lower interest rate. Approximately one half of the funds and assets of *Samurdhi* banks are invested in Treasury Bills and other securities, and the balance is made available as loans. Credit program funds are made available for *Samurdhi* beneficiaries through the People's Bank and Bank of Ceylon.
- *Janashakthi* Banks: The WDF has also encouraged small groups to develop credit discipline by disbursing small loans initially and increasing the size of the loan depending on regular loan repayment. Lending facilities are available for purposes like agriculture, self-employment, small-scale enterprises, fisheries, disaster relief, consumption, and housing.
- SEEDS provides three types of loans: Type A Loans are disbursed to initiate or develop income-generating projects. The target population consists of the absolute poor. Funding for the loans comes from CIDA, NDTF, JBIC, and ISURU. Type B Loans are provided to enhance the quality of life of SEEDS' clients. Type C Loans are issued to expand successful rural enterprises aimed at creating new employment opportunities in the rural sector.

"Credit-Plus" Services

Small-scale entrepreneurs usually do not have access to market information, technologies, and financial services. Thus, provision of credit alone is not sufficient to develop their enterprises. In order to address these problems, the MFIs have developed an approach that is known as "credit-plus." For example, the SEEDS provide, in addition to savings and credit facilities, various other services like training, information, advice, marketing opportunities, and technical skills. The SEEDS delivers these "credit-plus" services through its Banking, Training, and Enterprise Service Divisions.

Insurance Services

Some of the major MFIs provide insurance services to their clients as follows:

- The Samurdhi scheme has a social insurance scheme. The beneficiaries of the highest consumption grants pay a premium.
- The SANASA-TCCS developed the All Lanka Mutual Assurance Ltd. (ALMAO) to provide insurance cover to the poor. ALMAO provides life insurance, social security coverage, loans and savings protection, and property insurance and personal accident

benefits. Such benefits have been provided to more than 40,000 poor households in seven districts.

- The SEEDS has taken steps to provide micro-insurance cover to members of the Sarvodaya Shramadana Societies who are exposed to a wide variety of hazardous or unforeseen events.
- The WDF has four measures to protect the bank network: (a) Insurance: The Bank Societies are required to credit 1% of all loans disbursed by them to the Insurance Fund maintained by the WDF, which meets the credit risk when a member is unable repay a loan for reasons such as death or lifelong disablement of the borrower or a robbery. In addition, cash paid into the Bank Societies and cash in hand is insured by the WDF. For this purpose, the societies are required to pay a premium to the WDF. In addition, 3% is deducted from all housing loans and credit to the insurance fund. (b) Loan loss reserve fund: It is compulsory for the Bank Societies to credit 20% of profit from interest to the Loan Loss Reserve Fund. This fund enables the Societies to set off loan losses, when they unable to recover loans. (c) Contingency Fund: This fund has been built up with a 5% deduction from all loans issued for development purposes. The fund is held separately for the protection of Bank Societies. (d) Deposit Fund for safety of shares and savings: The Bank Societies are required to deposit 100% of funds raised on shares and 35% of savings with the WDF. The WDF invests these funds in treasury bills and commercial banks.
- The RDBs help those borrowers who fail to repay their loans through insurance cover, credit guarantee, loan rescheduling, and rehabilitation of sick loans.

Micro-lending Technologies or Methodologies used by MFIs

Microfinance practitioners adopt different technologies and methodologies in delivering their services. These can be grouped into four broad categories, as shown in Table 7: (a) cooperative method; (b) group method following the Grameen Bank model, which does not insist on collateral; (c) primary bank societies for mobilizing savings; and (d) barefoot banking model. In addition, several MFIs provide credit-plus services as described in the earlier section.

Table 7. Lending Methodologies Used by MFIs

MFIs/Schemes	Lending methodologies	Number of members	Loans outstanding at end of 2003 (SLR Mn.)
Samurdhi	Group lending Primary bank societies	2,108,096	11,393
Thrift and Credit Cooperative Societies (TCCS)	Cooperative method Primary bank societies	n.a.	8,447
Cooperative Rural Banks (CRBs)	Cooperative method Primary bank societies	614,497	n.a.
SEEDS	Group lending Primary bank societies	n.a.	6,757
Janashakthi Banking Societies	Group lending Primary bank societies	n.a.	1,077
Small Farmers and the Landless Credit Project (SFLCP)	Group lending Primary bank societies	89,189	1,110
(continued on next page)			

Poverty Alleviation Microfinance Project (PAMP)	Group lending Primary bank societies	46,536	291
Gami Pubuduwa Scheme	Group lending Barefoot banking	40,000	2,000

Source: Central Bank, MFIs

Lending methodologies adopted by selected MFIs are described below:

- The Women's Development Federation (WDF) widely uses the method of group lending for loan disbursements. The WDF, as the apex organization, coordinates and supervises the activities of the 67 *Janashakti* Bank Societies (JBS). In turn, the JBS oversee the 463 village-level Rural Women Development Societies (RWDS). The RWDS consist of 5,528 smaller five-member groups. As shown in Fig. 1, the *Janashakthi's* organizational structure is based on a bottom-up approach. Its leadership, management, and staff are drawn from the grassroots-level membership. Each five-member group guarantees repayment of loans by its members. This mechanism eliminates the conventional requirement of collateral or outside guarantees.

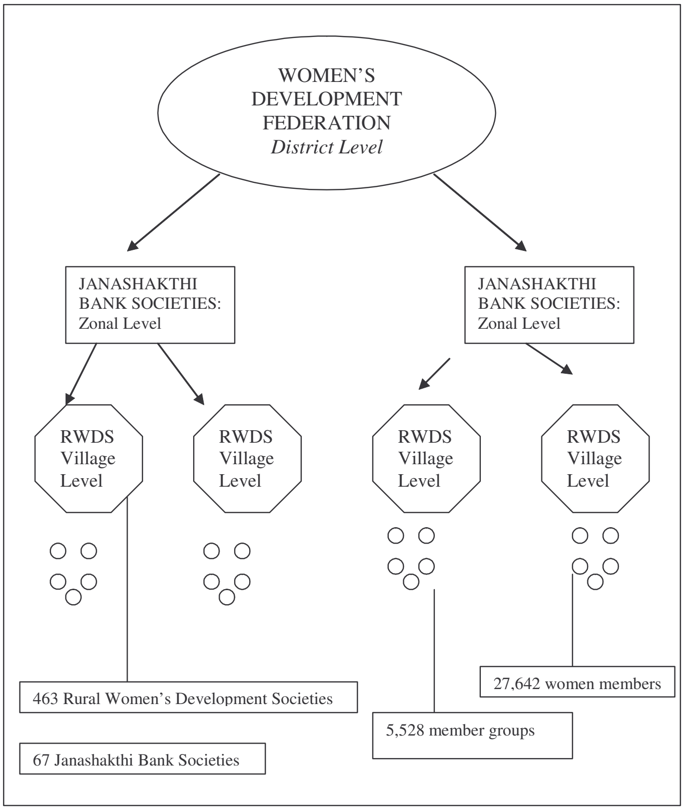

Fig. 1. Organizational Structure of *Janashakthi*

- The SEEDS also applies the group lending method for Type A loans which targets the poorest of the poor. The target groups are identified through selection sessions. The prospective beneficiaries are mobilized into self-help groups. Each group mobilizes savings with a compulsory minimum deposit per week. Loans are provided by accepting guarantees of group members. The maximum loan amount is SLR 10,000 at the first loan cycle, 20,000 at the second loan cycle, and SLR. 40,000 at the third loan cycle. The maximum loan amount that can be borrowed after the third cycle is SLR. 50,000.

- *Sanasa* Development Bank (SDB) operates the following lending mechanisms for microfinance programs:
  - · Loans are disbursed to Sanasa Primary Societies for short-term and medium-term credit requirements of their members. Each society is given SLR. 100,000 to be repaid in four years.
  - · Group loans to Sanasa and non-Sanasa groups to provide credit to entrepreneurs who are generally engaged in business of common interest and who are in close proximity to each other.
  - · Loans to indigenous people's organizations and community-based organizations (CBOs).
  - · Lending through NGOs to meet the credit needs of groups of micro-entrepreneurs.
  - · Partnerships with international agencies; several such agencies also make available funds to augment the Sanasa microfinance program.
  - · Community banking program: A special cluster is identified in each district where a Sanasa branch is established. The cluster has about five Sanasa Primary Societies which cover nearly 10 villages, i.e., around two thousand households. The bank, with the help of the society, identifies the needs for infrastructure and microenterprise development of the cluster. In the absence of any formal organization, the bank forms a microfinance group to meet the credit requirements of the group.

Collateral Requirements for Micro-loans

The MFIs heavily depend on the group lending method in disbursing loans. The members of small groups guarantee the repayment of loans taken by each member. The peer pressure has been very effective in recovering loans. This mechanism has eliminated the conventional requirements of collateral or outside guarantees to a large extent. Third-party guarantees and mortgages of property are also used to ensure repayment of loans.

GOVERNMENT POLICY AND LEGAL FRAMEWORK

Policy and Law Supporting and Promoting Microfinance

As mentioned earlier, the government plays several contrasting roles in the microfinance sector. First, the banking institutions that are involved in microfinance are subject to prudential regulation and supervision by the Central Bank. Second, the government has an intention to develop a sustainable microfinance sector. Third, both the government and the Central Bank themselves are directly involved in providing micro-credit to the poor though various poverty reduction schemes. Most of these schemes include (a) highly subsidized loans involving low repayment obligations and (b) savings schemes, which contradict the Monetary Law Act and Banking Act. Thus, the government does not seem to have a consistent policy strategy for the microfinance sector.

Until the 1990s, the government had supported the rural sector by directly providing concessional credit facilities and other financial benefits, particularly for paddy cultivation. Since then, the government has phased out such direct interventions in line with its private sector-oriented growth strategy and financial sector reforms. Accordingly, the government facilitates credit delivery to the rural sector through MFIs and other financial institutions. The previous government, which was in power until 2004, intended to (a) promote integration of

MFIs into the larger financial markets in the country and (b) develop an institutional mechanism to regulate and supervise MFIs.[5] But those expectations never materialized.

In an effort to promote the microfinance industry, the government established the Rural Finance Sector Development Project (RFSDP) in collaboration with the Asian Development Bank in 2003. It commenced operations in 2004. In its first phase, the project aims to create a conducive environment for rural finance institutions to carry out sustainable operations by assisting them by way of providing training, consulting, and introducing changes to the legal structure. In 2005, the Ministry of Finance was given the responsibility for the microfinance sector. A new institutional arm called the Development Finance Department (DFD) has been set up in the ministry for this purpose. This reflects the government's firm commitment to reform and strengthen the microfinance industry. An appraisal mission has submitted a report to the government to implement the program "Promotion of Microfinance Sector in Sri Lanka" (PROMIS).[6] The program's objective is to encourage MFIs to deliver market-driven, sustainable, and poverty-focused financial services. There are three program components; (a) improving the central government authorities' capacity to integrate microfinance into the financial system framework; (b) offering improved services through the microfinance service providers (supported by the program) to the microfinance industry; and (c) strengthening the base of MFIs to provide improved financial services. The duration of the program is 10 years (2005–15), subdivided into 3 implementation phases.

Microfinance Programs Supported by the Government

Samurdhi Program

The *Samurdhi* program, which was launched in 1996, is the government's major poverty reduction program. It replaced the previous government's poverty alleviation program, *Jansaviya*. The *Samurdhi* program has been the single largest welfare program in the country since its inception. A total of 1.9 million of families receive Samurdhi benefits. The total expenditure of the scheme exceeds SLR 10 billion a year, which is nearly 1% of GDP.

The *Samurdhi* program has two components as follows:

a. *Samurdhi* Development Credit Scheme (SASANA), *Samurdhi* Enterprise Credit Scheme (SAVANA) and *Samurdhi* Leasing Scheme: SASANA offers development loans at an interest rate of 10%, which is lower than the market interest rates. The standard loan size is SLR 2500–10,000. SAVANA offers loans ranging from SLR 10,000 to SLR 50,000 for starting new enterprises and maintaining existing ones at the same interest rate. These are offered at subsidized interest rates. These conventional lending programs are operated by the state-owned banks. The default rates are very high in the case of these loans, and the government bears the credit risks.
b. *Samurdhi* Bank Program: This is based on the Grameen Bank model characterized by group liability (collateral). Individuals in the five-member groups save a part of their Samurdhi income transfers weekly or fortnightly to build a group fund. The money so collected may be lent to a member at a low interest rate in case of an emergency or

[5] "Sri Lanka has an extensive array of *micro-credit institutions*, many of which have received considerable support from the government. Future support for micro-credit institutions will aim at twinning these bodies with larger financial market institutions and encouraging a shift from micro-finance schemes *per se* to the development of financially sound and sustainable organization, with focus on women. The National Development Trust Fund will be restructured to become an apex organization for the development of micro-finance. A body will be established with responsibility for developing policy and exercising regulatory functions for the many micro-finance organizations. Complementary to this will be the development of a legal framework that clarifies the role and responsibilities of the different organizations involved in micro-finance. Government will prepare a Micro-Finance Institutions Act to provide that clarity" (Government of Sri Lanka, "Regaining Sri Lanka," 2003).

[6] This report (David Radke et al.) is based on a joint GTZ-KfW-SIDA "Fact Finding Mission Report," 2004.

may be invested by the group itself, in rare instances, towards a common project. The groups that have successful savings and credit operations can get together and form Samurdhi Banking Societies. The Samuurdhi Managers manage these banks. The members of the groups can become shareholders of a bank by purchasing shares worth SLR 500, enabling them to deposit a part or all of their savings in the bank and withdraw it if needed. A single member in a group can withdraw money from the group account on the approval of the group and the zonal committee. Samurdhi banks offer loans to members mainly for cultivation, self-employment, consumption, emergencies, and fisheries. Repayment begins from the date of loan disbursement. Interest is charged at market rates. Approximately one half of the funds and assets of a *Samurdhi* bank are invested in Treasury Bills and other securities, and the balance is made available as loans. The recovery rate is very high, mainly as a result of peer-pressure to repay the loans. These banks are not subject to regulation or supervision by the Central Bank.

National Development Trust Fund

The government also provides support for microfinance through the National Development Trust Fund (NDTF), which was established, as a second-tier body, in 1991 under the Trustee Ordinance. Earlier it was known as the Janasaviya Trust Fund (JTF). The NDTF was funded by the World Bank, the Federal Republic of Germany and the Government of Sri Lanka. A twenty-member board of trustees appointed by the government manages the NDTF. The members are from both public and private sectors. The Board manages a credit fund, which is used to channel credit to final borrowers for income-generating and self-employment projects through partner organizations including RDBs, NGOs, commercial banks, and CRBs. The Board also manages the human resources development fund, the rural works fund and the nutrition fund.

The NDTF has maintained a high repayment rate of more than 90% on its loans to partner organizations. While the operations of the fund had been successful in several respects, it encountered a number of problems.[7] However, as observed by McGuire *et al.* (1998), in comparison with the traditional arrangements, second-tier MFIs such as the NDTF offer a number of advantages:

- They can ensure that all MFIs face a level playing field, with support available to all MFIs meeting predetermined standards.
- They can require that MFIs face one set of performance and reporting standards.
- By lending to MFIs, they can also harness the strengths of non-government microfinance programs.

Credit Facilities through the State Banks and Rural Banks

As already mentioned, the earlier credit facilities of the government were characterized by subsidized interest rates, funding by the Central Bank, and periodic loan write-offs. Such loans were disbursed mainly through the two state-owned banks, Bank of Ceylon and People's Bank. Some of these credit facilities are still continuing.

The setting up of the Cooperative Rural Banks (CRBs) in 1964 was a major contribution of the government to microfinance. The CRBs, which form the rural bank arm of the People's Bank, are directly linked to the Multi-Purpose Cooperative Societies under which they

[7] The mid-term review by the World Bank in May 1995 classified the project as a "problem" project. Difficulties included (a) inadequate processes for selecting partner organizations, (b) inadequate monitoring and supervision by NDTF, and (C) inappropriate targeting of the program.

operate. A major objective of CRBs was to provide banking facilities to the rural poor who hitherto had no access to institutional sources.

The government intervened in providing microfinance in a larger scale in the second half of the 1980s. In 1986, the government and the Central Bank took action to establish the Regional Rural Development Banks (RRDBs) under the RRDB Act No. 15 of 1985. A major objective of the RRDBs was to take banking facilities, mainly rural credit, to the remote and un-banked areas in the rural sector. For this purpose, the branch network of the RRDBs was expanded to reach out the rural population. By 1996, there were 17 RRDBs with 175 branches in different districts. In delivering credit, the RRDBs used innovative methods following the Grameen Bank model of Bangladesh. They did not insist on collateral or guarantees, but offered credit on the basis of the viability of the project to be financed. Group lending was another new technology adopted by the RRDBs. As a result of these client-friendly methods, RRDBs became effective in rural credit delivery, despite certain setbacks like inadequate internal auditing and inconsistent accounting standards.

As mentioned earlier, the RRDBs were restructured in 1997 to form the Regional Development Banks (RDBs).[8] The objective of the RDBs is to provide finance for agriculture, industry, trade, commerce, and fisheries activities, and for projects of *Samurdhi* beneficiaries of the region. Separate RDBs were set up in six provinces (Ruhuna, Kandurata, Rajarata, Wayamba, Sabaragamuwa, and Uva) covering 18 administrative districts. Following the restructuring, the RDBs have autonomous management. With the recruitment of efficient managers, the banks are showing reasonable profits and dividends.

Microfinance Programs Supported by the Central Bank

The Regional Development Department (RDD) of the Central Bank functions as the apex agency for a number of donor-funded and government-sponsored credit schemes. It implements policies and programs through participating credit institutions (PCIs) with a view to facilitating micro, small, and medium-scale enterprise. The main functions of the RDD are (a) issuing operating instructions to PCIs, (b) disbursement and recovery of refinance under the credit schemes, (c) monitoring and supervision of such projects, (d) arranging awareness programs with the assistance of line ministries, (e) maintenance of records, and (f) providing necessary assistance to donors and other stakeholders under the development credit scheme. The Central Bank implements the following two microfinance programs[9]:

Small Farmers and the Landless Credit Project (SFLCP)

The SFLCP, dubbed *Isuru*, was introduced in 1990. It was jointly funded by the International Fund for Agricultural Development (IFAD), the Canadian International Development Agency (CIDA), and the Government of Sri Lanka (Central Bank). The target group is poor persons who earn less than SLR 3000 per month and who have no access to financial services from formal banking institutions. The project is implemented in Galle, Matara, Puttalan, and Kandy districts.

The "credit-plus" approach is used in delivering credit under this project. Financial services are provided by the RDBs and the grassroots-level organizations enrolled as Par-

[8] "Regional Development Banks Act No. 6," 1997.

[9] Apart from implementing the above two microfinance schemes, the RDD of the Central Bank carries out project inspections and follow-up work in respect of a number of ongoing credit schemes. Also, it continues to provide refinance under various donor-funded credit programs and administer the credit guarantee schemes applicable to some credit programs. These include North Central Province Participatory Rural Development Project, Matale Regional Economic Advancement Project, New Comprehensive Rural Credit Scheme, Kegalle District Integrated Rural Development Project, *Surathura* Program, and Southern Province Rural Development Project.

ticipatory Agencies. The funds are channeled through the RDBs to partner organizations like the TCCS and *Sarvodaya*. The project was intended to provide cost-effective and sustainable micro-credit to the poorest of the poor.

The group approach has been adopted in the operation of the project. The Central Bank implements the project through a Central Project Office and through district project offices. The RDBs act as bankers to the project. The Central Bank provided credit to the RDBs at an interest of 3%. The RDBs lend to the partner organizations at interest rates varying from 9% to 11%. Partner organizations on-lend to final borrowers at interest rates ranging from 16% to 20%. Foreign funding for the project was terminated in 1997, as originally scheduled, and since then the project has been continued using a Revolving Fund.

As of the end of 2003, the project was in operation in 4123 villages in the four districts. There were 15,175 Self-Help Groups (SHGs) with 89,139 beneficiaries, which was well above the target of 32,000 beneficiaries set in the original project design. A striking feature of the project was the high participation of women, who accounted for 72% of the total number of participants. At the end of 2003, sums of SLR 1110 were advanced as micro-loans to borrowers to undertake income-generating self-employment activities.

The SHGs were amalgamated in 1997 to form village-level *Isuru* Development Societies (IDSs), as formal corporate bodies, to strengthen the fund base, improve negotiating capacity, and enhance synergic power. The village level IDSs are amalgamated into four district-level IDSs. In 2003, action was taken to form the National *Isuru* Federation by amalgamating the district-level IDSs. The Federation, comprising representatives from district level IDSs, is expected to be a strong national level forum of *Isuru* beneficiaries that will ensure long-run sustainability of the project.

