

### Editorial

For our last issue (No. 11, June 1998), we interrupted our publication schedule to publish a rapidly assembled survey of the impact of the East Asian financial crisis on microfinance in countries of the region. We are continuing to monitor the situation and will report further developments in future issues of the Newsletter.

This time around we take the opportunity to present the findings of a major study of the policy and regulatory environment for microfinance in Asia, conducted with the support of Network member institutions in nine Asian countries. *Getting the Framework Right* is the most comprehensive treatment available of policy and regulation for microfinance in Asia. Judging by the positive response from readers, it fills an important gap in the literature.

We also report on research conducted with BWTP Network member institutions in the Philippines, addressing crucial issues of financial sustainability and service quality for MFIs. An associated research project has been commenced on the impact of access to credit on the lives of the poor. Professor Ronald Chua of the Asian Institute of Management has completed a "baseline" survey of the circumstances of a group of the poor immediately prior to their commencing a microfinance program. He has designed a longitudinal study which will avoid many of the pitfalls associated with "impact" research. We hope to keep readers posted on results as they come to hand.

Finally, in this issue we carry a report by Network Executive Committee member Zulfiqar Ahmad of Pakistan, who represented the Network at a recent followup meeting to the Microcredit Summit in New York. Zulfiqar was obviously stimulated by the opportunity to meet practitioners from many countries in New York City, and it shows in his report.

### John D Conroy BWTP Network Secretariat

#### Getting the Framework Right: new study released

A major new study, prepared by the Foundation for Development Cooperation on behalf of the BWTP Network, was released in June 1998.

The study is entitled *Getting the Framework Right: Policy and Regulation for Microfinance in Asia*, and was prepared by Foundation staff Paul McGuire and John Conroy, and consultant GB Thapa. It represents the third in a series of major studies of best practice in microfinance prepared by the Foundation for the BWTP Network, following on from the influential publications *Banking with the Poor* (1992) and *Best Practice of Banking with the Poor* (1995).

The field work was carried out in 1997. The authors conducted more than 250 interviews with microfinance practitioners, bankers, regulators and policymakers in the nine Asian countries represented in the BWTP Network. These detailed country studies, which are included as appendices, underpin the analysis of the main report.

A first draft of the study was presented at the Fourth Regional Workshop on Banking with the Poor in November 1997, and members of the BWTP Network endorsed a statement based on the draft. This statement is included as a preface to the published volume.

As well as reviewing the current policies of governments and donors, the report analyses regulatory and prudential frameworks for both non-bank microfinance institutions and banks offering microfinance services. It highlights policy measures that have been successful, and identifies the key elements of an appropriate policy and regulatory environment to encourage the growth of microfinance on a sustainable basis.

The report's recommendations are both practical and far-reaching. They will prove an invaluable guide for policymakers, as well as for donors, practitioners and other supporters of microfinance. The main conclusions of the report are outlined in the following pages.

#### Getting the Framework Right - some key conclusions

Microfinance has the potential to make an important contribution to poverty reduction in Asia, but this requires the development of a microfinance sector that is able to reach large numbers of poor people on a sustainable basis.

This requires increased attention to the policy and regulatory environment. While countries differ in terms of their level of economic development, social conditions and institutional structure, an effective policy and regulatory environment for microfinance is likely to include a number of common elements.

### *Arrangements for direct support*

Active support from government and/or donor agencies, including direct financial support, is a necessary catalyst to the establishment of a viable microfinance sector.

MFIs in all countries have received considerable support from their governments and/or donor agencies. In the past, most of this has been in the form of financial assistance direct to an individual MFI. This support has been largely ad hoc in nature. The Guiding Principles for Selecting and Supporting Intermediaries, agreed by major donor agencies in October 1995, provide a number of suggestions as to how support by donors and government can best be directed to maximising outreach and sustainability. All governments and donor agencies should ensure that their support for MFIs is consistent with the Guiding Principles.

Most countries included in the study have some form of second tier microfinance institution which channels funds from the government and/or donor agencies to individual MFIs. Where they operate well, second tier microfinance institutions are a very effective means for supporting MFIs. Governments and donor agencies should channel their support for microfinance, as much as possible, through efficient and well managed second tier institutions.

At the same time, there is evidence both from Asia and from other regions that second tier institutions do not always operate on a sound basis, and may be subject to significant administrative, political and technical difficulties. If second tier institutions are to play an effective role, it is clear that there are a number of critical issues that need to be addressed.

Most importantly, they should establish and enforce appropriate performance and reporting standards for the MFIs that they fund. They should also operate as independent entities, support MFIs based on the standards they achieve rather than the model they follow, avoid restrictive interest rate policies, and develop appropriate criteria for funding scaling-up, institutional development and equity.

Seven of the nine countries included in the study still impose directed credit requirements, whereby banks are required to lend a certain proportion of their loan portfolio to particular sectors. These are an inefficient means of reaching the poor, and impose economic costs.

In some countries, the government operates specific microfinance programs in which funds are channelled through the banks. Such programs have generally not been successful and may 'crowd out' more effective programs. Where public funds are available to support microfinance, it is more appropriate to channel them through second tier microfinance institutions and specialist MFIs, rather than through the banking system.

One important way in which commercial banks can become involved in microfinance is through linkages with non-governmental organisations (NGOs) and self-help groups (SHGs). In most countries there is little positive support for linkages from policymakers. Central banks should take a more active role in encouraging linkages, by documenting and publicising successful examples, issuing clear guidelines that the banks can follow, and other measures.

The other main category of microfinance programs is those operated directly by government agencies. In general, governments should abolish direct microfinance programs and channel the funds through well-managed second tier microfinance institutions or MFIs instead.

### *Regulation of non-bank microfinance institutions*

In most countries, MFIs are able to obtain registration under the general provisions applying to NGOs and cooperatives. The broad requirements are generally quite simple.

NGOs engaged in microfinance should be required to be registered. On the other hand, in some cases MFIs are subject to unnecessary and burdensome rules and regulations, and the rules are not transparent. Unnecessary restrictions should be removed, and the discretionary powers vested in regulatory agencies should be limited as much as possible.

Only two countries impose general ceilings on the interest rates that MFIs can charge borrowers. In a number of other countries, however, there are ceilings on interest rates under government microfinance programs or as a result of various other actions by government. Countries that impose interest rate ceilings should either remove them or set them at levels that are consistent with the sustainability of efficient, well-managed MFIs. Other countries should avoid policies that reduce the interest rate margins available to MFIs.

MFIs which do not accept