Poverty Alleviation Microfinance Project (PAMP)

This project, funded by the Japan Bank for International Co-operation (JBIC), is a replication of the SLFCP. Considering the satisfactory performance of the SLFCP, the Japanese government decided to fund the PAMP as a microfinance intervention to alleviate poverty in six other districts: Kalutara, Hambantota, Badulla, Nuwara Eliya, Matale, and Kurunegala. The main objectives of this project are (a) to provide a cost-effective and sustainable microfinance credit delivery system, (b) to encourage high levels of women's participation, (c) to inculcate savings habits among the poor, (d) to improve the literacy level of the rural community, and (e) to improve self-confidence and weaning participants away from the dependency mentality.

The project is expected to be terminated by the end of 2006. Thereafter, it will continue for another 20 years utilizing the funds accumulated in the Revolving Fund from loan recoveries and interest income earned on balances invested.

Legal Infrastructures Supporting Collection of Loans

As the monetary authority, the Central Bank has the responsibility for ensuring the soundness and robustness of the country's financial system. It maintains financial stability by assessing potential risks and vulnerabilities in the financial system through surveillance of systemically important financial institutions. The commercial banks and the two licensed specialized banks engaged in micro-lending have the proper legal backing to recover loans. Under the Regional Development Bank Act No. 6 of 1997, the RDBs are empowered to recover loans. They are permitted to acquire, manage or sell mortgaged movable or immovable property or enterprises. Other NGOs and institutions engaged in microfinance usually rely on litigation to deal with loan defaulters.

REGULATORY AND SUPERVISORY ENVIRONMENT FOR MICROFINANCE

The Central Bank is responsible for regulating and supervising commercial banks, licensed specialized banks,[10] registered finance companies, and primary dealers of government securities to ensure safety and soundness of the banking and financial system, and to safeguard the interests of depositors and investors.

Regulation and Supervision of Commercial Banks

The regulation and supervision of commercial banks is governed by the Monetary Law Act of 1949 (as amended in 1995) and the Banking Act of 1988 (as amended in 1995). Supervision is based on the internationally accepted standards for bank supervision as set out by the Basel Committee of Banking Supervision.[11] The regulatory and supervisory functions of the Central Bank include (a) issuing directives on the licensing, operations, and closure of banks; (b) ensuring prudential requirements relating to banks; (c) resolution of weak banks; and (d) enforcement of regulatory actions. The major techniques of supervision include offsite monitoring and surveillance and periodic onsite examinations of banks, meeting with bank management, and cooperation with external auditors. The Central Bank monitors the compliance of banks with a number of prudential requirements such as capital adequacy, liquidity, large exposures, asset quality, provisioning for nonperforming loans, related party transactions, income recognition, share ownership, investments, and disclosure of accounts and audit of banks. In addition, internal controls and standards of corporate governance in banks are also assessed by the Central Bank.

Regulation and Supervision of Specialized Banks

The Regional Development Banks and *Sanasa* Development Bank, which are engaged in microfinance, are registered with the Monetary Board as Licensed Specialized Banks under the Banking Act No. 30 of 1988, as amended by the Banking Amendment Act No. 30 of 1995. These banks are subject to examination of the Director of Bank Supervision of the Central Bank of Sri Lanka. The Rural Bank Act No. 6 of 1997, which was enacted in June 1997, proposed to establish a Regional Development Bank (RDB) for each province, to take over the business of the then existing Regional Rural Development Banks (RRDBs). The authorized capital of each RDB was to be SLR 500 million. The RDBs are treated as Licensed Specialized Banks (LSBs) for purposes of the Banking Act, and as such they came under the supervision of the Central Bank. The regulatory and supervisory function of the Central Bank relating to LSBs is conducted by the Department of Bank Supervision. The Department carries out its function through periodic onsite examination and offsite surveillance of all LSBs.

The scope of onsite examinations includes appraisal of the quality of assets to determine the soundness of the asset portfolio. Other aspects such as capital adequacy, earnings, liquidity, systems, and internal controls and procedures are also examined. The regulatory requirements applicable to LSBs include maintenance of a minimum level of liquid assets, adherence to the single borrower limit, minimum capital based on risk-weighted assets, restrictions on accommodation to directors/their close relations and their interests, and submission of annual financial statements within the statutory period.

The guidelines issued under the Monetary Law Act in respect of income recognition of nonperforming advances and the adequacy of provisions for bad and doubtful debts were

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[10] The main distinction between commercial banks and specialized banks is that the former are permitted to accept demand deposits (current accounts) from the public and to engage in a full range of foreign exchange transactions, whereas the latter are not.

[11] In keeping with global trends, the Central Bank is moving towards the risk-based supervision of banks. This approach focuses on identification of banking risks, management of these risks, and assessment of the ability of banks to mitigate such risks.

reissued under the Banking Act. They became statutory requirements in terms of Section 46A of the Banking Act No. 30 of 1988 as amended by the Banking (Amendment) Act No. 33 of 1995. Similarly, capital adequacy requirements, which were hitherto enforced under the Monetary Law Act, were brought under the Banking Act.

Regulation and Supervision of Nonbank MFIs

In Sri Lanka, there are no explicit laws pertaining to regulation and supervision of nonbank MFIs. Among the institutions that are engaged in microfinance, only commercial banks and specialized banks are subject to prudential regulation and supervision by the Central Bank. There is no special unit in the Central Bank to supervise the MFIs. No other authority is available to carry out this function. However, the Regional Development Department of the Central Bank of Sri Lanka monitors rural finance activities in a broader sense.

The Thrift and Credit Cooperative Societies (TCCS) are governed by the Cooperative Societies Law of 1972. Cooperatives are required to be registered with the Registrar of Cooperative Societies, and they have to fulfil certain conditions for registration: (a) a society must have its object the promotion of economic, social or cultural interest of its members in accordance with cooperative principles; (b) it must have at least ten members owing shares with a value of at least SLR 100 (US$1.00) each, and must have its own bylaws, (c) officers from the Department of Cooperative Development supervise the operations of a pre-cooperative for around six months before it is registered, to ensure its economic and organizational viability; (d) every society is required to have a monthly meeting of the membership; and (e) it is required to have an annual general meeting, and to issue an annual report and financial statements. Although the TCCS are regulated by the Department of Cooperatives, they are not subject to any prudential regulation or supervision, as in the case of the financial institutions that come under the jurisdiction of the Central Bank.

Apart from the above institutions, other MFIs are not subject to any regulatory or supervisory mechanism.

The Role of the Central Bank vis-à-vis MFIs

While regulating and supervising the commercial banks and the specialized banks that are engaged in microfinance, the Central Bank itself acts as a provider of development finance, as explained above. The Central Bank has also been engaging in various other microfinance promotional activities such as providing training and conducting research. The Central Bank has in the past had the responsibility of providing such facilities as, until recently, the Monetary Law Act required it to fulfil multiple objectives including the promotion of high levels of production, employment, and real income and the encouragement and promotion of full development of the productive resources. These multiple objectives, at times, were inconsistent with the core functions of the Central Bank, namely maintenance of economic and financial stability. Therefore, the objectives of the Central Bank were streamlined by amending the Monetary Law Act in 2002 to enable it to pursue its core objectives, i.e., (a) maintaining economic and price stability and (b) maintaining financial system stability. In accordance with this changing policy strategy, the Central Bank has taken several initiatives to reduce its involvement in RDBs and various credit schemes including SFLCP. However, it continues to be a direct provider of microfinance.

Basically, the Central Bank does not have a major focus on MFIs. The activities of MFIs are not in its monetary framework. There is no regulatory or supervisory mechanism in the Central Bank to oversee MFIs. Taking into account this lacuna, the Central Bank states:

> A major issue relating to microfinance institutions and programmes is their sustainability. In ensuring sustainability, the major areas of concern are building the capacity of microfinance institutions, good governance, supervisory and regulatory sys-

> tems, improvements of accounting practices, increased use of information and communication technology and commercial viability. (Central Bank of Sri Lanka, "Annual Report of 2002," p. 256)

The multiple roles played by the Central Bank as a regulator, as a supervisor, as a provider and as a promoter of MF have different implications for the industry. The MF schemes implemented by the Central Bank, including SFLCP and PAMP, have been found to be effective in social mobilization, outreach, and women's participation. However, these programs have various disadvantages like high overhead costs in administering and monitoring the credit arrangements. Also, the continuous involvement of the Central Bank in providing MF is questionable in the context of an industry that is growing independently to deal specifically with this task. The provision of micro-credit at subsidized interest rates of 3–6% by the Central Bank hinders the competitiveness of the industry, and thereby retards the commercialization of MFIs.

As noted by Gant et al., the regulatory and supervisory practices of the Central Bank have been strengthened with regard to the entities under its jurisdiction. But the Bank has not kept pace with the growth of formal and semi-formal financial services, and does not effectively supervise or protect the assets of the relatively poor.

Self-regulation Practices

Many leading MFIs have a self-regulation mechanism. A few examples are given below.

- Thrift and Credit Cooperative Societies (TCCS): The TCCS has a well-organized self-regulation mechanism. Before the establishment of the *Sanasa* Development Bank (SDB), the Federation Thrift and Credit Cooperative Societies (FTCCS) functioned as the apex body for 33 District Unions. The District Unions oversee 8340 Primary TCCS (PTCCS). Since 1997, the SDB has taken over the role of the FTCCS in providing various services to TCCS. The primary aim of the SDB is to strengthen the primary societies, which directly serve the lower income groups. The SDB provides training to staff from the district unions and larger primary societies. The district unions, in turn, provide training to primary societies. The SDB also coordinates the procedures and operations of the district unions and primary societies. For example, it has introduced standard loan documentation and other forms for all primary societies. The district unions supervise the activities of the primary societies. The primary societies are required to furnish monthly financial statements including portfolio data, income and expenditure records, and balance sheet data to the district unions. District union offices monitor this information and conduct visits to the primary societies. If the primary societies fail to furnish the relevant information, they will not be able to obtain credit from the district union.
- The WDF is the apex of the *Janashakti* Bank structure. The WDF is headed by an Executive Committee, which is composed of 17 women members. The Executive Committee acts as the final authority in policy making and as the main source of accountability for the organization as a whole. The Federation's general management and management are responsible, *inter alia*, for accounting and financial management.
- The SEEDS' Board of Directors regulates the activities such as the appointment of senior officers, investment of funds, and entering into negotiations.

Relationship between Second-tier Bodies and MFIs

As a second-tier body, the National Development Trust Fund (NDTF) has imposed operational procedures for partner organizations borrowing from it. Accordingly, an organization to be qualified as a partner organization of the NDTF is required to have (a) at least two years' experience in lending to the poor and (b) a recovery rate of at least 90% over the last two years, and at least 70% over the last two years. Also it must (a) demonstrate financial viability or potential for viability; (b) have a well-developed and active savings mobilization component, with loans from NDTF limited to the balance of members' savings and shares; (c) demonstrate sound, well-organized management, and acceptable accounting systems and credit monitoring facilities; and (d) have the capacity to make small short-term loans at commercial rates of interest without collateral, and use a group lending approach. These rules have been enforced more effectively since 1995.

In addition, the NDTF has introduced several specific prudential requirements. Accordingly, partner organizations are required to (a) maintain a group contingency fund, set up by deducting 5% of the principal of loans, and subject to certain conditions; (b) establish a loan loss reserve as a provision against defaults; and (c) maintain a minimum of 35% of members' savings in reserve at all times. The NDTF has also imposed certain criteria to be adopted by partner organizations in selecting borrowers.

The NDTF requires partner organizations to provide audited quarterly reports covering accounts such as loan balances, arrears, and contingency funds. Partner organizations are also required to furnish various other data including information on savings and loans. However, the NDTF has not strictly enforced these procedures in the past. As a result, many partner organizations have not met the criteria.

Forum of Microfinance NGOs

This informal forum was set up in 1995 under the UNDP Civil Society Organization Development project. There are about 55 members including major participants like TCCS and Sarvodaya. Other participants include donor agencies, Central Bank, Bank of Ceylon, and international NGOs working in Sri Lanka. The main activities of the forum are:

- To collect and disseminate information on training in credit and savings operations.
- To coordinate research and documentation on microfinance.
- To provide a focal point for liaison and policy dialogue with government bodies.

The forum has not yet addressed the issues relating to self-regulation of the microfinance sector. However, various initiatives taken by the forum are likely to improve the standards and self-regulatory practices in the sector. .

SPECIFIC REGULATORY REQUIREMENTS AND SUPERVISORY PRACTICES

Registration and Licensing Requirements

In Sri Lanka, there is no special law that stipulates registration and licensing requirements for MFIs. There is no compulsion to obtain prior approval or license from any government body. At present, therefore, many MFIs are reported to function without any prior approval. In obtaining registration/licensing, different MFIs follow different procedures (Table 8).

Table 8. Legal Status of Major MFIs/Programs in Sri Lanka

Institution/ Program	Legal status	Funding sources	Governance system
Samurdhi Program	Samurdhi Authority of Sri Lanka Act No. 30 of 1995	Government and members' savings	Government's Samurdhi Authority
Regional Development Banks (RDBs)	Banking Act No. 30 of 1988, as amended by the Banking Amendment Act No. 30 of 1995	Central Bank, Bank of Ceylon & People's Bank	Board of Directors of RDBs
SANASA Development Bank	Banking Act No. 30 of 1988, as amended by the Banking Amendment Act No. 30 of 1995	Members' savings	Board of Directors of Sanasa Development Bank
Farmers' Banks	Agrarian Development Act No. 46 of 2000	Government and members' savings	Department of Agrarian Development
Gemi Pubuduwa Scheme	Banking Act No. 30 of 1988	Hatton National Bank	Hatton National Bank
Rural Banking Innovative Project (RBIP)	Banking Act No. 30 of 1988	People's Bank and GTZ	People's Bank and GTZ
Sarvodaya Economic Enterprise Development Services (SEEDS)	Companies Act No. 17 of 1982	Donor funds, NDTF, and members' savings	SEEDS Guarantee Ltd.
Kantha Ran Divi Maga	Banking Act No. 30 of 1988	Bank of Ceylon	Bank of Ceylon
Janasakthi Banking Societies in Hambantota	Society Ordinance and Voluntary Social Services Organization (Registration and Supervision) Act No. 31 of 1980	Donor funds, NDTF, and members savings	Women Development Federation, Hambantota
Social Mobilization Program (SMF) in Hambantota	Society Ordinance and Voluntary Social Services Organization (Registration and Supervision) Act No. 31 of 1980	Government of Sri Lanka, NORAD	Social Mobilization, Hambantota
Cooperative Rural Banks (CRBs)	Cooperative Societies Law No. 5 of 1972	NDTF and members' savings	Co-operative Department and Multi-purpose Co-operative Societies (MPCS)
Thrift and Credit Co-operative Societies (TCCSs)	Cooperative Societies Law No. 5 of 1972	NDTF and members' savings	SANASA Federation
(continued on next page)			

Small Farmers and the Landless Credit Project (SFLCP)	Administrative Agreement with the government by the Central Bank of Sri Lanka	Revolving funds	Central Bank of Sri Lanka
Poverty Alleviation Microfinance Project (PAMP)	Administrative Agreement with the government by the Central Bank of Sri Lanka	Donor funds, government, JBIC, revolving funds	Central Bank of Sri Lanka

Source: Central Bank of Sri Lanka

Other Rules and Regulations

- **Minimum capital requirements for MFIs:** The minimum share capital is stipulated only with respect to commercial and specialized banks. As described earlier, other MFIs have been registered or not registered at all with some authority with a nominal capital base.
- **Ownership of MFIs:** There are no specific rules and regulations pertaining to the ownership of MFIs.
- **Foreign participation:** Foreign donor agencies have extensively participated in MF activities in Sri Lanka. Most of them perform as MF fund providers or practitioners. There are no specific laws governing foreign participation.
- **Interest rate policy:** The interest rate structure in Sri Lanka is largely determined by market forces without direct intervention from the Central Bank or government. Hence, MFIs are free to determine their deposit and lending rates.
- **Capital adequacy regulations:** The Central Bank has stipulated minimum Capital Adequacy Ratio (CAR) to licensed commercial banks and licensed specialized banks, in terms of the guidelines of international standards of the Basel Capital Accord. Accordingly, the RDBs and *Sanana* Development Bank, which are licensed specialized banks, are subject to these requirements. The Central Bank has taken initiatives to enhance the resilience of banks to risks by expanding the scope of prudential supervision through the imposition of tighter regulatory standards. Accordingly, the CAR, which stood at 8% in relation to risk-weighted assets, was raised to 9% in January 2001 and to 10% in January 2003. Other MFIs are not subject to any CAR.
- **Loan loss provisioning:** Such regulations are not applicable for MFIs other than commercial banks, the RDBs, and *Sanasa* Development Bank. .
- **Assessment of credit quality, risk, etc.:** There is no such mechanism to cover nonbank MFIs.
- **Limit on the level of unsecured or un-collateralized loans in the loan portfolio of MFIs:** There is no such regulation.
- **Group guarantees as a legitimate form of security:** Based on the Grameen Bank model of Bangladesh, group guarantees are accepted as a legitimate mode of security. In Sri Lanka this method is widely applied by many MFIs.
- **Method of supervision for MFIs used by the regulatory authorities:** The two licensed specialized banks, RDBs and Sanasa Development Bank, are supervised by the Bank Supervision Department of the Central Bank using onsite and offsite surveillance techniques.
- **Authority to mobilize savings from the public:** In terms of the Banking Act of 1988 and the Finance Companies Act of 1988, institutions other than licensed commercial banks, licensed specialized banks, and registered finance companies are not permitted to collect deposits from the public. But there are numerous MFIs, including the primary bank societies promoted by the government agen-

cies and the Central Bank, that violate these regulations and collect savings from the public.

- **Transformation of NGOs into formal institutions:** The Banking Act of 1995 provides for NGOs to seek licensing as specialized banks. The minimum capital requirement for a specialized bank is SLR 100 million (US$ 1 million). An NGO seeking such license should forward its application to the Central Bank of Sri Lanka. As mentioned earlier, under the proposed PROMIS program, the authorities intend to facilitate integration of the microfinance industry into the formal financial system, and thereby to improve microfinance services. However, the presence of subsidized micro-credit programs sponsored by the government, the Central Bank, state-owned banks, and various donor agencies inhibit the growth of commercial MFIs.

CONCLUSION

In Sri Lanka, MF has a long history of nearly a century. Its growth has accelerated since the late 1980s, when the government shifted its social welfare policy strategies from the provision of consumer subsidies to delivery of credit to the targeted poor for income-generating economic activities as a major instrument for poverty reduction. The successive governments have included microfinance as a major component in their safety nets schemes, mainly the previous *Janasaviya* program and the current *Samurdhi* program. Apart from the government, a large number of institutions including the cooperatives, local and foreign NGOs, commercial and specialized banks, and international donor agencies provide various types of microfinance products and services such as micro-credit, insurance, business development services, and training. The lending technologies adopted by the microfinance institutions (MFIs) include cooperative method, Grameen Bank type group lending, primary bank societies, credit-plus approach, and barefoot banking. These innovative methods have largely eliminated the collateral requirements usually imposed by the traditional banks in credit delivery.

The government does not have any coherent policy framework vis-à-vis the MF industry, but it plays multiple roles in the sector. First, the government, through the Central Bank, acts as a regulator and a supervisor of formal banking institutions that deliver microfinance under the Monetary Law Act and Banking Act. Also, the Department of Co-operative Development, a government body, supervises, in a somewhat loose manner, the cooperative institutions engaged in microfinance. Certain regulations pertaining to the cooperatives are detrimental to their growth as they result in unhealthy interventions by the authorities, rigid rules, and political pressure. As regards hundreds of other microfinance institutions spread throughout the country, neither the government nor the Central Bank plays any regulatory or supervisory role. Most of these institutions do not apply best practices in microfinance, and therefore their long-term sustainability is at risk. Second, both the government and the Central Bank play the role of a direct provider of microfinance. The government provides funds to the state-owned banks to deliver micro-credit to the poor under its *Samurdhi* program. The Central Bank also delivers micro-credit under various poverty reduction programs. These micro-loans are generally offered at highly subsidized interest rates, and therefore, such schemes have inhibited commercialization of the microfinance sector. Also, some of these government-sponsored schemes violate the current banking and financial regulations. For instance, although savings mobilization is prohibited, under the Banking Law Act, for institutions other than licensed banks and finance companies, the state-sponsored *Samurdhi* Scheme and the Central Bank's credit programs themselves promote collection of savings from members of various informal bank societies. Third, the government and the Central Bank function as promoters of microfinance by providing training and various other facilities.

In the absence of an explicit formal authority to regulate and supervise microfinance, it is significant to note that certain well-established MFIs have adopted self-regulation practices to monitor their financial viability. Supervision of MFIs by a few second-tier bodies like the NDTF is also evident. Another welcome development is the recent establishment of a Forum of Microfinance aiming at coordination of the sector.

As there are no uniform standards or procedures to issue registrations and licences, different MFIs have obtained licences to start their operations from different authorities. Most of these MFIs are no subject to any regulation or supervision. Therefore, the question is whether it is necessary to regulate such institutions. The need for regulating the MFIs arises from two factors: (a) whether they are large enough to pose a threat to financial stability (either directly or through contagion effects to other financial institutions) and (b) whether they engage in financial intermediation by accepting deposits to fund their lending operations (IMF 2005). In the first case, prudential regulation and supervision should be geared to protect the integrity of the financial system as a whole. In Sri Lanka, the MF industry remains small despite its fast growth in recent decades, and therefore it does not seem to pose any major risk to financial stability. For example, the total outstanding loans disbursed by MFIs amounted to only about 7.5% of the outstanding loans of commercial banks at the end of 2003. In the second case, the regulators should ensure soundness of financial institutions so as to protect small savers. In Sri Lanka, deposit-taking is prohibited except by commercial banks, specialized banks, and registered finance companies. But this regulation is not strictly enforced by the Central Bank or any other authority, and consequently many NGOs and various other informal organizations continue to collect savings. However, a major threat to savers does not seem to be evident.

Against the above background, the benefits and costs of bringing the MFIs under prudential regulation and supervision should be assessed. Prudential supervision calls for regular surveillance of the supervised institutions, and it is more complicated and expensive than non-prudential supervision. Given the widespread distribution of a large number of MFIs all over the country, prudential supervision would require a substantial amount of human and physical resources. Neither the Central Bank or any other authority may have such capacity. Therefore, it seems more appropriate to adopt a non-prudential approach that involves self-regulation by MFIs themselves or surveillance by second-tier bodies or by an umbrella organization covering tasks like registration/licensing requirements and financial management.

The contributions that are being made by the MFIs in Sri Lanka with regard to poverty reduction, employment generation, and women's empowerment cannot be underestimated. These factors should be taken into account in designing any future regulatory and supervisory framework for the sector. Such a framework should not impinge upon the growth of the sector. The prime objectives of a future legal framework should be (a) to safeguard the savings of depositors, (b) to help marinating financial stability of the country, (c) to enhance productivity of MFIs, and (d) to ensure long-term sustainability of the MFIs.

It is also desirable to relax some of the current regulations that inhibit the growth of the sector. Certain administrative rules pertaining to the cooperatives are a case in point. The direct involvement of the government and the Central Bank needs to be phased out in the context of their adverse effects on the commercialization process, which is essential for long-term sustainability of the industry.

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VIETNAM

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INTRODUCTION

Poverty and Unemployment in Vietnam

Vietnam has an estimated population of 80 million. Rapid economic growth over recent years has significantly reduced poverty: as measured by the general international poverty standard, from about 58% in 1993 to about 29% in 2002, and on the food poverty line (Government/World Bank),[1] from about 24% to about 14% during the same period. The number of poor households has been halved since 1993. This has been accompanied by improvements in social indicators to values that compare favorably with those of other countries at similar levels. However, with a low per-capita income of less than US$ 500, a significant proportion of the population continues to live in relatively impoverished conditions. The number of poor households still accounts for about 15% of the total throughout the country. And about 80% of the poor live in rural areas and are in households living in disadvantaged communities in mountainous, isolated, and remote areas of the Northern Uplands and Central Highlands. Although poverty among ethnic minorities has declined, the decline has not been as rapidly as for the majority. Many ethnic minorities live in the remoter areas. Nearly 80% of the poor are in farm families with low levels of educational attainment and limited access to information and functional skill training. As estimated by the Asian Development Bank, there are about 6.7 million low-income households. Low-income households (LIHs) are characterized by relatively low agricultural productivity resulting from relatively less land per capita and lower availability of irrigation. They are highly vulnerable to shocks from illness and death in the households, commodity price cycles, and natural disasters. Poor households have small land holdings, and landlessness is becoming widespread, especially in the Mekong Delta.

In addition to poverty alleviation, employment generation has been considered one of the priorities of the government's socioeconomic policies and programs. Due to economic developments such as the policy emphasis on transforming economic structure and attracting foreign direct investment, enhancements in the development of the private sector and of small and medium enterprises (SMEs) in particular, and improvements in the legal framework, a number of new jobs have been generated in different sectors of the economy and especially in the industry, construction, and service sectors. The unemployment rate in urban areas has decreased, from 6.9% in 1998 to about 5.8% in 2003. In the year 2003 alone, about 530,000 new jobs were generated in urban areas. In rural areas, the structural transformation of agricultural production has created more employment opportunities; hence the percentage of working time increased to 77.6% in 2003 from 71.1% in 1998. However, the unemployment rate in urban areas is still high, and there is still a great concern about the low percentage of working time and low-income-generating employment in the rural areas.

The Government's Development Strategies, Policies, and Poverty Alleviation and Employment Generation Programs

Given the situation described above, ongoing poverty reduction and employment generation measures undertaken by the government include various national programs that adopt an integrated approach to poverty reduction through infrastructure, heath, education, agriculture,

[1] The food poverty line is equivalent to 2100 calories per capita per day.

credit,[2] and in particular microfinancing. Some major programs are the National Target Program on Hunger Eradication and Poverty Reduction (HEPR), Program on Socio-economic Development in Especially Disadvantaged communes in Mountainous, Isolated and Remote areas, National Target Program on Poverty Reduction and Employment, Program 327 (project to reforest 5 million hectares), and Job Generation Program (Program 120). For the period 2001–2005, the government decided to allocate about VND 70–75 trillion (US$ 5–5.5 billion) for implementing eight national target programs related to the objectives of hunger eradication and poverty reduction.

Of particular importance was the government of Vietnam's announcement of the Ten-Year Socioeconomic Development Strategy (2001–2010), which aimed to accelerate economic growth and poverty reduction through macroeconomic and structural policies designed to protect macroeconomic stability. The sectoral policies of the Strategy are focused on improving access to resources for the poor, reduce their vulnerability, and enhance social equity. Based on the Ten-Year Socioeconomic Development Strategy, the Comprehensive Poverty Reduction and Growth Strategy (CPRGS) concretizes the general objectives, mechanisms, policies, and methods of the above-mentioned national, sectoral, and local socioeconomic development strategies and plans with concrete implementation roadmaps. At the same time, the CPRGS is an action program to guide the international community's support for the government of Vietnam's economic development and poverty reduction efforts. The CPRGF has reaffirmed the government's commitments of achieving the International Development Goals agreed upon at the Millennium Summit in 2000. The Strategy has analyzed the poverty situation in different dimensions and considers poverty reduction as a basic ingredient to ensure sustainable growth and social equality

In general, the government is striving to promote rural development and to avoid greater disparities between the urban and rural standards of living. The focus of the government's strategies is to promote rural development and reduce poverty. Poverty reduction programs have emphasized technological change and microfinance[3] as means to finance the change, and deposit promotion to better enable the poor to accumulate savings for future investment and provide a cushion against seasonal production shortages and unforeseen crises. The government is attacking the task of poverty reduction with employment creation. This is reflected not only in the CPRGF but also in the socioeconomic development goals of the government for the period 2001–2005 and for the period 2001–2010, as follows: reducing the number of poor households by two fifths by 2005 and by three fifths by 2010 as compared with the year 2000. For employment generation, the Strategy set the objective of creating new jobs for 1.4–1.5 million people annually, reducing the unemployment rate in the urban areas to 5.4% in 2005 and to less than 5% in 2010; a related goal was increasing working time in the rural areas to 75% in 2005 and to 80% in 2010. Special emphasis was placed on the objective of concentrating resources on successfully implementing the National Target Poverty Alle–viation and Employment Generation in the period 2001–2005, enhancing the credit activities

[2] Up to 2005, there was no official definition for "microfinance loans." However, for some national programs, the credit component could be considered to be microfinance loans, as it consisted of small size loans provided mainly to low income households or for the poor.

[3] Before the issuance of the Decree on MFIs, there was no separately announced policy for microfinance. But the significance and the policy of facilitating microfinance not only has been clearly stated in almost all poverty reduction programs, but also is incorporated in some other national programs which have credit components. To implement this policy, the government provided valuable support by allocating state funds to national programs, directing the Vietnam Bank for Social Policies to extend credit to the poor and to targeted clients, accommodating the performance of mass organizations and NGOs engaging in microfinance, and so on. In March 2005, the government issued the Decree on Organization and Operations of MFIs, which created a legal framework for NGOs and mass organizations, socio-political and socio-professional organizations, charity funds, and social funds engaged in microfinancing.

for job creation implemented through the National Fund for Supporting Employment Generation. The total funding for this program is about VND 22.5 trillion.

Overview of Microfinance in Vietnam and Its Role in Alleviating Poverty and Generating Employment

Since the Decree on MFIs has just come into effect, there are no recent statistics on operation of MFIs. This section gives a brief overview of microfinance in Vietnam before 2005; details on scale, outreach, and other related issues are covered below.

The Major Providers of Microfinance in Vietnam

Microfinance in Vietnam is provided by various institutions including formal financial institutions, a semiformal sector, and informal lenders. In the formal sector, under the control of the State Bank of Vietnam (SBV), services are mainly provided by the Vietnam Bank for Agriculture and Rural Development (VBARD, formerly VBA), the Central Credit Fund/ People's Credit Fund (CCF/PCF) network, and the recently established Vietnam Bank for Social Policies (VBSP), which took over the functions of Vietnam Bank for the Poor (VBP) at the beginning of 2003. All these organizations provide some services to low-income households. VBARD, VBP, and VBSP are owned by the state. CCF is partly owned by SBV and partly by its member PCFs. The PCFs are in turn owned by their members. VBARD, VBP/ VBSP, and the PCFs have carried out a large proportion of rural finance and microfinance in Vietnam. In addition, a system of about 14 rural joint-stock banks located in rural areas is also providing micro-credit.[4]

The Semi-formal Sector

The semi-formal sector providing microfinance services comprises government ministries, mass organizations, and others. The Ministry of Planning and Investment (MPI), Ministry of Labor Invalids and Social Affairs (MOLISA), and Ministry of Agriculture and Rural Development (MARD) provide micro-credit under national programs. They have been generally characterized by subsidized credit. Mass organizations—primarily Vietnam Women Union (WU), Vietnam Farmers' Union (FU), and Vietnam Youth Union (YU)—also provide small loans on their own account, implement programs for international nongovernmental organizations (INGOs), and facilitate the formation of credit groups for VBARD and VBP. The mass organizations have the primary objective of improving the economic situation of their members. Financial services serve this interest and act as a catalyst for the support of other activities. WU has also operated some savings schemes. In 2002, there were some 57 INGOs that reported supporting microfinance activities, channeled through the mass organizations. NGO schemes are recognized by the government, but are not legally regulated or supervised in their financial sector operations by the SBV. In practice, many NGOs carry out microfinancing focusing on the poor. NGOs provide technical assistance to mass organizations, or to provide funds as well as technical assistance, or play role as an agent of formal financing institutions. The variety of international NGO schemes is reflected in their diverse objectives. Some are exclusively concerned with savings and credit. For others, savings and credit activities are an entry point in communities to promote programs on health or family planning. The savings and credit programs of NGOs are effective at providing financial services to the poor.

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[4] Actually, in term of size and scope of operation, the private banks and PCFs cannot compete with the SOCBs. And in some cases, smaller institutions like private banks and PCFs can borrow funds form the larger SCOBs. But rural joint stock banks are probably competitors of the PCFs to some extent, as they also operate in the rural areas. However, the PCFs mainly provide credit to their members, so there is not much overlapping scope of clients and no severe competition between PCFs and rural private banks.

About 8% of more than 7000 agricultural cooperatives also provide credit to their members as intermediary between the banks and the borrowers. They borrow from the banks to carry out their activities and often lend the borrowed money to their members. They have some advantages in carrying out credit activities, as they (i) link credit activities with other activities and (ii) have a close relationship with the People's Committees of communes.

Informal Microfinance

Despite great efforts to improve credit provision to rural areas, the formal financial sector does not meet rural households' demand for loans, especially in remote areas where the formal banking system does not operate. The major formal financial institutions mainly provide loans for investment purposes; lending for consumption purposes is left to the informal sector. In particular, poor households may require loans for urgent consumption in the months immediately before harvests. In such circumstances borrowers must accept high interest rates or sell "young rice." They also seek immediate consumption assistance in times of disasters, food shortages, or health crises. They may require loans from informal lenders, who include: (i) private moneylenders; (ii) relatives, friends, and neighbors (often without interest); and (iii) *Ho* and *Hui* (the local Rotating Savings and Credit Associations, or ROSCA). There are no recent statistics on the size of the informal credit. Sector. According to the Vietnam Living Standard Survey funded by UNDP/SIDA that was carried out in 1994 among 4800 households, 77% of households had taken out loans from the informal sector. However, the current proportion of households depending on the informal sources is likely very small, as VBARD itself provides loans to nearly 75% of the rural households. Besides VBARD, other formal institutions also provide loans to rural households. The details of terms, conditions, and interest rates offered by informal sources in comparison with other formal institutions are detailed below.

The Stance of the Government, the Donor Community, and the Central Bank

The Government's Stance and Its Role vis-à-vis Microfinance

In Vietnam, it is widely recognized and expected that microfinancing is integral to poverty reduction in providing opportunities to the poor for building assets, enhancing income-earning capacity, smoothing consumption, and managing risks better. It has empowered the poor, especially the women. Microfinancing helps to meet the urgent need for stimulating greater off-farm employment. Microfinancing can make an important contribution in extending outreach into the remoter areas where poverty and unemployment are now concentrated. A wide landscape of formal and semiformal institutions and informal arrangements essentially provides microfinancing.

The government wields considerable influence on the growth of the microfinancing sector through state-owned banks and budgetary allocations for national programs. Some national programs, mainly funded by the State Budget, have a credit component that is used to support the implementation of primary objectives.[5] Typical examples are the Job Creation Program under the supervision of MOLISA and the Greening Bare Hills Program under the supervision of MPI. The government has been both regulator of the banking system (via the SBV) and an active participant (via the state-owned commercial banks that dominate the banking industry).

The government's general policy direction for microfinance is to foster the development of microfinance in order to reduce poverty, foster economic growth, and at the same time

[5] Unfortunately, there are no official statistics on the percent share in the budget of microfinance or credit programs. But a number of the national programs have credit components provided to targeted clients. Actually the national programs are directed by the government and can be considered subsidized credit , which perhaps to some extent may cause reactions from other private MFIs in term of interest rates.

create employment opportunity and stimulate consumption. It is clearly stated in the CPRGF that the government has the role of expanding the outreach of financial services in the rural areas; applying the policy of extending credit with low interest rates to the poor, women, and disadvantaged people; allowing direct subsidization of the institutions providing financial services to the poor in the remoter areas; enhancing the role and improving the effectiveness of the VBP and PCFs; and so forth. To achieve these objectives, the government is striving to separate its two roles.

To gain transparency and sustainability of the formal microfinance institutions, e.g. VBP, the government has set up the Policy Bank (VBSP) to replace VBP. The government has recognized the importance of creating a supportive policy and regulatory framework for microfinance and has requested ADB technical assistance in preparing the framework for developing a sustainable pro-poor financial system to efficiently provide services to a larger segment of poor households, and for developing corresponding policy, legal, and regulatory guidelines, enhancing the institutional capacity of SBV for implementing the framework. And with the assistance of the Asian Development Bank, the government is now preparing a long-term strategic framework for microfinance development. The framework is to guide and coordinate microfinancing activities responsive to real needs and pro-poor innovations. In March 2005, the government promulgated the Decree on MFIs (the original title of the Decree in Vietnamese is “Decree on Organization and Operation of Small-scaled Finance Institutions in Vietnam”). The Decree stipulated that MFIs—including socio-political and socio-professional organizations, NGOs, and charity and social funds—are entitled to borrow from other credit institutions. Though the guidelines of the State Bank have not yet been issued, hopefully they will provide a comprehensive framework for supporting the performance of the MFIs and facilitating microfinance development.

The Role of the Donor Community

The donor community has continuously provided valuable assistance to the government in formulating development strategies, policies, and poverty alleviation programs, especially the CPRGS, which emphasizes the objectives of fostering socioeconomic development, poverty reduction, and measures for poverty reduction. The donor community has also been very keen on providing micro-credit to the poor in Vietnam. Through various projects and programs, e.g., projects on rural financing funded by the World Bank and the ADB and a Vietnam–Canada project for enhancing access to rural financing/microfinancing, the donor community has given significant support to the government in the field.

The Stance of the State Bank of Vietnam

The SBV, the central bank of Vietnam, also considers microfinancing to be one of the priorities of the banking system. To meet the objective of poverty alleviation set by the government, the SBV has actively directed the commercial banks, especially VBARD, in providing credit to the poor, farm households, etc. And the SBV has gradually formulated the legal framework for pro-poor credit targeted programs. In reality, a number of pro-poor targeted credit programs have been successfully conducted by the banking system: credit programs to implement government policies on agricultural and rural development; a credit program for poverty reduction, a credit program for overcoming the aftermath of flooding; a credit program for housing development in Cuulong Delta; programs for fisheries; programs for aquaculture products; and so forth. The successes of those programs can be observed in the form of a reduction in the poverty rate, the creation of employment, the recovery of borrowers’ businesses and production after natural calamities, the development of aquaculture production, and economic transformation. As the size and scope of operations of private banks or other MFIs in Vietnam are still modest, those institutions can be considered complementary channels for credit to poor and low-income households. The targeted credit programs which are mainly carried out by the SCOBs like VBARD, have not adversely affected the viability of the private banks or other MFIs.

The SBV has been the Executing Agency for the project to prepare the framework for microfinancing development. Based on the scope of the project, the SBV has reviewed existing policies and operational aspects relating to sustainable microfinance, then has worked to develop a legal, supervisory, and regulatory framework with ADB assistance. In addition to VBARD, VBSP, and PCFs, the SBV also recognized the role of other institutions engaging in providing credit to the poor; thus it has drafted a Decree on the operations of the MFIs that are not credit institutions. The Decree on MFIs, just issued by the government, clearly shows the stance of the SBV (see the text of the Decree in the Appendix).

THE STRUCTURE AND PERFORMANCE OF THE FINANCIAL SYSTEM

Overview of the Structure of the Country's Financial System: The Regulatory and Supervisory Role of the Central Bank

The Vietnamese financial system has been in the early stage of reform to a market-oriented system. The system has been virtually monopolized by banks: four major state-owned commercial banks (SOCBs) hold over 70% of the total financial assets in the market, with the rest held by others. The four major state-run commercial banks are VBARD, the Industrial and Commercial Bank of Vietnam (ICBV), the Bank for Foreign Trade of Vietnam (VCB), and the Bank for Investment and Development of Vietnam (BIDV). The SOCBs are providing credit mainly to the state-owned enterprises (SOEs), the large non-SOEs, and the agriculture sector. The SOCBs have accounted for the majority of market share as they have some advantages in term of branch networks and traditional relationships with clients.

Besides the four major SOCBs, the list of banks in Vietnam includes the other two state-owned banks (the Vietnam Bank for Social Policies (VBSP) and the Bank for Mekong Delta Housing Development), 36 joint-stock banks, 4 joint-venture banks, 27 branches of foreign banks, nonbank financial institutions, and a system of People Credit Funds. The joint-venture banks and foreign bank branches mainly provide services to foreign-invested enterprises. The joint stock banks mainly provide services to small and medium enterprises.

Nonbank financial institutions which are subjected to the Law on Credit Institutions include 7 finance companies and 8 leasing companies. Among the nonbank credit institutions are 5 financial companies that are considered affiliates of the general State-owned corporations, and which mainly provide services to those corporations and their members. Among the leasing companies are 5 leasing companies that are considered affiliates of the SOCBs. Under the Law on Credit Institutions, nonbank credit institutions are not entitled to mobilize demand deposits and time deposits of less than 12 months' maturity. As a result, they are disadvantaged vis-à-vis the banks in term of scope of operation.

In addition to the nonbank institutions listed above, 18 insurance companies operate in Vietnam under the supervision of the Ministry of Finance (MOF). And in the financial market in Vietnam, the Securities Trading Center (STC) was officially created in July 2000 in Ho Chi Minh City. Its operation is under the supervision of the State Securities Committee. As of the end of 2003, 22 companies are listed, with total market capitalization of VND 2.4 trillion, and 103 types of bonds are transacted with a total value of VND 2.5 trillion.

PCFs/CCF (People's Credit Funds/Central People's Credit Funds) is a network of commune-level, autonomous, small-scale financial institutions. It has a two-tier system. Despite its small size (consolidated assets are less than 5% of VBARD), the PCF/CPF system has been fairly successful in extending microfinance to agricultural households.

The Regulatory and Supervisory Role of the State Bank of Vietnam (SBV)

The State Bank of Vietnam is a government body which regulates the monetary and banking activities of the system of financial and credit institutions operating in Vietnam. As stipulated in the Law on the State Bank of Vietnam, the SBV fulfils that function by formulating and implementing national monetary policy, developing strategies for the development of banks and credit institutions; drafting laws and decrees and promulgating a number of regulations and decisions on monetary and banking activities; issuing and revoking the establishment and operation licenses of credit institutions; issuing and revoking banking operation licenses of other organizations; controlling foreign exchange and gold trading operations; and other functions. In practice, the SBV regulates money market conditions and the operations of the credit institutions mainly by using monetary policy instruments. In recent years, the SBV has made significant progress in shifting from using direct instruments into using indirect instruments such as open market operations, refinancing, etc. The interest rate management and exchange rate mechanism have gradually been renovated in the direction of liberalization and market principles.

As a central bank, the SBV also has responsibility for inspection of all financial and credit institutions, including those in rural areas. The focus of SBV supervision is compliance with laws, the financial condition of the institutions, and the potential risks facing credit institutions that are subjected to the Law on Credit Institutions. Other institutions providing microfinance (including NGOs) are not subjected to this supervisory system. Recently the SBV has adjusted and renovated the legal framework and procedures for inspection and supervision activities. The surveillance has gradually moved to risk-based assessment. The elements of risk-based assessment are derived from CAMEL and BASEL principles, which include assessments and supervision on compliance with capital requirements, capital adequacy, liquidity ratio, loan loss classification and provisioning, other prudential ratios, and so forth (for details see Tables 13 and 14 below). The SBV has enhanced the quality of both onsite inspection and offsite surveillance. The international standards, practices, and principles of inspection and supervision—e.g., CAMEL and BASEL—have been to some extend adopted. Up to 2005 there had been no official supervision of MFIs (NGOs, mass organizations) and their microfinancing operations. The above-mentioned risk-based supervision is applied to the credit institutions, including the banks and PCFs, that provide microfinance services.

The Overall Performance of Credit Institutions in Vietnam

Overall Performance of the Banks

As mentioned above, banking institutions in Vietnam have played the dominant role in the financial market. Under the Law on Credit Institutions, the banks are permitted to conduct all banking activities and other related business operations. Banking activities include monetary business activities and banking services, the receipt of deposits, and the use of deposits to extend credit and provide payment services. Thereby, the banks have the following major mandates: (i) receive deposits from organizations, individuals, and other credit institutions in the form of demand deposits, time deposits, savings deposits, and others; (ii) mobilize funds by issuing valuable papers such as CDs, bills, notes, etc.; (iii) use the sources of funds to provide credit to organizations and individuals in the form of loans, discount valuable papers, issue guarantees, finance leasing, and conduct other functions as permitted by the SBV. The banks extend short-term loans to economic entities, organizations, and individuals to meet their financing requirements for production, business, services, and living requirements. In addition, the banks also provide medium–long-term credit to organizations and individuals for implementing investment projects to develop production, business, services, and living requirements. Accordingly, the major products of the banks are various types of deposits and fund mobilizations, as well as various types of credit. As the financial system is monopolized by banks, the banks have accounted for about 90% of the total credit; the total of outstanding loans is about VND 265,000 billion as of the end of 2003. The deposit balance is about VND 280,000 billion as of the end of 2003.

In order to ensure the quality of their loans, the banks have to seek production and business projects that are feasible, efficient, and capable of repayment based on studies of the feasibility of the projects and the creditworthiness and financial capability of the clients before making credit decisions. Then they extend loans that are secured by pledged or mortgaged assets of the borrowers, guaranteed by the assets of a third party or the assets created by use of the loan funds, or guaranteed by the creditworthiness of socio-political organizations; in some cases, they are permitted to extend loans without collateral based on government/ SBV guidelines.[6] But they are never permitted to extend any loan on the basis of being secured by the shares of the lending bank.

The lending interest rates on funds in foreign currency were liberalized in 2001, while the lending interest rates on funds in VND are still based on the base rate announced by the SBV. Since June 2002 the deposit and lending interest rates in VND are totally determined by the banks and credit institutions themselves. The SBV has set only the ceilings on US$ deposits at a rate applied to such economic entities as credit institutions given the fact that Vietnam is still considered a partly dollarized economy. With the progress made in liberalization of interest rates, the credit institutions and the banks in particular have more freedom and autonomy and accountability for their business decisions. In fact, they determine their own interest rates primarily based on the following principles: the lending interest rate = the deposit interest rate + operating and management costs + provisions + taxes + profits. To mobilize deposits, reasonably real interest rates for the depositors should be ensured—i.e., there should be a reasonable real difference of at least 2–3% per annum between the deposit interest rate and the inflation rate. At present, with a year-on-year inflation rate of about 5%, actually the VND deposit rates are relatively high. But the US$ interest rates are heavily dependent on the developments of US$ interest rates in the international markets (Table 1).

Table 1. Common Interest Rates (April 2005)

VND interest rates	% p.a.	US$ interest rates	% p.a.
Deposit interest rates		Savings deposits	
Demand deposits	2.40–3.00	Demand deposits	1.00–1.30
3–month deposits	6.72–7.44	3–month deposits	2.00–2.60
6–month deposits	7.20–8.04	6–month deposits	2.40–2.85
12–month deposits	7.80–8.52	12–month deposits	3.00–3.50
Lending interest rates		Lending interest rates	
Short-term	9.00–13.00	Short-term	4.50–5.00
Medium- and long-term	10.80–15.00	Medium- and long-term	5.00–5.70

Source: SBV

With regard to loan repayment experience, there is no published assessment on the repayment experience of the banking system in Vietnam. The bad debts of the system are about 4.7% of total loans outstanding as of the end of 2003. However, there is still some debate regarding the that rate because of several factors affecting the rate such as accounting standards,

[6] Based on Decree No 178/1999/ND-CP dated 29 December 1999 and Decree No 85/2002/ND-CP dated 25 October 2002, the credit institutions are entitled to make their own decisions and be responsible for unsecured loans. In addition, the SBV has issued Circular No 03/2003/TT-NHNN dated 24 February 2003 and Decision No. 312/2003/QD-NHNN dated 4 April 2003, providing guidelines on the limits of uncollateralized loans for some types of borrowers: examples are limits of VND 30 million in unsecured loans for farm households with guided conditions and limits of VND 100 million for the cooperatives that provide inputs for agriculture, forestry, fishery production, etc.

relatively easy loan rescheduling, and ways of dealing with frozen debts and security by the government. For some banks, e.g., VBARD, the recovery rates of households and private companies seems relatively high as the banks have mechanisms to put repayment pressure on borrowers through local authorities such as the People's Committee, WU, and FU. For nonperforming loans (NPLs), there are no recent data on the true size of the NPLs as there is a large difference between Vietnamese and international accounting standards. The SBV has instructed the SOCBs to classify NPLs as non-recoverable loans; loans that can be recovered in the long run (mainly loans made to loss-making SOEs for which the government has not yet developed concrete restructuring plans); and loans that could be recovered by liquidating collateral assets. The total amount of estimated NPLs tentatively doubles the amount of bad debt. In 2005, the banking system started to classify NPLs according to international standards.

In general, Vietnam's banking system has problems common to many countries in the region: high nonperforming loans,[7] poor management practices, and an inability to intermediate effectively between savers and investors. The banking system is now in the process of in-depth reform. Bank restructuring has been enforced with positive outcomes. However, the process of restructuring has been somewhat slow owing to numerous challenges. For the SOCBs, under the framework of the restructuring plan, financial re-engineering has been undertaken by dealing with nonperforming loans, preventing the recurrence of new overdue debts, and increasing statutory capital to ensure international adequacy ratios (minimum at 8%). The organizational restructuring focuses on separating policy lending from commercial activities and restructuring SOCBs' organizations to make them more transparent. The operations and supervision focus on the institutional strengthening of risk management, internal control, capital and investment management, and asset-liability management. To separate policy lending from commercial lending, the government set up the Social Policy Bank in 2002. For the joint stock banks, the banks have been restructured in term of organizational, operational, and financial aspects. Recently the SBV has asked the joint stock banks to increase their statutory capital in accordance with the prevailing requirements, revoked business from the poorly performing banks, and consolidated small banks to create bigger and more profitable ones. By the end of 2002, joint stock banks basically met the requirements for statutory capital. The number of joint stock banks is now 36, compared with 52 in 1996.

Overall Performance of Nonbank Financial Institutions

Nonbank financial institutions (excluding the insurance companies) have much smaller sizes and scopes of operation than the banks. Their total of loans outstanding is about VND 17,000 billion as of the end of 2003. As stipulated in the Law of Credit Institutions, nonbanks are allowed to engage in some banking activities as their regular business, but are not permitted to receive demand deposits or to provide payment services. Their major mandates are as follows: (i) receiving time deposits, with maturity of no less than 1 year, from organizations and individuals; (ii) mobilizing funds by issuing valuable papers; (iii) receiving trust funds; and (iv) using funds sources to provide loans in accordance with the regulations of the government.

The nonbank financial institutions have been set up to diversify the financial products in the market, as a complementary channel for fund mobilization and allocation to the traditional banking system. In particular, the five finance companies that are affiliates of the general corporations are providing services for the members of the corporations, and they have more advantages than the banks in this area as they have a great deal of professional knowledge and internal information. For the leasing companies, they are mainly providing leasing services with a very narrow scope of operation—for example, for common assets such as transport and

[7] Unfortunately there are no exact statistics for nonperforming microfinance loans, as the official definition for microfinance loan was first given in the Decree on MFIs which was promulgated in March 2005.

construction equipment. Clients in Vietnam are still not very familiar with leasing, and often consider it the last alternative when they have no opportunities to borrow funds from banks. Since the nonbank credit institutions are newly established, they have almost perfect records of performance, especially in terms of quality of loans, except for the joint stock finance companies that have already been liquidated or have merged with commercial banks. There are no officially published data on the repayment experience, but the majority of nonbank credit institutions have no records of overdue debts or overdue rates of less than 1% of total loans. Although there are no data on the sizes of NPLs for the nonbank credit institutions, a low rate of NPLs can be assumed. With regard to collateral requirements, the nonbank financial institutions have to comply with the same regulations on security of loans as the banks.

The new Law on Insurance Business became effective in April 2001, which created a legal framework for the formation and operation of the insurance companies. Among the insurance companies, the state-owned insurer remains the dominant player, with non-life and life market shares of approximately 47 and 55% respectively. Coverage is low, with annual insurance premiums amounting to 1% of GDP. Premiums have grown at an average rate of 30% per year, reaching an estimated amount of VND 4.9 trillion (US$ 321 million) in 2001.

Overall Performance of People's Credit Funds (PCFs)

The PCF is a type of cooperative financial institution; it was introduced in 1993 with the aim of re-establishing a strong rural financial system based on community and self-management with strong support from SBV. PCFs are cooperative credit institutions, established voluntarily by local members. The funds mobilize deposits and provide loans[8] and other financial services to improve members' economic and social welfare. Therefore, PCFs are governed by operational principles such as self-help for cooperatives, mutual help among members, democratic and horizontal style of management, and payment of dividends on shares. Each PCF is its own legal entity and is managed independently. The number of PCFs was 896 in 2003 after peaking at 977 in 1998. But the number of PCF members and the loan outstanding balance increased significantly, from about 640,000 members and VND 1.6 trillion in 1998 to 911,256 members and about VND 4.0 trillion in 2003, respectively. During this period, the numbers of loans declined from 730,000 to 663,757, indicating that loan size increased and loan terms lengthened. PCFs make loans to households only. Nearly 56% of PCF borrowers are low-income households (LIHs). Total funds collected grew about 20% on average per year, up to about VND 4.7 trillion in 2003, of which about 5.2% was from capital, 67.7% was from deposits, and 27.1% was from borrowing, mainly from CCF. The overdue rate improved from 3.8% in 1998 to 0.84% in 2003 as the result of restructuring and strengthening of management at PCFs implemented by SBV. The ratio of deposits to loans improved marginally, from 74% in 1998 to 79.2% in 2003. CCF reports show that the loan repayment rate throughout the system is above 98%.

CCF is a credit cooperative with its own legal title, and it operates independently. Major functions of CCF are: mediating funds among PCFs all over the country; ensuring the liquidity and solvency of PCFs; advising PCFs; monitoring and supervising PCFs; and acting on behalf of PCFs in relation to government, domestic, and international organizations. The SBV is now continuing to reorganize and strengthen existing PCFs and considers the establishment of new credit funds when possible. To strengthen the efficiency, viability, and safety of the PCFs, SBV is now finalizing the legal framework for the PCFs' activities: its provisions cover regulating the issuance and revocation of business licenses and the liquidation of PCFs; regulating the mediating of funds in the PCF system; regulating the organization and activities of Boards of Directors, Supervision Committees, and managers; giving guidance on lending,

[8] Nearly 56% of the PCF borrowers are LIHs. Thus, although as of 2005 the term "microfinance loan" had not been officially defined yet, the majority of the PCF loans could be considered microfinance loans.

accounting, and documentary mechanisms; regulating the establishment of Prudent Funds, PCF Associations, etc.; and other functions.

Rural Joint Stock Banks

Rural private banks also provide credit at the commune level (see Table 2). They have only about 12,000 loan clients nationwide, accounting to less than 0.1 % of rural households. Some banks have lent to the poor using the WU to organize women's groups that enter into loan agreements with the banks.

Informal Lenders

There are no recent statistics on the operations of informal lenders. And informal lenders are not subjected to the supervision of the SBV or any other authority. However, it is important to access their operations as they are among the active providers of credit, especially in rural areas (Table 2).

Table 2. Rural Household Loans and Loan Sizes by Sources (1997)

Source	Loans		Average interest rate (%/month)	Average loan size (ooo Dong/US$)
	%	%		
Informal financial sector	51.0	100.0		1,752/118
Moneylenders	9.8	19.0	4.56	2,141/145
Relatives and friends	24.2	48.0	2.63	1,861/126
ROSCA and other individuals	16.8	33.0	3.69	1,366/ 92
Formal and semiformal financial sector	49.0	100.0		3,209/217
Joint stock banks and cooperatives	2.2	4.4	1.59	2,230/151
Government banks	40.0	82.2	1.27	3,512/237
Government programs and others (NGOs)	7.8	13.4	0.87	1,574/105

Source: "Vietnam Living Standard Survey (VLSS)," 1997–1998

In practice the informal lenders charge interest rates much higher than those charged by formal financial institutions. Based on the VLSS database (Table 3), it is clearly that the lending rates charged by the informal sector typically are double those of the formal sector. Recently the lending rates charged by the informal sector in some rural areas in the North are about 2–3%/month, and as high as about 5–10%/month in rural areas in the South. There are several explanations for the persistent high interest rates in informal sector lending, such as high risk (no collateral), remoteness limiting choices (lack of choice for households because of geographical remoteness or local market control—i.e., some households being deliberately pushed to a few private lenders), restrictions on formal loan limiting access, small loan sizes, and high transaction costs per Dong lent, mainly due to small loan sizes.

Table 3: Average Monthly Interest Rates on Loans to Farm Households by Source (%)

Informal sector			Formal financial sector		
3.95			1.26		
Moneylenders	Relatives	ROSCA and individuals	Joint stock banks and cooperatives	Government banks	Government programs
4.56	2.63	3.69	1.59	1.27	0.87

Source: "Vietnam Living Standard Survey," 1997–1998

Recovery is usually preferred in cash but is sometimes in harvested crops, livestock, or gold. In addition, there are some traditional rural informal organizations called *Ho* or *Phuong*. A *Ho* is usually composed of 5 to 20 members who save a certain amount of money every month during harvesting time. Those who wish to borrow the money from the *Ho* make bids, and whoever offers the highest interest rate can borrow. The *Ho* can be considered a prototype of a mutual finance network. It does not introduce fund from outside, and it is not suited to providing consumption credit or a large amount of investment. On the other hand, the *Phuong* comprises 3 to 5 members who save a certain amount of money, and the members borrow without interest in an order determined beforehand.

Some Observations on the Performance of Banks, Nonbanks Institutions, and Informal Lenders

As we have seen, banks play the dominant role in the financial market in Vietnam. In other words, the banks are major financial intermediaries that mobilize funds for economic development. However, as mentioned above, the banking system in Vietnam is now in the process of restructuring. Banking reform requires the cooperation of the whole system in dealing with nonperforming loans, recapitalization, separation of policy lending from commercial lending, etc.

The nonbank credit institutions serve as a complementary channel for fund mobilization and allocation. In general, as the nonbanks are newly established, they have almost perfect records of performance. Since the nonbank institutions have much smaller sizes of operation as well as smaller networks of clients than the banks, sometimes banks act as agents for the nonbank credit institutions for fund mobilization. Nonbank institutions may also borrow from the banks in the inter-bank market or vice versa. To comply strictly with the credit restrictions set by the SBV and to avoid credit risks, nonbank institutions sometimes co-finance with the banks on large projects. The deposit interest rates and lending rates offered by the nonbanks are heavily based on the corresponding rates of the commercial banks. Actually, there are close links between the banks and nonbanks.

Informal lenders also act as credit providers in rural areas, especially in the South. There are no available recent data on the operations of informal lenders, nor is there evidence showing linkages between informal lenders and the formal sector. Informal lenders often charge much higher interest rates than those charged by the formal sector. Thus, if only in order to set high lending interest rates, informal lenders also have to keep watching interest rate developments in the formal market. The Rotating Savings and Credit Associations (ROSCA) are likely to deposit the savings of their members with the banks if they do not find other more lucrative alternatives. It is also predicted that they might borrow from the banks to re-lend.

The Emergence of Microfinance Institutions

Limited access to available resources, including financial capital, is among the main underlying causes of poverty in Vietnam. Until the 1990s, in rural areas, with the ineffective operations of credit cooperatives and of the formal sector in general, the farmers heavily depended on financial networks of friends, relatives, and moneylenders. However, in line with the transition from a centrally planned to a market-oriented economy, the banking system shifted from a one-tier system to a two-tier system, comprising the central bank and the network of commercial banks. Thus the Vietnam Bank for Agriculture (VBA) was established in 1991 as the first state-owned commercial bank that specialized in extending credit in the rural areas. The formation of the VBA is actually aimed at improving financial services in the rural areas as one of the priorities of the government's socioeconomic development program strategy from 1991 to 2000.

But demand for VBA loans increased as its interest rates were substantially less than rates offered by moneylenders. Therefore, funds were rationed, and loans tended to go to the least risky applicants (farmers with good lending records, collateral, and high income potential). Poorer farmers often missed out. In 1995, the Vietnam Bank for the Poor was set up, partly in response to the non-poor-farmer focus of the VBA. It was also an important part of the government's Hunger Eradication and Poverty Reduction Program, which aimed to reduce the percentage of poor households in Vietnam to 10% by the year 2000. The level of outreach of the VBP in its first years of operation was impressive. It was understandable given its low interest rates on loans, which were often made lower by contributions from local People's Committees. However, the VBP then found difficult to meet both its social welfare and financial autonomy objectives.

In addition, in order to accommodate the commercial banking activities of the state-owned commercial banks (SOCBs), it was necessary to separate policy lending from commercial lending. In late 2002 the Vietnam Bank for Social Policies (VBSP) was created to replace the VBP and to conduct other policy lending programs that had been implemented by different institutions and government agencies. The VBSP is now the first policy bank that specializes in policy lending, including micro-lending to the poor. Thus it is the formal financial institution that carries out microfinance.

In the rural areas, together with the largest VBA, a number of rural shareholding banks emerged to replace the small network of rural cooperatives that collapsed in 1989. The shareholding banks were significant providers of financial services, especially in the south of Vietnam. They typically derive most of their funds from the VBA, which they on-lend at higher rates. The People's Credit Funds (PCF) also emerged to fill the vacuum left by the collapse of credit cooperatives.

Mass organizations such as Vietnam Women Union (WU), Vietnam Farmers' Union (FU), and Vietnam Youth Union (YU) also provide small loans on their own account, implement programs for international nongovernmental organizations (INGOs), and facilitate the formation of credit groups for VBARD and VBP. For the mass organizations, financial services serve their primary objective of improving the economic situation of their members and act as a catalyst for the support of other activities.

The government, at both the central and local levels, was instrumental in the formation of the above-mentioned microfinance institutions. The State Bank of Vietnam also played a leading role in establishing VBA, VBP, VBSP, PCFs, and a number of rural private banks that provide microfinancing in rural areas. The formal microfinance institutions are already receiving considerable assistance from the international community. The Asian Development Bank, for example is supporting an expansion of the PCFs; the World Bank, the IMF, and UNDP have been active in providing technical assistance for the VBA.

THE STATUS AND PERFORMANCE OF MICROFINANCING IN VIETNAM

The Status and Performance of Major Providers[9] of Microfinancing

The Formal Sector

VBARD was the first formal credit institution in Vietnam with a mandate to provide financial services to farming and rural households. VBRAD is the largest rural financial institution in Vietnam. It provides services through a nationwide branch network. Its market share out of the total credit extended by formal financial institutions to rural households was about 75% at the end of 2003.

VBP was set up in 1995 with the mandate to provide credit to rural poor households and to support poverty reduction. In reality, VBP is institutionally "merged" with VBARD. Except at headquarters, it has no separate staff and relies totally on the VBARD branch network to carry out its functions. VBP borrowers can access loans at subsidized interest rates lower than market rates. Mobilized funds account for only 0.8% of total fund resources. Other resources are either borrowed from other financial institutions at interest rates subsidized by the government or received as contributions from local authorities. VBP was integrated into the Vietnam Bank for Social Policies in 2002 (all assets and debts were transferred up to 30 June 2003).

VBSP was established in December 2002, on the basis of the Vietnam Bank for the Poor combined with other policy financing. Its initial capital at establishment was VND 5000 billion, which as to be increased afterwards. Its target clients include poor households, disadvantaged students, people in need of funds for job creation, workers abroad for limited periods, and economic entities and households located in island, mountainous, and remote areas. The Bank is given some privileges such as is being tax-exempt, and it has no obligation to meet a reserve requirement at the SBV. The state-owned commercial banks are obliged to deposit at the VBSP annually the equivalent of 2% of their mobilized funds for the previous year.

The CCF/PCFs system is a successful demonstration of the provision of microfinance services through cooperatives.[10] After a six-year pilot program, the system had generally made sound lending decisions and performed creditably. Government did not intervene to

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[9] Since by 2005 there was no specific legal framework for MFIs, we do not have officially recognized MFIs in Vietnam. Therefore, this report provides information about the performance of the major providers of microfinance services in Vietnam before 2005.

[10] In the mid-1980s, 2000 credit cooperatives were set up to address the needs of the private sector; they numbered 7180 by the end of the decade. As the sole local source of funding, these cooperatives attracted savings principally from small investors by offering favorable rates (up to four times the rates offered by other financial institutions). Over 7000 cooperatives rapidly collapsed, for several reasons: (i) the closure of agricultural cooperatives, resulting in repayment of loans obtained from the cooperatives; (ii) insufficient monitoring of the line agencies and an insufficient legal framework which allowed pyramidal schemes and sometimes fraudulent local managements to spread; (iii), galloping inflation in late 1980s, which adversely affected the confidence of depositors; and (iv) the weaknesses of the cooperatives' management. In parallel with the restructuring of the agriculture sector, beginning in 1993 the Government of Vietnam set up a network of PCFs. Since then, the SBV has gradually modified the rules and regulations governing the management and operations of PCFs, and strengthened the system. Consequently, as of the end of 2003, the PCFs provide services to 911,926 clients who are their members—on average about 1016 members per PCF. Total outstanding credit of PCFs is about VND 4,049 billion as of the end of 2003. Besides the large number of borrowers, the simple lending procedures and methods (just 2–3 days to process a loan request, compared with 10–15 days taken by other banks; small loans provided without collateral); the low ratio of overdue debts (around 1% of total credit); and the reasonable rate of profitability (see Table 4) constitute the elements of the PCFs' successes. Moreover, the PCFs have played a significant role in poverty reduction and rural development, by improving their members' economic and social welfare and offering alternatives to the informal lenders with their unreasonably high rates.

save PCFs that failed to operate profitably, and some PCFs were closed by SBV for failing to meet the standards set for PCFs. In general, CCF capacity was gradually improved (see Table 4).

Table 4. Profitability of VBARD, VBP, and CCF (%)[11]

	1997	1998	1999	2000	2001
VBARD					
Return on capital employed	12.1	13.3	9.8	8.7	8.2
Rate of funds sourced	7.7	10.5	5.7	4.3	3.8
Profit margin	4.4	2.8	4.1	4.4	4.4
ROA (before loan loss)	1.4	1.3	1.6	1.6	2.0
CCF					
Return on capital employed	11	8.4	9.7	6.1	11.7
Rate of funds sourced	5.6	6.6	9.0	1.6	5.4
Profit margin	5.4	1.8	0.7	4.5	6.3
ROA (before loan loss)	6.5	3.4	2.9	2.8	1.8
VBP					
Return on capital employed	8.5	7.9	7.7	7.2	7.0
Rate of funds sourced	8.9	5.9	8.0	5.6	6.3
Profit margin	–0.4	2.0	–0.3	1.6	0.7
ROA (before loan loss)	0.2	0.9	0.03	0.3	0.1

Source: "JBIC Sector Study for Agriculture and Rural Development Sector in the Socialist Republic of Vietnam" (2003)

Looking at Table 4, it is clear that the profitability of the three formal financial institutions is relatively low, and especially that of the VBP. With that record of performance, the sustainability of the VBP is questionable, which is one of the rationales for the establishment of VBSP. For VBARD and CCF, profitability is reasonable if NPLs are maintained at healthy levels. However, there are no recent exact data on NPLs as bank assets have to be revalued using international standards.

The Semiformal Sector

As mentioned above, the national programs have been generally characterized by subsidized credit. Typical examples are as follows:

The Job Creation Program

Under the supervision of MOLISA, the Job Creation Program has extended VND 1070 billion (US$ 72 million) of credit with a maximum term of 36 months at a subsidized interest rate of 0.6 % per month. Nearly 50,000 clients, most of them small businessmen in the rural areas, have benefited from this program. Loans were first made through the State Treasury offices, then through the VBSP since 2003.

Greening Bare Hill Program

This program, with total funds of VND 2,920 billion (US$ 195 million), was designed to finance 1300 reforestation and small-scale infrastructure projects during 1993–1998. VND 420 billion (US$ 28 million) was used to provide interest-free loans to farmers to planting

[11] Return on capital employed: Interest received/Average balance of loan, deposit, bonds; Rate of funds sourced: Interest paid/average balance of deposit, borrowing, trusted funds;ROA: Net income/average balance of total assets.

orchards and forests. Borrowers were charged an interest rate of 0.1–0.2% per month to cover the service costs. The program was initially under the supervision of MPI. It has been replaced by the Program for Greening 5 Million Hectares of Forest since 1998.

Hunger Eradication and Poverty Reduction (HEPR) and Employment Generation Program (2001–2005)

This program aims to eliminate hunger and poverty, to reduce the number of poor households to less than 10% by 2005, to create employment for 1.4–1.5 million workers every year, and to reduce the rate of unemployment to below 6%. Loans are made for production of poor households in line with investments for infrastructure improvement in poor communes and promotion of employment. The total cost amounts to VND 22,580 billion, of which 16,245 billion VND is for HEPR and VND 6,335 billion is for employment generation. The program is conducted with the cooperation of MOLISA, MARD.

Program 135 (2001–2005

This program aims to reduce the number of poor households in the extremely poor communes (2325 communes) by 25%. Total cost is VND 7,600 billion.

Aquatics Raising Program (2000–2010)

One of the targets of this program is employment creation for 2 million workers by 2010. The credit will include medium- and long-term loans for construction and improvement of processing and seedling production facilities, and short-term loans for aquaculture materials.

Mass Organizations

As mentioned above, primary mass organizations are Vietnam Women Union (WU), Vietnam Farmers' Union (FU), and Vietnam Youth Union (YU), which also provide small loans on their own account, implement programs for international nongovernmental organizations (INGOs), and facilitate the formation of credit groups for VBARD and VBP. They are in a better position to know the households in the communes; therefore, they support the People's Committee in preparing the list of poor households and setting up the credit groups. WU has a network covering villages throughout the country, and its members account for about 50% of women over 18 years of age in the country. WU can provide both financial and technical support to the poor, so loan funds are usually well utilized. WU provides about 2 million loans annually with high repayment rates. But the majority of loans are relatively small at around VND 1 million. Like WU, FU has extended loans to about 1.8 million farmers with the average size of loans at VND 2.2 million. FU is responsible for managing the Farmers' Support Fund established by the government and other funds such as the Hunger Alleviation and Poverty Reduction Fund from provinces and districts.

Nongovernmental Organizations

NGO schemes are equivalent to about 7.6% of formal government schemes (about US$ 1.8 billion). The schemes funded by NGOs account for only about 4% of total rural microfinance lending, primarily targeting those excluded from access to formal finance. The local level capacities for microfinance services to disadvantaged populations have been the focus of many NGO programs. These organizations are recognized by the government, but are not legally regulated or supervised in their financial sector operations by the SBV. In practice, many NGOs carry out microfinancing focusing on the poor. NGOs provide technical assistance to mass organizations, or provide funds as well as technical assistance, or play the role of agent to formal financing institutions. The variety of international NGO schemes is reflected in their diverse objectives. Some are exclusively concerned with savings and credit. For others, savings and credit activities are an entry point in communities to promote programs on health or family planning. The savings and credit programs of NGOs are effective at providing financial services to the poor.

Products and Services of Microfinance Institutions (MFIs)

As there was no legal framework for MFIs before 2005, there were various types of microfinance institutions that provided microfinance to poor people, farming and rural households, and microenterprises. But the focus of almost all microfinance providers is the poor. They extend credit, receive savings deposits and then provide loans, etc. The micro-lending technologies or methodologies, the types of collateral accepted by the MFIs, and other features may differ from one MFI to another.

VBARD

The bank has more than 1600 branches and more than 22,000 staff members with a nationwide operational network in Vietnam. Particularly since 1998 it has strengthened its operational network by introducing mobile banks, which are given the same functions as inter-commune branches. The major clients of VBARD are the poor and households engaged in agriculture, fishery, forestry, and aquaculture. Lending to agriculture, forestry, and fishery takes priority, and the bank has only recently considered individual households as targeted clients. In practice, the average loan amount increased from around VND 6.4 million in 2001 to about VND 9 million in 2003. The outreach of the bank was about 7 million households in 2002. The credit growth increased at an annual rate of about 30% from 1996 to 2003, and the credit outstanding reached about VND 87,000 billion as of the end of 2003.

With regard to the lending methodology, direct lending accounts for 83% of the total lending volume of VBARD. The remaining 17% has been in the form of group lending through mass and other organizations. VBRAD itself has been accountable for determining the types of collateral for its loans in accordance with the regulations of the government and the SBV. However, there are some preferential policies for targeted clients: for example, households engaging in agricultural production, forestry, aquaculture, and salt production, the agricultural cooperatives may be the beneficial of waivers of collateral. For households and microenterprises engaging in the production of agricultural products, if they have signed contracts to sell their products, they may borrow from VBARD and secure the loans with the assets created by use of the loans. In practice, however, VBRAD usually requires a certificate of land use rights and guarantees from local authorities as loan security.

VBP/VBSP

The VBP has extended loans to millions of poor households at an average of VND 2.5 million per household. The numbers of poor borrowers have increased steadily: there were 1.2 million in 1998 and 2.75 million at the end of 2002. The credit share of the bank is about 80% of the total credit to the poor in rural areas. Outstanding loans expanded by 2.5 times, from VND 1,769 billion at the end of 1996 to VND 4,704 billion at the end of 2000 and VND 6,194 billion at the end of 2001. The bank is an independent institution and had branches all over the country. However, below the branch level it commissioned the VBARD to carry out lending and repayment operations. At the commune level, People's Committees and mass organizations guide and supervise the savings and borrowing groups, whose members assume the common responsibility for borrowing by members. The selection criteria of the poor eligible for loans vary at the local level, which raises the issue of targeting.

The maximum amounts of loans to the poor have been increased and are based on the nature of the activity: for households with production of livestock, aquaculture, etc., the amount of the loan may be up to VND 5 million per household, while for others it is only VND 3 million per household. But it should be noted that for poor households, no collateral is required to be eligible for loans, but the borrowers must be formed into groups. The procedure for obtaining a loan consists mainly of filling out the form and getting the approval of the Poverty Reduction Board at the commune level. The lending methodology is mainly group lending—providing loans through a group of 3–50 members. The members of borrowing groups have joint responsibility for repayment of the loans and have to have the acknowledgement of the People Commune Committee. VBP was integrated into the Vietnam Bank for Social Policies (VBSP), established in 2002 (all assets and debts were transferred by 30 June 2003).

Table 5. Average Interest Rates and Terms of Loans[12] (%/month, year)

VBARD		VBP		PCF		JSB		Moneylenders	
Interest rate	Term	Interest rate	Term	Interest rate	Term	Interest rate	Term	Interest rate	Term
0.9	1.9	0.7	2.2	1.1	0.7	0.9	3.9	2.8	0.5

Source: JBIC Sector Study Series, No. 9, 2002

The VBSP offers six lending programs: (1) loans to poor households; (2) loans to disadvantaged students; (3) loans for promoting job generation (resolution No 120/HDBT, dated 11 April 1992); (4) loans to foreign migrant workers; (5) loans to policy beneficiary areas (in Regions II and communes covered by Program 135); and (6) measures for policy beneficiaries who borrowed loans for house construction/renovation in the Mekong River Delta and Tay Nguyen (Central Highlands). The VBSP has mandates to provide credit for social policies, and in practice it primarily carries out micro-credit for supporting poor households and individuals for the purpose of job creation; thus it can be considered as one of the MFIs. Table 6 summaries the major credit activities of VBSP.[13]

Table 6. VBSP Credit Activities

Target groups	Maximum loan size	Interest rate	Collateral, guarantee
Poor households	VND 7 million (at present); proposal to increase the loan size to VND 10 million	0.45% per month (Region II, III); 0.5% per month	No collateral, but borrowers must be in the list of poor households, selected by communal Credit and Savings Group and certified by the communal level People's Committee
(continued on next page)			

[12] The figures in the table are based on survey data collected by JBIC in selected provinces.

[13] Actually, the VBSP is mandated to provide credit services for social policies based on clearly defined credit programs (recently 6 specific programs). The bank is allowed to consign VBRA (in the past the VBP was used to commission the VBRA or former VBA) to carry out lending and repayment activities. However, there is no room for overlapping clients between VBSP and VBRA or VBA. VBRA has no target clients; it is open to all who are economically active, especially in rural areas, whereas VBSP serves only targeted clients selected by the authorized agencies (e,g, the People's Committee) based on the 6 programs.

Job creation	VND 200 million	Normal: 0.5%/ month. Special: 0.35%/ month. Applied to businesses that employ disabled people	If the loan exceeds VND 15 million, collateral is required, and the borrower must guarantee the loan by their creditworthiness (reputation). The maximum loan shall not exceed 70% of the value of assets used as collateral. If the loan is below VND 15 million, the borrowers must guarantee the loan by their creditworthiness (reputation).
Policy beneficiaries who borrow on deferred payment for housing construction/renovation in Mekong River Delta and Tay Nguyen	VND 7 million	3% pa, including the first 5 years of grace period	No collateral requirement provided the borrower is included in the list approved by the provincial level People's Committee or the offices/agency authorized by said People's Committee
Disadvantaged students	VND 200,000 per month	0.45% per month	Disadvantaged students must have a guarantor
Lending to policy migrant workers	The maximum loan shall be 80% of total expenses, stated in the labor contract	As for poor households	The borrower and their family shall have repayment commitment
Policy beneficiaries in mountainous regions II or III and inaccessible area	No limit, but the loan amount shall depend on the request of the borrower, capital, the value of assets used as collateral for their loan lending (if any) and the VBSP's sources	15% to 30% lower than the lending rate of other commercial bank in the area	The economic entities must comply with VBSP collateral regulations

Source: VBSP

PCFs

The PCF network covers over 1000 communes (11% of the total number of communes in the country) and currently provides 7% of the outstanding credit in the formal rural financial sector and covers about 6% of the rural households (56% of the PCFs' borrowers are low-income households). The outstanding loans increased from VND 1,280 billion at the end of 1997 to VND 4,049 billion at the end of 2003.[14]

[14] The PCFs provide loans mainly to their members. However, recently some of the PCFs also extend credit to non-member clients; thus they can compete with other rural joint stock banks in providing credit to rural households. From the borrowers' side, they are free to borrow from PCFs, joint stock banks, or SCOBs (they

As at the commune level the PCFs are small-scale savings and credit cooperatives, only members of a PCF have access to loans; the members live in the same commune and know each other. The lending is mainly extended in the form of short-term loans to the members. But in recent years, non-members of the commune who satisfy the conditions of the PCFs also have become eligible to receive loans. Average lending amount is VND 4.7 million. PCF employ 2–3 loan officers to look after each commune. The procedure for applying and receiving a loan takes only 2–3 days. The majority of loans are direct lending, but recently PCFs have introduced group lending to deal with the poor. In group lending, the PCF disburses only 80% of a loan to a client; the remaining 20% is kept as a group deposit. When a member faces difficulty in repaying his loan, the repayment is made from this deposit.

Mass Organizations

The Vietnam Women's Union and Vietnam Farmers' Union have countrywide networks covering all levels from central areas to local commune. They undertake various activities including lending to agricultural—particularly poor agricultural—households. Social organizations own and manage members' savings and grants from donors such as international NGOs, and serve as facilitations for VBARD and VBP.

The first role that the organizations play as an agent of such institutions as VBARD and VBP is to provide funds to individual agricultural and poor households. In these cases, the social organizations usually play the central role in formulating the borrowing groups, selecting actual borrowers, and acting as agents in borrowing and repaying loans on behalf of the group members. In the case of VBARD, the borrowing groups have no joint responsibility to repay the borrowed funds; instead, the repayment is individual's responsibilities and the group puts peer pressure on the individual borrower. The bank may not lend further to, or may even withdraw funding from, a group whose member fails to repay, which would also add to the pressure for repayment. On the other hand, in the case of VBP, the group has joint responsibility, and in case of a repayment failure the other members of the group must repay the loan.

The second function is that, using their own funds or funds of other organizations like NGOs, the mass organizations lend to and receive money for their members. They have close contacts with agricultural households and local residents, which give them an advantage in lending small amounts of money to a number of poor households. At the same time, however, they may have few staff members and insufficient capacity for credit activity. Loans are small—basically at VND 300,000 to VND 800,000, and are made through the groups. The WU creates savings and credit groups, mostly between 10 to 15 members, that meet regularly to make loans from members' savings and provide peer pressure for repayment. Thus the repayment rate is above 90%. Since the mass organizations carry out credit activity without obtaining licenses from the SBV, they have problems with supervision and deposit insurance. Thus the amount of direct lending by the organizations is relatively small: the Women Union, the largest organization among them, had lent about VND 70 billion as of the end of 2001.

The NGOs

The NGOs' schemes are varied in their objectives, in the lending mechanisms used (joint or individual liabilities), in the interest rates charged, and on important issues such as whether savings should be compulsory or voluntary. However, there are some common points, as follows: (i) the poor who cannot by reached by VBRA, VBSP, or PCFs are explicitly targeted, and the major beneficiaries are women; (ii) operating areas are limited; (iii) lending is done through groups; (iv) the partner organization is mainly the Women Union at different levels, (v) loan size is small (the majority of loans are around US$ 100), and donor funds are relied

can be borrowers from specific institutions if they accept the terms and conditions for the loans and if the credit providers consider them eligible borrowers) on to cover costs; (vi) there are no restrictions on loan use; (vii) there is little emphasis on mobilizing savings; (viii) and peer pressure and group guarantee substitute for formal collateral arrangements (Tables 7 and 8).

Table 7. The Larger International NGO Schemes (2000)

Name of donor organizations	Average size of credit groups (persons)	Balance of loans outstanding (millions of VND)	Lending monthly interest rate	Balance of savings accounts (million VND)	Monthly savings deposit rate	Number of provinces covered
Rabo Bank	60	82,291	0.7	11,930		8
German Restructuring Bank (KFW2)	18	51,538	market rate			3
IFAD	12	41,193	1.0	32		1
UNFPA	17	25,808		745		8
UNICEF	13	14,565	1.0	6,402	0.15–1.0	22
Save the Children UK	5	11,435	2.0	2,799	1.4	1
American Oxfam	5	10,005	1.0	3,643	0.5	5
VN–Sweden	40	10,000	1.0		0.2–0.6	5
German Restructuring Bank (KFW1)	15	7,988	1.2			1

Source: DFID/SBV microfinance survey

Table 8. Microfinance Activities Conducted by the Large NGOs as of December 2002[15]

Name	Total	AAV	ADRA	CEP	CRS	SC-J	SC-UK	SC-US	TYM	VN+
Establishment		02/93	10/91	11/91	02/98	02/00	06/93	03/98	08/92	08/99
Microfinance mechanism		GM	SG		SG	GM	VB	SG	GM	GM
Coverage (provinces)	22	6	1	1	1	2	3	1	5	2
Proportion of women	98%	100%	100%	81%	99%	100%	100%		100%	100%
Loan balance (thousand US$)	8,448	1,168	19.7	3,632	42.3	83.6	1,753	135.6	1,461	153
Average loan size (US$)		44	65	111	48	28	62	30	90	30

(continued on next page)

[15] GM: Grameen Bank Model; SG: Solidarity Group Model; VB: Village Bank Model; AAV: Action Aid Vietnam; ADRA: Adventist Development and Relief Agency; CEP: Capital Aid Fund for Employment of the Poor; CRS: Catholic Relief Services; SC-J: Save the Children/Japan; SC-UK: Save the Children/UK; SC-US: Save the Children/US; VN+: Vietnam Plus.

Deposit balance (thousand US$)	2,314	440,5	2,5	823	0.6	12	518	0.1	517	
Overdue rate		0.2%	0%	0.9%	0.01%	0%	0%	0.6%	0%	7%
Loan loss provision/avg. loan balance		0.15%	0%	0.2%	0%	0.4%	0.16%	0%	2%	2%
Net operation income/avg. total assets		8.3%	3.4%	2.2%	1.5%	1.1%		4.03%	4.9%	24%
Loan interest rate (%/month)		1.35%	1%	1.1%	1.5%	1.5%	1.5%	1.6%	0.86%	1.5%
Deposit interest rate (%/month)		0.4%	0.5%	0.4%	0.15%	0.8%	0.6%	0.45%	0.5%	0.83%

Source: Vietnam Microfinance Bulletin, Vol. 2, 2003

With regard to the interest rates, the NGOs mainly set interest rates based on the rates offered by the VBARD. Of the 78 responders to a DFID/SBV survey, 29 said that they set rates with reference to the VBARD/VBP/SBV rates. And another 9, who mentioned the "market interest rate," invariably meant the VBARD rate (Table 9).

Table 9. Determinants of Lending Interest Rates by NGOs

Lending interest rate decided by	Number of schemes
Reference to VBARD/VBP/SBV rates	29
Government decision (e.g., VBARD schemes)	10
Local authorities and scheme management	3
Desire to cover operating cost	8
Mention of "market interest rate"	9
Financial sustainability analysis	10
Criteria not specified	9
Total	78

Source: DFID/SBV microfinance database[16]

Collateral for Microfinancing

As mentioned above, some micro-credit offered by organizations in the formal sector (such as VBARD or VBSP) requires collateral in physical form. But the common mechanism for microfinance offered by the semi-formal institutions, the informal sector, and even by VBP/VBSP is providing loans without traditional collateral (Tables 10 and 11). The lenders provide loans based on the borrower's reputation (past records of repayment, commitments, etc.), or on collateral substitutes such as joint liability, peer pressure, or guarantors.

[16] Microfinance in Vietnam: "A Survey of Schemes and Issues," DFID/SBV, April 2001.

Table 10. The Necessity of a Mortgage (by Funding Source)

	VBARD	VBP	PCF	JSB	Money-lenders	Others	Total
	No of households, %						
Necessity of mortgage							
With mortgage	185	2	31	6	0	17	241
%	92.5	6.3	93.9	100.0	0.0	44.7	77.2
W/o mortgage	14	30	2	0	2	21	69
%	7.0	93.8	6.1	0.0	100.0	55.3	22.1
No answer	0	0	1	0	0	0	1
%	0.0	0.0	2.9	0.0	0.0	0.0	0.3
Type of mortgage							
Certificate for land	51	0	5	6	0	3	65
(Red book), %	27.6	0.0	16.1	100.0	0.0	17.6	27.0
Certification for	5	0	0	0	0	0	5
house, %	2.7	0.0	0.0	0.0	0.0	0.0	2.1
Other valuable assets	35	1	7	0	0	12	55
%	18.9	50.0	22.6	0.0	0.0	70.6	22.8
Certification for land	90	1	19	0	0	2	112
and house, %	48.6	50.0	61.3	0.0	0.0	11.8	46.5
No answer	4	0	0	0	0	0	4
%	2.2	0.0	0.0	0.0	0.0	0.0	1.7
Total number of borrowed households	200	32	34	6	2	38	312

Source: JBIC sector study for agricultural and rural development sector in the Socialist Republic of Vietnam, 7/2003

Table 11. The Necessity of a Guarantor (by Funding Source)

	VBARD	VBP	PCF	JSB	Money-lenders	Others	Total
	No of households, %						
Necessity of guarantor							
With guarantor	58	28	13	0	0	19	118
%	29.0	87.5	38.2	0.0	0.0	50.0	37.8
W/o guarantor	131	2	20	6	2	19	180
%	65.5	6.3	58.8	100.0	100.0	50.0	57.7
No answer	10	2	1	2	0	0	15
%	5.0	6.3	2.9	33.3	0.0	0.0	47.5
Type of guarantor							
Relatives	2	0	0	0	0	0	2
%	3.4	0.0	0.0	0.0	0.0	0.0	1.7
Borrowing group	40	12	6	0	0	2	60
%	69.0	42.9	46.2	0.0	0.0	10.5	50.8
Others	16	16	7	0	0	17	56
%	27.6	57.1	53.8	0.0	0.0	89.5	47.5
Total number of borrowed households	200	32	34	6	2	38	312

Source: JBIC sector study for agricultural and rural development sector in the Socialist Republic of Vietnam, 7/2003

Actually, the acceptance of a non-traditional form of collateral is somewhat reasonable. Since microfinance targets the poor in the rural areas, only a small proportion of the households have a "red book" (certificate of land use rights) or other physical, durable goods that can be used as collateral for the loans. This constrains the access of the poor to the formal financial sector. The WU and FU are in a good position to know the borrowers in credit groups, and they often vouch for borrowers with NGOs that conduct microfinance activities with the support of mass organizations; they also are able to keep a close eye on the borrowers. Thus the government has provided support for facilitating the savings and credit activities of the mass organizations, especially the WU. And the lending methodologies of NGOs based on the models of solidarity groups or the Grameen Bank put pressure on individual borrowers who are the members of the groups to ensure repayment. Self-help and self-monitoring among the members of the groups ensure high rates of repayment. Thus it is understandable that NGOs and mass organizations accept non-traditional collateral as security for the loans. Besides close monitoring of the use of the funds by the borrowers, the mass organizations and NGOs in particular also provide technical support, training and education, and consultancy services on the choice of investment and of the appropriate loans. In addition, amortization methods of repayment on a regular weekly or monthly schedule, and the mechanism of extending larger loans based on the repayment of the previous smaller loans by the whole group, are also ingredients that ensure a high rate of repayment.

In addition, even when collateral is available, its realization is still problematic. To obtain the collateral, lenders have to request assistance from the local People's Committee or even the police. This incurs costs. To sell seized assets, the lenders must have proper documentation such as an invoice, certificate of ownership, certificate of registration, or land use right certificate. There is inconsistent implementation and interpretation between different authorities on documentation requirements, which creates constraints on asset realization. With regard to land use rights, changes in land use master plans create further complications because under the current regulations only certain types of land can be transferred. A situation could arise in which at the time the bank receives the mortgage, the land is classified as transferable, but it is subsequently re-designated as land for public purposes and therefore cannot be transferred. Thus the bank cannot sell the land use right in order to recover the loan. The long duration of court cases contributes to the delay in realization of assets. And cultural issues also affect the sales of property. In general, therefore, acceptance of traditional collateral may have some disadvantages. In addition, from the borrowers' side, having land as collateral does not solve the problem of lack of access of the poor to credit. The problem is deeper; and must be reform in the system of property rights to ensure that land as collateral provides a good solution to the problem.

THE POLICY, LEGAL AND REGULATORY ENVIRONMENT FOR MICROFINANCING IN VIETNAM

Government Policy and Legal Framework

The Different Laws and Legal Documents That Influence Microfinance Activities

The National Assembly has recently passed or modified laws that have considerable impact on the operations of financial markets. These include the Law on the State Bank of Vietnam, which clarifies its role and responsibilities as a central bank; the Law on Credit Institutions, which introduces of registration of nonbank institutions that conduct banking activities; the Civil Code, which clarifies rights and obligations with regard to private lending and borrowing; and the Cooperative Law, which provides a framework for the development of Credit Cooperatives. The Law on Credit Institutions distinguishes between credit institutions (banks, nonbank credit institutions, foreign credit institutions), cooperative credit organizations, and "other organizations." As defined by the ADB, the MFIs are not credit institutions as defined by this Law, and they primarily carry out microfinance activities. MFIs can be considered "other institutions" under the Law on Credit Institutions. However, there are no legal documents under the Law which stipulate the activities of "other institutions." Recently, in March 2005, the government promulgated a Decree on MFIs which stipulated that MFIs include socio-political, socio-professional, and social organizations; charity and social funds; and NGOs.

The laws that in particular affect microfinance activities are the 1995 Civil Code and the 1999 Law on Enterprises, particularly with regard to general business and ownership. The 1996 Law on Cooperatives also has an impact. Under the Civil Code, private credit markets are recognized, rights of lenders and borrowers are protected, and borrowers are obliged to repay the principal and interest to lenders.

The Law on Enterprises was ratified on 12 June 1999. The Law prohibits foreign organizations and foreigners who do not permanently reside in Vietnam from establishing enterprises, but permits them to contribute to capital in accordance with the provisions of laws that encourage foreign investment. However, there are no provisions of the Law of Foreign Investment, Law on Enterprises, or other related laws clearly covering the capital contributions of foreigners to local MFIs, or local NGOs. The Law on Cooperatives constituted the legal framework for the entire cooperative movement including financial sector cooperatives. Registering as cooperatives is one way for existing rural small credit schemes currently managed by mass organizations and supported by INGOs to have legal status.

In practice, a number of foreign NGOs have been providing microfinance as part of their activities in Vietnam, and that practice is tolerated insofar as the actual lending is made through some social organizations such as local WU. These NGOs are licensed to provide aid in accordance with the regulations on NGO aid under Decision No. 340–TTg of 24 May 1996 promulgating the Regulations on the Activities of Foreign NGOs in Vietnam. Pursuant to Decision No. 340, an NGO would need to get approval from a competent government authority (i.e., the provincial People's Committee or the Prime Minister, depending on the amount and the type of intended aid). Once approved, the NGO would enter into an agreement with a local mass organization that is to administer the funds for lending to beneficiaries. As such, before the issuance of Decree on MFIs, NGOs[17] in Vietnam did not constitute microfinance institutions on their own.

Thus, governance in mass organizations microfinance activities is determined partly by their charters and partly by the Prime Minister's Decision No. 340 on INGOs. The Decision that facilitates foreign NGOs' operations by setting out the eligibility criteria for their establishment in Vietnam contains the provision that they are nonprofit organizations. This technically prohibits foreign NGOs from operating self-sustaining schemes. Technically, an INGO can set up a wholly foreign owned enterprise under the Law of Foreign Investment. However, there is no clear provision under this Law for provision of microfinance services.[18] Social funds and charity funds regulated by Decree No. 177/1999/ND–CP of 22 December 1999 are also required to be nonprofits.

The savings and credit activities of mass organizations such as WU and FU and the NGOs are not governed by the Law but are authorized by virtue of Official Letters and Decisions of the Prime Minister. The government issued Official Letter No. 209 on 17 January 2000 to allow the WU to continue implementing the savings program for HEPR. Following this rule, on 28 July 2000, the SBV also issued Official Letter No. 619 confirming support for

[17] There is no provision excluding local NGOs from being applicants for bank loans, but there is no clear provision for extending loans for microfinance purposes. In the Decree on MFIs, the local NGOs can be applicants for microfinancing licenses and they are allowed to borrow from other credit institutions.

[18] Obviously there is no clear provision for providing microfinance in the Law of Foreign Investment, and before March 2005, there was still no specific framework for microfinancing. However, to conduct microfinancing services, the NGOs have to be given permission from several authorities.

WU in savings and credit activities nationwide. These are the highest-level legal documents for the operations of the local semi-formal sector and have for the time being resulted in continued development of WU savings and credit programs outside the regulatory framework. Actually the WU is encouraged to receive savings deposits to provide credit to the poor, low-income households through the savings–credit groups, which significantly contributed to poverty reduction.

WU and FU are chartered to protect the legal rights and interests of their members and to encourage them to participate in development. Their governance structures, with members and representatives at all levels of society, have made them attractive implementing agencies for INGO projects, many of which have incorporated microfinance components. Governance in these schemes has effectively been determined by the sponsoring INGOs.

In sum, there is currently no applied legal guidance on governance for NGOs and mass organizations savings and credit operations. Vietnam has not issued any law particularly regulating microfinance yet. The government is considering a Draft Decree on Microfinance, which is scheduled to be passed later this year. And the government is currently considering whether to permit the establishment of independent non-credit-institution entities to provide microfinance. The Draft Decree on Microfinance considers the regulation only of microfinance activities carried out by MFIs, which are not credit institutions as defined by the Law on Credit Institutions. The current draft of the legislation that is in our possession appears to permit NGOs and mass organizations to be applicants for microfinance operating licenses.

Support Provided by the Government for Microfinance

As mentioned earlier, the government has provided considerable support for microfinance activities, not only by setting up policy direction for fostering microfinance development and by regulating the financial institutions engaged in microfinance (via SBV), but also by allocating State funds for national programs, funding and providing liquidity support for the formal financial institutions engaged in microfinance, such as VBARD and VBSP, and other measures.

The national programs have major common characteristics, as follows: (i) they provide subsidized credit (credit with subsidized interest rates or interest-free credit); (ii) loans are mainly provided without physical collateral, and borrowers must be on the list of poor households or must guarantee the loans by their creditworthiness (for some programs, such as the Program on Job Creation, if the loan exceeds VND 15 million, collateral is required); (iii) the terms of the loans may differ from each other, but the loans are mainly medium and long term; (iv) national programs are conducted with the cooperation of different government ministries and mass organizations; (v) there is close linkage among the tasks of poverty reduction, infrastructure improvement in the poor communes, and promotion of employment.

For liquidity support, the financial institutions engaging in microfinance activities, such as VBARD, VBSP, and CCF, can access different channels of short-term liquidity support from the SBV. In practice, if they are experiencing a shortage of liquidity, like all other credit institutions, they can be supported by the SBV through obtaining refinancing loans, discounting their valuable papers, or participating in open market operations. However, in some exceptional cases they may ask for special loans from the SBV—i.e., loans with special longer terms and lower interest rates than the common rates. For example, the VBARD may get special refinancing loans from the SBV if it needs special support for extending loans to borrowers to overcome food shortages.

Legal Support for the Collection of Loans for MFIs

There is no legal support for MFIs[19] since they are not officially recognized yet. As for semi-formal MFIs, including NGOs, such support would not exist either, as the law still does not recognize the right to provide microfinance. As for registered banks that act as microfinance providers, the major available support is the mechanism for realization of security. This mechanism includes sale by auction, taking assets in lieu of repayment, etc. Before exercising these powers under law, the banks must have obtained a valid security, which would require registration at the National Agency for Registration of Secured Transactions under the Ministry of Justice if the security is a pledge of movable property. If the security is a mortgage of immovable property, the law has recently permitted registration at the provincial Department of Natural Resources and Environment. The system of registration is fairly new (even with pledges); thus it is difficult to assess its efficiency. However, pledges seem to work well for banks and other credit institutions. As for mortgages, the system does not work well in practice as the majority of real estate in Vietnam is unregistered and the registration of mortgages has not been operative yet.

Legal Protections for Borrowers Who Fail in Their Business

Vietnamese law does not permit personal bankruptcy. As for business bankruptcy, the Law on Business Bankruptcy does not work in practice since its conditions for bankruptcy filing and declaration actually impedes the ability to bankrupt.[20] Under the current Law on Business Bankruptcy: A bankrupt business may be allowed to restructure if the majority of creditors agree; the court (the Provincial Economic Courts) authorizes the bankruptcy of businesses. However, the current regime is highly ineffective and only about a hundred bankruptcy cases have been dealt with since 1997 when the Law on Business Bankruptcy commenced its effect.

The Regulatory and Supervisory Infrastructure

The Regulatory and Supervisory Infrastructure for Banks, Nonbanks and MFIs

As mentioned above, all banking institutions and nonbank credit institutions including those providing microfinance such us VBSP, VBARD, and the CCF/PCFs, are subject to the supervision of the SBV. At the SBV, the Banking Inspectorate Department (BID) is responsible for inspection of all formal financial institutions including those providing microfinance services. There is no supervision of the SBV in the semiformal sector including the NGOs and other microfinance institutions, as these institutions providing microfinance services are outside the Law on Credit Institutions. The SBV carries out onsite inspection and offsite supervision. Each year, BID prepares an overall inspection plan from which the Inspection Division at each SBV branch develops its own detailed inspection plans. All institutions are inspected the same way. All institutions must be inspected onsite at least yearly. SBV may execute an inspection on at any time without notice. For offsite supervision banks send reports to the SBV monthly. These include the balance sheet, the profit and loss account, and a loan portfolio report. Reports are normally prepared in consolidated form. SBV uses a series of ratios and other performance criteria to gauge the safety and efficiency of financial institutions. In addition, commercial banks also have to send reports to the Bank and Nonbank Credit Institutions Department and Monetary Policy Department at the SBV.

The SBV has provincial branches that are responsible for inspecting financial institutions and/or their branches in their province. The focus of the onsite work by the SBV is com-

[19] The credit institutions (banks, PCFs) that are engaged in microfinance can rely on the legal framework for collections of loans. However, the other MFIs ,and NGOs lend at their own risk.

[20] As of 15 June 2004, the Law on Business Bankruptcy was replaced by the Law on Bankruptcy, which has been in effect since 15 October 2004. Not only enterprises but also cooperatives are subject to the Law on Bankruptcy.

pliance with laws, the financial condition of the institutions, and analysis of the potential risks faced. Assessment of financial management, human resources, credit management, and risk management are important aspects of onsite inspections.

As mentioned above, currently there is no direct or delegated supervision in the semiformal sector. Just for the PCFs, the CCF has an increasing role in supervision, and this is attracting attention to the possibility of delegating supervision. The responsibility for supervising and coordinating the semiformal sector and its relationship with banks and financial institutions remains unclear. Regarding delegated supervision, VBARD cannot currently be considered a suitable institution. Significant reform in VBARD is still required before it can conduct its own affairs adequately. In a recent development under the World Bank Second Rural Finance Project, the Vietnam Bank for Industrial Development (BIDV) has been appointed to accredit MFIs that satisfy the accreditation criteria. In the course of the project BIDV will undergo substantive institutional reform. If successful, a future possibility could be the use of BIDV as a supervisory intermediary. But for the time being, SBV is effectively the only institution qualified to supervise. Self-regulation requires the development of industry standards, independent of government, and establishment of a credible apex body to ratify and supervise the implementation of the standards. Thus the Decree on MFIs stipulated that the regulatory and supervisory body for MFIs is the SBV.

The Role of the State Bank of Vietnam (SBV) vis-à- vis MFIs

*A*s mentioned above, the SBV is acting as both regulator and supervisor for the system of credit institutions, including VBARD, VBSP, and CCF that engage in microfinance activities. However, the SBV does not regulate and supervise the microfinance activities provided by the semiformal sector, i.e., mass organizations and NGOs. And the SBV is not the provider of development financing. In fact, there is no comprehensive framework for microfinance development. And the SBV is now the Executing Agency for the Project on Preparing the Decree on Microfinance in Vietnam. The Decree will provide the overall and comprehensive legal framework and guidelines for microfinance activities and for developing sustainable MFIs; and it will coordinate all microfinance activities while being responsive to the real needs of the microfinance sector. Based on the Decree on Microfinance, the SBV is the regulator and supervisor for the MFIs.

Second-tier Bodies

There are no second-tier bodies acting as “regulators” for MFIs. NGOs specialized in microfinance provide the funds in the form of non-refundable aid to the organizations administering the lending, and such NGOs usually control the lending process through informal mechanisms. Such control is only possible during the term of the particular project of the relevant NGO. After such term expires, the funds are self-administered by the mass organizations; the regulatory body of credit institutions (the SBV) does not relate to NGOs in any way as NGOs are regulated by another agency, the government’s Committee for NGOs.

Self-regulation Practice

Before March 2005, there was no specific law or legal framework for microfinancing and no official definition of MFIs. As mentioned above, the NGOs lent at their own risk; thus, to ensure the safety of their microfinancing operations, the NGOs developed their own performance standards and prudential ratios. In general no self-regulation was practiced. The Decree on Microfinance also has not stipulated self-regulation for MFIs, but the SBV is the regulatory body for MFIs.

Specific Regulatory Requirements and Supervisory Practices
Registration and Licensing

As mentioned earlier, before 2005, there was no comprehensive legal framework for the formation and operation of MFIs in Vietnam. There was no special law under which an MFI should register and obtain a license to operate. Formal credit institutions such as VBARD and PCFs followed the procedures for obtaining a business license from the SBV for conducting banking activities including micro-credit expansion and savings mobilization. Based on the Law on Credit Institutions, an application for the establishment and operation license for a credit institution should include the following: draft of charter; business plan for the first years; list, curriculum vitae, and certificates evidencing the qualification and professional capability of the founding members, members of the board of directors, members of the controllers committee, and the (general) director; amount and plan of capital contributions and a list of organizations and individuals making capital contributions.; financial conditions and other relevant information relating to major shareholders; approval by the relevant People's An application for the operation of an organization which is not a credit institution includes the following: application for a banking operation license; decision or permit of establishment; certificate of registration of current line of business; charter; list and curriculum vitae of members of the board of directors, the (general) director, and members of the controllers committee (if any); financial conditions in the last three years; and business plan for banking activities. The Law on Credit Institutions also clearly stipulates that within 90 days from the date of receipt of the complete application file for the establishment and operation license of a credit institution or the banking operation license of an organization which is not a credit institution, the SBV shall either issue a license or refuse to do so. In the event of refusal, the SBV shall serve a written notice giving the reasons therefore. In the new Decree on MFIs, almost the same procedures are specified (see the Appendix).

For NGOs and mass organizations the procedures are rather complicated. INGOs are registered under the NGO Committee and are managed through the People's Aid Coordination Committee. Local NGOs are registered and managed through the Government Committee on Organization and Personnel. NGOs are not allowed to run microfinance businesses themselves by employing their own staff. Thus, they have to work with mass organizations in this area. To establish projects, a series of explanations must be given and permission from several authorities at the central, provincial, and even district and commune levels is required. When the area of operations changes, the same procedures are also required. Mass organizations like WU and FU, which were established in 1930, participate in providing microfinance based on the decisions of the government, which sees them as playing role in implementing government policies on poverty alleviation and job generation.

The Draft Decree on Microfinance stipulates that the licensing body for MFIs is the SBV, and it appears to consider the NGOs and mass organizations as possible applicants for microfinance establishment and operating licenses. This is now officially stipulated in the Decree (Appendix).

Minimum Capital Requirements and Conditions for Registration and Licensure

The only institutions that are subject to the Law on Credit Institutions are obliged to meet the regulations on minimum capital requirements (see Table 12), The conditions and procedures for obtaining licenses are mentioned above. The Decree on MFIs stipulated that the licensing body for MFIs is the SBV. An organization that applies for microfinance establishment and operating licensure must meet the minimum capital requirements (VND 500 million for non-voluntary deposit-taking MFIs and VND 5 billion for voluntary deposit-taking MFIs) and prove that there is a demand for small-scale finance activities; must have the approval of the provincial or local People's Committee for the establishment of a small-scale finance institution in the locality; must have adequate capital as stipulated in the Decree;

must have offices and infrastructure appropriate to the proposed small-scale finance activities; must have administrators, controllers, and managers as stipulated in the Decree; and must have a feasible business plan. The application must be considered and approved or rejected within 60 days of receipt (Appendix).

Regulation of Ownership

Before 2005, there were no regulations governing ownership, although the Draft Microfinance Decree contemplates the foreign capital contributors of MFIs and NGOs as possible applicants for MF licenses or capital contributors to MFIs. The Decree on MFIs stipulates that Vietnamese individuals, foreign individuals, and local and foreign organizations may be capital contributors to small-scale finance institutions or MFIs (Appendix).

Table 12. Minimum Capital Requirements

Regulation	Limits
Minimum capital	
VBARD	VND 2,200 billion
Other SOCBs	VND 1,100 billion
Joint stock banks, Ho Chi Minh and Hanoi	VND 70 billion
Joint stock banks, other provinces and cities	VND 50 billion
Joint stock banks, rural areas	VND 5 billion
Urban cooperative banks	VND 5 billion
Rural cooperative banks	VND 3 billion
Local PCFs	VND 0.1 billion
Regional PCFs	VND 1 billion
CCF	VND 100 billion
Vietnamese nonbank credit institutions	VND 50 billion
Joint-venture nonbank credit institutions	US$ 5 million
Foreign-owned nonbank credit institutions	US$ 5 million

Source: SBV

Foreign Shareholders in MFIs and the Contribution of Foreign Donors to the Capital Formation of MFIs

Before 2005, there were no available regulations on this issue. However, the Decree issued in 2005 (Appendix) stipulates that foreign individuals and organizations can be capital contributors to the MFIs.

Regulations on Qualifications of the Members of the Boards of MFIs

As stipulated in the Decree on MFIs, the members of the boards of management, controllers, and directors of MFIs shall satisfy certain requirements on their expertise and professional ethics in accordance with guidance of the state bank. The following people are not permitted to be members of such boards: people who are under criminal prosecution or were sentenced for any serious crime against national security, grave misappropriation of public or individual citizens' property, or other serious economic crimes, or who were convicted of any other crimes in relation to which the sentence has not been cleared from the court's records, etc.

Interest Rate Policy and the Impact on MFIs

Before the issuance of the Decree on MFIs, there was no official MFI recognized by the law, so there was no regulation on the interest rates of MFIs. In fact, the formal sector engaged in microfinance has been characterized by a mixed of market and subsidized rates, the subsidies accruing mainly for disaster relief programs. NGOs' and mass organizations' schemes have gradually followed VBARD in setting interest rates, which means that subsidies have gradually been removed as VBARD rates have been liberalized. It is noteworthy that in June 2002 the SBV revised the interest rate policy, and there is no regulation putting a ceiling or cap on lending and deposit interest rates of the credit institutions. Consequently, credit institutions (except VSPB) are able to determine their own interest rates. In general, with self-determination of interest rates, the efficiency and financial sustainability of the credit institutions can be ensured. In the Decree on MFIs, there is no specific provision on interest rates of MFIs, but the Decree stipulates that the MFIs shall operate on the principles of self-government and financial autonomy. Therefore, the MFIs also determine their interest rates themselves (see the Appendix).

Regulation on Capital Adequacy

As stated earlier, only the credit institutions that are subjected to the Law on Credit Institutions have to comply with the regulations on capital adequacy. Before 2005, there was no regulation on capital adequacy for other institutions engaging in microfinance. However, in fact each institution engaged in microfinance has its own methods to ensure the safety of its performance of microfinance activities (i.e., setting its own prudential ratios and requirements, such as own capital over total assets, liquid assets over total savings, etc). The Decree on MFIs stipulates the requirements for minimum capital and places some restrictions on the operations of MFIs, but there is no specific provision of requirements on capital adequacy for MFIs.

Regulation on Loan Loss Provisioning

Only the credit institutions that are subjected to the Law on Credit Institutions have to comply with the regulations on loan loss provisioning (Table 13). For other institutions engaging in microfinance, each institution has its own principle of loan loss provisioning (Table 8 above). The Decree on MFIs has no specific provision on loan classification and loss provisioning applied to MFIs.

Table 13. Loan Classification and Provisioning Set by the SBV

Unsecured debt		Secured debt	
Overdue less than 91 days	20%	Overdue less than 181 days	20%
Overdue 91 to 180 days	50%	Overdue 181 to 360 days	50%
Overdue more than 180 days	100%	Overdue more than 360 days	100%

Source: SBV

Assessing Credit Quality and Monitoring the Risks of Microfinance Loan Portfolios

Before the issuance of Decree on MFIs, there was no available regulation for MFIs. However, in reality, the SBV was always concerned with assessing the quality of the loan portfolios of the credit institutions, the loan repayment history, the historical data of overdue debts, the size of NPLs, the securities of the loans, and some portfolio quality ratios—loan loss provisions, portfolios at risk, and loan losses. Common measures to avoid the risks of loan portfolios are compliance with credit restrictions, e.g. up to 15% of own capital (on aggregate to any single borrower or related group) for large exposure, and up to 5% of own capital in total for related party lending. Thus the Decree on MFIs also stipulates some restrictions on credit operation of MFIs, and the SBV will provide detailed guideline on the issue.

Limits on the Level of Unsecured or Uncollateralized Loans

There is no available regulation putting limits on the level of unsecured or uncollateralized loans for MFIs. Even credit institutions are also entitled to determine their own levels of unsecured loans, although the government and SVB issued guidelines on the levels of unsecured loans depending on the purpose of loans and the types of borrowers.[21]

Legitimate Forms of Security

Vietnamese law (the Civil Code and the Law on Credit Institutions and its implementing Decrees) allows the following types of security: (i) pledges of movable assets; (ii) mortgages of immovable property; and (iii) third-party guarantees (whether backed by assets or not). The other types of non-traditional security, like joint liability, peer pressure, and group guarantees, are not officially recognized. However, Vietnamese law permits credit institutions to accept non-binding guarantees (guarantees just by reputation but not backed by assets) by mass organizations (e.g., the women's unions) to back small loans to low-income borrowers. The guarantees by mass organizations such as WU and FU are only applied to the small loans as stipulated by the SBV. The mass organizations provide assistance and guidance to poor individuals and households who borrow funds for businesses, production, or services; and they monitor and encourage the borrowers to use the borrowed money properly and efficiently and to make payments in due time.

Microfinance Loans as Legitimate Microfinance Loans or Consumer Loans

In the Decree on MFIs, "microfinance loans" means small-sized loans with or without collateral provided to low-income households and individuals in order to support their income- generating business activities and improve their living standards.

Documentation to Evaluate the Creditworthiness of Microfinance Borrowers

There is no such documentation to evaluate the creditworthiness of microfinance borrowers.

Methods of Supervision

As mentioned above, the SBV has step by step adopted the methods of CAMEL (Uniform Interagency Bank Rating System) on supervision for the credit institutions that are subject to the Law on Credit Institutions. But for the MFIs, the requirements for supervisory bodies and methods of supervision are still unclear.

The Nature of Microfinance Loans and Related Credit Procedures

Before 2005, there was no specific law on microfinance. Microfinance loans were not official defined. However, it is obvious that the SBV, as the expected regulatory and supervisory authority for MFIs in Vietnam, understands the nature of microfinance loans and related credit procedures. Thus, the SBV recognizes the need of drafting the specific legal framework for microfinance. And the Decree on MFIs defines microfinance loans as small-size loans with or without collateral security, provided to low-income households (or poor households). Hopefully the SBV will provide detailed guidelines on the related issues. But possibly loan documentation may be simple. Financial statements on the borrowers' businesses often may not be available. The non-traditional types of collateral, especially group guarantees. may be applied.

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[21] Based on Decree No 178/1999/ND-CP dated 29 December 1999 and Decree No 85/2002/ND-CP dated 25 October 2002, the credit institutions are entitled to make their own decisions and be responsible for unsecured loans. In addition, the SBV has issues Circular No. 03/2003/TT-NHNN dated 24 February 2003 and Decision No. 312/2003/QD-NHNN dated 4 April 2003 providing guidelines on limits of uncollateralized loans for some types of borrowers, such as a limit of VND 30 million on unsecured loans for farm households with guided conditions, and a limit of VND 100 million for the cooperatives that provide inputs for agriculture, forestry, fishery production, etc.

NGOs and Savings Mobilization from the Public

As mentioned above, the Law on Credit Institutions distinguishes between credit institutions (banks, nonbank credit institutions, and foreign credit institutions), cooperative credit organizations, and "other organizations." As defined by the ADB, the MFIs are not credit institutions as defined by this Law, and they primarily carry out microfinance activities. MFIs can be considered "other institutions" under the Law on Credit Institutions—i.e., MFIs can be entitled to receive deposits (including savings from the public). However, there are no legal documents under the Law that stipulate the activities of "other institutions." Thus the banking law does not stipulate the savings mobilization of the NGOs. Moreover, before 2005 there is no specific law on MFIs, and there is no regulation on savings mobilization of the NGOs. In facts, savings mobilization in the NGO and mass organization schemes has not been given particular emphasis and is absent altogether in some schemes. Overall, savings total about 10% of total outstanding loans in these schemes. The Decree on Microfinance distinguishes between non-deposit-taking and deposit-taking MFIs. Accordingly, the NGOs can be possible applicants for either non-deposit-taking or deposit-taking MFIs.

Transformation of NGOs into Formal Institutions, e.g., Banks

Since there is no available law or regulation on MFIs up to 2005, the legal status of non-financial entities that undertake microfinancing is ambiguous. The fact that there is no determining legal provision for transforming the mass organizations supported by international NGOs or INGOs into formalized MFIs affects long-term investments in institutional capacity for micro-financing specialization. The absence of an effective legal form for MFIs means that the transition from mass organizations or NGOs activities to formalized MFIs is not possible. As mentioned above, for a mass organization or INGO- supported scheme that want to attain legal status, the PCF model is the only one currently available. As adoption of the PCF model results in membership of the CCF apex, it is currently not possible for an MFI to emerge on a national scale. The issuance of the Decree on MFis may solve the issue of transformation of NGOs into formal MFIs, as NGOs can be applicants for establishment as MFIs.

Micro-insurance and Similar Products; Supervisory Infrastructure

Before 2005, there was no available regulation on micro-insurance and similar products. The Decree on MFIs just stipulates that the MFIs have the right to act as agents in the field of insurance.

Training Needs Faced by Regulators and Supervisors Regarding Microfinance

Before 2005 there was no officially authorized regulatory and supervisory body for MFIs and especially for microfinance activities of NGOs and mass organizations. But based on the newly passed Decree on MFIs, the SBV is undertaking regulation and supervision for MFIs. Thus, it is essential to provide training for the SBV in developing a regulatory and supervisory framework for MFIs. For example, the major possible areas of training may be as follows: setting up measures to ensure security for the operation of MFIs, including the establishment and use of provisions for risks; appropriate prudential rules for MFIs (loan classification and loan loss provisioning, capital adequacy ratios, etc.); the issue of deposit insurance for MFIs; developing and applying the onsite and offsite supervision procedures appropriate for MFIs in Vietnam; the issues related to preparing accounting and financial reporting and disclosure regimes for MFIs; developing effective data collection and processing system for both SBV and MFIs, etc.

CONCLUSIONS AND RECOMMENDATIONS

Some Recommendations for the Microfinance Framework and Related Regulatory Requirements

Having recognized the importance of creating a supportive policy and regulatory framework for microfinance, the government has asked the ADB for assistance in developing it. In practice the government has issued a Decree on Microfinance as a step towards creating a microfinance framework and regulation conducive to microfinance development. However, as mentioned above, there are still a number of further steps that should be technically implemented to establish comprehensive legal framework for MFIs. And the SBV should promulgate the relevant guidelines on implementation of the Decree.

Like some others, I personally still think that in order to promote microfinance the government should further facilitate the contribution of the foreign individuals and organizations in general, as they can bring the best practice of microfinance into Vietnam. Accordingly, a legal framework on taxation, profit remittance, etc., should be formulated in an appropriate manner that encourages foreign capital flows into the microfinance sector. In addition, the microfinance operations of mass organizations should be significantly accommodated as they have some advantages in providing microfinance: they are community-based, and they can effectively target the poor.

As stated earlier, to ensure the safety and soundness of the MFIs, it is also necessary for the State Bank to develop non-prudential and prudential rules and restrictions for MFIs. It is suggested that liquidity requirements for MFIs should be higher than for commercial banks, as they cannot usually make rapid calls on capital. Voluntary deposit-taking MFIs should have liquidity at least equal to that of other financial institutions, together with access to a lender of last resort. At the initial stage, the MFIs should be required to make loan classification and loan loss provision aggressively. It is proposed that the regulations on provisions for credit institutions may be applied for MFIs. But both deposit-taking and non-deposit-taking MFIs need to comply with the regulations on credit restrictions for related part lending and on large loans to avoid the risk. As microfinance loans are small loans, the limit on large exposures should be smaller than that for the credit institutions[22]: it can be about 10 or 12% of own capital (on aggregate to any one borrower)

Given the nature of microfinance, it is also suggested that regulations on forms of security for microfinance loans should be issued, which consider not only traditional collateral but also forms of non-traditional collateral—joint liability, peer pressure, group guarantee—as legitimate form of security. It is likewise essential to formulate some kind of guideline documentation for evaluating the creditworthiness of microfinance borrowers, assessing the credit quality of microfinance loan portfolios, and monitoring the risk of the microfinance portfolios.

In the first stage, the SBV can be the right organization to undertake the tasks of regulating and supervising MFIs. However, in the future delegated supervision can also be an alternative. The methods of supervision should be based basically on the CAMEL (Uniform Interagency Bank Rating System) standards, taking into account the feature of simplifying reporting requirements for MFIs. To efficiently monitor the performance of MFIs, it is also necessary to have regulations on the accounting and reporting regimes for MFIs.

As the Decree just came into effect in March 2005, to enhance microfinance services, the State Bank of Vietnam should provide specific guidelines on bankruptcy provisions for the MFIs (including mass organizations and NGOs) that are engaged in microfinance.

Finally, the Decree on MFIs was promulgated, which has created a legal framework for microfinance institutions. However, besides the MFIs, there is still the policy bank (VBSP), which also provides credit to the poor. Actually, the establishment of VBSP is a significant

[22] Large exposures for credit institutions is up to 15% of net worth (on aggregate to any one borrower)

step forward in enhancing business capacity and financial soundness of the banking system, as separation of policy banking from commercial banking was implemented. This is actually consistent with the banking reform in the context of shifting to market-based principles and economic integration. But given that the VBSP acts as policy bank, in order to promote microfinance, the government should have further policies and regulations to a create legal playing field for the MFIs.

Recommendations on Related Policies and Laws

To accommodate the development of the microfinance sector, ensuring stable macroeconomic environment is of great importance. This requires the efforts of the government and of the line ministries at different levels and. For example, monetary, fiscal and other macroeconomic policies should be conducted effectively to ensure the purchasing power of the local currency, control inflation, and facilitate economic growth. The government is expected not only to establish a legal framework or strategy for microfinance sector development, but also to provide active and efficient support for MFIs in the form of funding or liquidity support (via the role of the SBV as the lender of last resort). Moreover, the strategy and policies on microfinance development should continuously be in line with other policies and strategies, such as policies on socioeconomic development, policies on agriculture promotion and structural transformation, and so forth.

To foster the development of the microfinance sector, there should be legal support for the collection of loans for MFIs; this means the mechanism for registration and realization of security and related procedures should not only be legally supported, but also work well in practice. To accommodate the access of poor households to MFIs, the government should take further actions to streamline the process of considering and issuing the land use certificate [23] or "red book." The administrative reform should be expedited to make all the mechanisms and procedures related to microfinance loans transparent and implemented in a timely fashion.

Creating a legal framework for the protection of borrowers who fail in their business is also an aspect of concern. A personal bankruptcy law should be issued, or the current law should be revised to permit not only business bankruptcy but also personal bankruptcy. It is important that the law should work well in practice.

Microfinance loans have mainly been conducted through credit groups. Lending methodology through credit groups should be further developed, as it has advantages from economics of scale and minimizes the risks from lending activities. However, the credit groups have not been legally recognized. The extension of microfinance loans through credit groups could be facilitated if the groups have their own legal status.

Training and Capacity Building

As the microfinance sector continues to develop, human resources are of great concern. It is essential for the government to place priority on enhancing training activities not only for the regulators and supervisors of MFIs but also for the staffs of MFIs themselves. For the SBV, as the regulatory and supervisory body for MFIs, it is necessary to provide training for staff members in developing a regulatory and supervisory framework for MFIs. As mentioned above, the major possible areas of training may be: (i) developing and applying the onsite and offsite supervision procedures appropriate for MFIs in Vietnam; (ii) setting up measures to

[23] The land use certificate "red book" can be used as collateral for the loans. In order to obtain a "red book," the applicant should follow a standard procedures such as filling in the application form, submitting the book of permanent residence and certificate of marriage, submitting the documents certifying the authorized permission to use the land, build the house, make related transfers, and so forth. And the map of the land and related house should be established. All the required documents should be submitted to the relevant People's Committee for consideration before issuing the"red book."

ensure security for the operation of MFIs, including the establishment and use of provisions for risks, appropriate prudential rules for MFIs (loan classification and loan loss provisioning, capital adequacy ratios etc.); (iii) establishing accounting and financial reporting and disclosure regimes for MFIs; and (iv) developing effective data collection and processing system for both SBV and MFIs.

For the MFIs, it is also very necessary to organize training courses on the basic aspects of microfinance loans, lending methodologies, project analysis, risk management and measures for ensuring financial sustainability, and so forth. The mass organizations in particular basically lack professional skills for fund management. Accordingly, in order to enhance the efficiency of their microfinance activities, further training in these fields should be given great emphasis. Besides enhancing the knowledge of credit management and savings mobilization, the staffs of mass organizations such as WU and FU should be progressively trained in other different technical topics so that they will be in the best position to consult the borrowers or the members of the borrowing groups on effective use of loaned funds, improving market analysis skills, technology transfer, methods of adapting to changes in the business environment, and so forth. The training may be in the form of study tours, field trips, on-the-job training, training courses, workshops etc. It would be ideal if the government could allocate funds for training or share the training expenses with the MFIs. The government could also establish a microfinance training center specializing in training and research work for microfinance.

In addition to the training provided to the regulatory and supervisory body and the MFIs, it is also very important for the government to carry out measures to enhance the capacity and productivity of poor or low- income households in their production or business.

Upgrading the Decree into a Law on Microfinance and Other Measures

The Decree on Microfinance has just come into effect. The Decree just regulates the microfinance of the institutions that are not credit institutions. That means the microfinance activities of the formal credit institutions are still not subject to the Decree but are subject to the Law on Credit Institutions. It appears that the microfinance services carried out by the agricultural cooperatives are not based on the Draft Decree, either. Thus, in the short run, it is necessary to monitor the application of the Decree and its impact on microfinance sector, and then to assess the merits and demerits of the Decree. Besides the Decree on Microfinance, the SBV should simultaneously promulgate specific regulations on the micro-credit activities of agricultural cooperatives. Eventually, in the long run, to create a comprehensive legal framework for microfinance development, the Decree should be upgraded into a Law on Microfinance, the highest-level legal document, and should cover all the institutions, including the credit institutions, engaged in microfinance.

Moreover, as mentioned above, to encourage NGOs to enter the microfinance sector, it is necessary to enhance the financial soundness and operational capacity of NGOs and to explore the possibility of capacity building by establishing a microfinance association or forum.

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APPENDIX

The Government of the Socialist Republic of Vietnam
Independence—Freedom—Happiness

Decree of the Government
On Organization and Operations of Small-scaled Finance Institutions in Vietnam

The Government

Based on the Law on organization of the Government dated 25 December 2001;

Based on the Law on the State Bank dated 12 December 1997 and the Law on amending and supplementing a number of articles in the law on the State bank dated 17 June 2003;

Based on Law on the Credit Institutions dated 12 December 1997 and the Law on amending and supplementing a number of articles in the Law on the Credit Institutions dated 15 June 2004;

Pursuant to the proposal of the Governor of the State Bank of Vietnam.

Decree

Chapter I
General Provisions

Article 1. Scope of Regulation and Application

1. This Decree regulates the organization and operations of small-scaled finance institutions in Vietnam.
2. The organizations which are allowed to establish small-scaled finance institutions in Vietnam based on the prevailing legal regulations, includes:
3. Vietnamese socio-political organizations, social organizations and socio-professional organizations, social funds, charity funds
4. Vietnamese non-governmental organizations
5. The Vietnamese individuals, foreign individuals, local and foreign organizations may together with the organizations stipulated in Clause 2, Article 1 contribute capital to establish small-scaled finance institutions

Article 2. Interpretation of Terms

1. ***Small-scaled finance*** means providing small-sized and simple financial and banking services to low income households and individuals, especially the poor households and individuals.
2. ***Small-scaled finance Institutions*** means financial institutions which operate in the finance-banking sector, and whose primary function is to use their own capital, borrowed capital and mobilized savings for providing some small-scaled and simple financial and banking services to low income households and individuals.
3. ***Small-scaled and simple financial and banking services*** include microcredit, receipt of compulsory savings, receipt of voluntary savings, acting as agent for money transfer, insurance; receiving and making payment of money on behalf of low income household and individuals.
4. ***Microcredit*** means the small sized loans with or without collateral provided to low income households and individuals in order to support their income generating business activities and improve living standards.
5. ***Low income or poor households and individuals***: as stipulated based on local or regional criteria in Vietnam or based on the criteria defined by the small-scaled finance institutions.

6. ***Compulsory savings*** mean savings of households and individuals deposited at the small-scaled finance institutions as security for the loans provided by the small-scaled finance institutions.
7. ***Voluntary savings*** mean savings deposited at small-scaled finance institutions.
8. ***Legal capital*** means the minimum amount of charter required by the law for establishment of a small-scaled finance institution.
9. ***Charter capital*** means the amount of capital contributed for the establishment of a small-scaled finance institution, which is stated in the charter of the small-scaled finance institution.
10. ***Own capital*** means the charter capital and reserve fund.
11. ***Licence*** means an Establishment and operating Licence of a Small-scaled finance Institution, which is issued by the State Bank of Vietnam.

Article 3. Legal Capital

1. For small-scaled finance institutions which are not entitled to receive voluntary savings (non-voluntary savings deposit-taking MFIs): VND 500 million;
2. For voluntary savings deposit-taking MFI: VND 5 billion.

Article 4. Duration of Operation

1. The duration of operation of a small-scaled finance institution is maximum 50 years.
2. In case the small-scaled finance institution needs to extend the duration of operation, the extension duration shall not exceed the original duration for each time of extension.

Article 5. Geographical Area of Operation

1. The operation of a small-scaled finance institution shall be restricted by the geographical area of provinces, central cities and shall be identified in the license.
2. In case the small-scaled finance institution needs to expand the area of operation exceeding the area identified in the licence, the small-scaled finance institution shall establish its branches in the expanded area. For the establishment of the branch, the small-scaled finance institution must meet requirements on increasing capital in line with the extent of operation and shall be approved by the State bank of Vietnam.

Article 6. Principles for Operation and Financial Management

Small-scaled finance institution is a legal entity having charter capital, assets and its owned seal, which operates on the principles of self-financial autonomy, capital self- generating, self responsible for operating expenses and being accountable for its capital and assets.

Article 7. State Policies

The State shall protect the ownership, legal rights and legitimate benefits of the small-scaled finance institution; ensure the fairness and other rights as stipulated by the legal documents on the operation of small-scaled finance institutions; promulgate the legal regulations and policies encouraging the development of small-scaled finance institutions. The State shall respect the autonomy and accountability of the small-scaled finance institutions for the operation, not intervene in the management and legal operation of small-scaled finance institutions.

Chapter II
Licencing for Establishment and Operation of Small-scaled Finance Institution

Article 8. Conditions for Issuance of Establishment and Operating Licence

1. Have demand for conducting small-scaled finance activities;

2. Have opinions of the provincial or central city People Committee on the necessity of establishment of a small-scaled finance institution in the locality;
3. Have adequate capital as stipulated in Article 3 of this Decree.
4. Have offices and infrastructure appropriate to the proposed small-scaled finance activities.
5. Have administrators, controllers and managers as stipulated in Chapter III of this Decree.
6. Have a feasible bussiness plan
7. For the voluntary savings deposit-taking small-scaled finance institution, besides the conditions stipulated in points 1, 2, 3, 4, 5, 6 of this Article, the following conditions must be met:
    a. Have been licenced by the State Bank of Vietnam;
    b. Have been operated as compulsory savings deposit-taking small-scaled finance institution for recent 3 years;
    c. Have efficient mechanism of administrators, controllers and managers;
    d. Have a good operating results for recent 3 years based on the regulations stipulated by the State Bank of Vietnam
    e. Have information system meeting the requirements of management;
    f. Have met the prudential requirements in banking activities and other applicable provisions of relevant laws.

Article 9. Application File

The application file submitted to the State Bank of Vietnam for licensing include:

1. Application letter for the Licence, in which the proposed scope and geographical area of operation shall be clearly defined;
2. A written approval of the People Committee of the province or central city on the necessity of the establishment of small-scaled finance institution in the locality;
3. Draft charter;
4. The operation plan of small-scaled finance institution, in which the efficiency and economic benefits shall be clearly defined;
5. A list, curriculum vitae, professional and qualification degree of members of the board of management and the board of controllers, the General Director (Director) of small-scaled finance institution;
6. Documents certifying the amount of charter capital; list and addresses of the organizations and individuals contributing capital; the financial status and information relating to the organizations and individual being capital contributors;
7. For the voluntary savings deposit-taking small scaled finance institutions, the audited financial statements for the latest 3 years shall be submitted.

Article 10. Licensing Fee

The small-scaled finance institution which has been licenced by the State Bank of Vietnam shall pay licensing fee as determined by the Ministry of Finance.

Article 11. Procedures of Licensing and the Use of License

1. Within 90 days upon receipt of the full application file as stipulated in Article 9 of this Decree, the State Bank of Vietnam considers and issues licence for the small-scaled finance institution. In the case of refusal of an application, the State Bank of Vietnam shall provide a written statement of the reasons for refusal.
2. The licence for the small-scaled finance institution issued by the State Bank of Vietnam determining the duration of operation, geographical area of operation and the eligible activities of small-scaled finance institution.
3. The licenced small-scaled finance institution shall make proper use of its name and shall operate in strict compliance with the provisions stated in the Licence. The licence shall not be falsified, erased, transferred, leased or lent in any manner.

Article 12. Commencement of Operation

1. To start conducting the operation, the licenced small-scaled finance institution shall satisfy all of the following conditions:
   a. Its charter shall be approved by the State Bank of Vietnam;
   b. It shall have a business registration certificate, adequate legal capital;
   c. The part of its legal capital contributed in cash shall be deposited into a frozen account opened at the State Bank of Vietnam at least 30 days prior the date of commencement of operation of small-scaled finance institution. Such an amount of capital shall only be released after the institution has commenced its operation. This regulation is not applied to the small-scaled finance institutions that has operated before the enforcement date of the Decree;
   d. It shall have documents certifying the ownership right or the right to use in respect of head office of the small-scaled finance institution in Vietnam;
   e. It shall have to publish the contents stated in the issued licence in accordance with provisions of the law. This provision is not applicable to the non-voluntary savings deposit-taking institution.
2. At least 30 days prior the commencement of operation, the small-scaled finance institutions shall submit a written document to the State Bank of Vietnam and People Committee of the province or central city informing of the commencement of operation.
3. Within 12 months from the date of receiving the licence, if the small-scaled finance institution does not start its operation, the licence shall be invalid.

Article 13. Renewal and Revocation of a Licence

1. Renewal of a licence
   a. The application for renewal of a licence of small-scaled finance institution shall be submitted to the State Bank of Vietnam at least 02 months prior the expiry date of the licence. The application for renewal include:
      An application for renewal;
      A report describing the operations of the small-scaled finance institution of the latest 03 years
   b. Within 30 days of receipt of all of the application documents, the State Bank of Vietnam shall issue a decision permitting the renewal or refuse the application. In the case of refusal of application, the State Bank of Vietnam shall provide a written statement of the reasons for refusal.
2. The licence of small-scaled finance institutions may be revoked in the following cases:
   a. There is an evidence that the application file for licence deliberately contains false information;
   b. It fails to commence its operation within 12 months since the date of issuance of licence.
   c. It is dissolved whether on a voluntary basis or it is compulsorily dissolved by the State competent authority;
   d. It is divided, merged with or integrated into another organization, or it is bankrupt;
   e. It receives voluntary savings deposits without the approval of the State Bank of Vietnam;
   f. It carries out its activities other than for permitted purposes stated in the licence.

Article 14. Integration, Merger, Dissolution and Liquidation

In the case that the small-scaled finance institution needs to implement integration, merger, dissolution and liquidation, the small-scaled finance institution shall submit application letter and file to the State Bank of Vietnam. Within 30 days of receipt of the entire application file, the State Bank of Vietnam shall provide a written response to the small-scaled finance institutions. In the case of refusal, the State Bank of Vietnam shall provide a written statement of the reasons

The application file and procedures for integration, merger, dissolution and liquidation of the small-scaled finance institution shall be implemented in accordance with the guideline of the State Bank of Vietnam.

Article 15. Bankruptcy and Liquidation

The bankruptcy and liquidation of small-scaled finance institution shall be implemented in accordance with the guideline of the State Bank of Vietnam and the provision on bankruptcy.

Chapter III
Organization, Management, Control and Operation of Small-scaled Finance Institutions

Article 16. The Organizational Structure of Small-scaled Finance Institution

1. Small-scaled finance institution shall have a board of management, a board of controllers and General Director (Director).
2. The board of management of non-voluntary savings deposit-taking small-scaled finance institution shall have at least 03 members, and the board of controllers shall have at least 01 member.
3. The board of management of voluntary savings deposit-taking small-scaled finance institution shall have least 03 members, and the board of controllers shall have at least 03 members.
4. The board of management, board of controllers, General Director (Director) of small-scaled finance institution shall satisfy requirements on expertise and professional ethics as stipulated by the State Bank of Vietnam.
5. The election, appointment or dismissal of the board of management, board of controllers, General Director (Director) of small-scaled finance institution shall be conducted in accordance with applicable provisions of relevant laws.

Article 17. Functions, Duties of Board of Management, Executive Board, Board of Controllers

1. The Board of management shall perform the function of managing the small-scaled finance institution in accordance with the provisions of relevant laws, make decision on the policies, orientation for the operation of small-scaled finance institutions and implement the other rights and obligations stated in the charter of the small-scaled finance institutions.
2. The executive board shall have General Director (Director) and deputy General Director (Deputy Director) which shall manage and execute small-scaled finance institution on behalf of the board of management. The General Director (Director) of the small-scaled finance institution shall act as legal representative of the small-scaled finance institution.
3. The Board of Controllers shall on behalf of the board of management control financial activities of small-scaled finance institution and the management of the General Director (Director) of implementing other rights and duties stated in the Charter of small-scaled finance institution.

Article 18. Persons Not Permitted to be Members of the Board of Management, Board of Controllers, General Director (Director)

1. Those who are under criminal prosecution.

2. Those who were sentenced for any serious crime against national security, grave misappropriation of socialist and citizen's property, other serious economic criminals.
3. Those who were convicted for any other crimes in relation to which the sentence has not been cleared from the court's record.
4. Those who were members of the board of management or General Director (Director) of a bankrupt company except for the cases provided in the law on bankruptcy.
5. Those who were legal representatives of a company whose operations were suspended as s result of a serious violation of laws.
6. Parents, spouses, children or siblings of any member of the Board of management, board of controllers, general director (director) of small-scaled finance institution.

Article 19. Setting Up and Closing Branch

1. Small-scaled finance institution may set up its domestic branch where there is a need for operation. Setting up and closing branch shall be approved by a written document of the State Bank of Vietnam.
2. Conditions, application file and procedures for setting up and closing the branch of small-scaled finance institution shall be conducted in accordance with the guideline of the State Bank of Vietnam.

Article 20. Capital Contribution and Transfer of Capital

1. The capital contribution is made by the organizations and individuals based on the capital contribution agreement.
2. The capital contribution and transfer of capital shall be conducted in accordance with the provisions of the State Bank of Vietnam.

Chapter IV
Operation of Small-scaled Finance Institution

Article 21. Provisions on the Operation of Small-scaled Finance Institution

1. Small-scaled finance institution shall be entitled to conduct some or all activities stipulated in Article 22, Article 23, Article 24, Article 25 and Article 26 of this Decree.
2. The State Bank of Vietnam shall determine the specific activities in the licence of small-scaled finance institution.

Article 22. Capital Mobilization

Small-scaled finance institution shall be entitled to mobilize capital from the following sources:

1. Receipt of savings:
   a. Compulsory savings
   b. Voluntary savings
2. Borrowings:
   a. Borrowing from the credit institution permitted to operate in Vietnam
   b. Borrowing from individuals and foreign organizations upon approval of the State Bank of Vietnam
3. Small-scaled finance institution may receive of trusted capital from the programs, Government projects, individuals and organizations in Vietnam or abroad.

Article 23. Credit Activities

1. Extension of credit.
2. Extension of credit by using trusted capital.

Article 24. Other Activities

Small-scaled finance institution shall be entitled to act as agent in the fields relating to banking activities, insurance.

Article 25. Opening of Accounts

Small-scaled finance institutions may open accounts and deposit money at the State Bank, commercial banks and other credit institutions.

Article 26. Payment Services

Small-scaled finance institutions may provide limited payment services in accordance with the provisions of the State Bank of Vietnam.

Article 27. Restrictions to the Credit and Savings Mobilization

1. Small-scaled finance institutions shall comply with the following restrictions on credit and savings mobilization:
   a. Maximum amount of a microcredit;
   b. Maximum outstanding credit for one borrower;
   c. Restrictions to savings deposits
   d. Maximum outstanding savings deposits of one client;
2. The State Bank of Vietnam shall have responsibility of providing detailed guideline for restrictions to credit and savings mobilization appropriate to the types of small-scaled finance institutions.
3. The voluntary savings deposit-taking small-scaled finance institutions shall participate in deposit insurance in accordance with provisions of relevant laws.

Article 28: Changes subject to approval

1. Any change to be made by a small-scaled finance institution to any matters listed below shall be subject to the State Bank's written approval:
   a. Name of small-scaled finance institution;
   b. Charter capital;
   c. Location of the head office, branches;
   d. Content and scope of its activities and duration of its operation;
   e. Changes relating to capital contribution and capital contributors;
   f. Members of the board of management, general director (director) and members of board of controllers.
2. The State Bank of Vietnam shall provide guidance on the documents and procedures for making changes in the above mentioned cases.
3. The small-scaled finance institution shall, upon the State Bank's approval, inform the competent State authority of any changes as stipulated in clause 1 of this Article**.**

Chapter V
Finance, Accounting, Reporting

Article 29. Finance

1. The fiscal year of small-scaled finance institution shall begin on 1st January and end on 31st December of each calendar year.
2. The financial revenue and expenditure of a small-scaled finance institution shall be accounted in accordance with applicable provisions of relevant laws.

Article 30. Accounting

Small-scaled finance institutions shall perform its accounting based on the system of accounts and vouchers in accordance with the laws on accounting and statistics and guidance of the State Bank of Vietnam.

Article 31. Establishment and Use of Funds

The establishment and use of funds of small-scaled finance institutions shall be implemented in accordance with the applicable provisions of relevant laws and guidance of Ministry of Finance.

Article 32. Reporting Regime

Small-scaled finance institutions shall comply with the reporting and statistics requirements in accordance with the provisions of the State Bank and Ministry of Finance

Chapter VI
Inspection, Special Control, Bankruptcy, Dissolution and Liquidation

Article 33. Inspection

1. Small-scaled finance institution shall be subject to inspection by Banking Inspectorate of the State Bank in accordance with the provision of relevant laws.
2. Rights and obligations of small-scaled finance institution shall be inspected in accordance with the applicable provisions of relevant laws and guidance of the State Bank

Article 34. Special Control, Bankruptcy, Dissolution, Liquidation

Special control, bankruptcy, dissolution, liquidation of small-scaled finance institution shall be implemented in accordance with provisions of the relevant laws and guidance of the State Bank.

Article 35. Rewards and Dealing with Violations

The rewards and dealing with breach of small-scaled finance institution shall be implemented in accordance with the provisions of the State Bank**.**

Chapter VII
Implementing Provisions

Article 36. Exemption Provisions

1. Exemption of the conditions stated in point a, clause 7 Article 8 of this Decree shall be implemented upon licensing the organizations conducting small-scaled finance activities before the enforcement of this Decree.
2. The exemption provisions shall be valid within 24 months since the date of enforcement of this Decree.

Article 37. Enforcement

1. This Decree shall be in full force and effect after 15 days from the date of publication in public press and replace all existing provisions which are contradicted to this Decree.
2. Within 24 months from the effective date of this Decree, those existing small-scaled finance institutions must carry out procedures for applying for the reissuance of establishment and operating licence in accordance with the provisions of this Decree or terminate the small-scaled finance activities.

Article 38. Implementing Obligations

1. The Governor of the State Bank of Vietnam shall be responsible for providing guidance of implementation of this Decree.
2. Ministers, Chief of ministerial bodies, Government bodies, chairmen of people committee of provinces or central cities shall be responsible for implementing this Decree.

On Behalf of the Government
PRIME MINISTER

Part III

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APO SURVEY ON MICROFINANCING

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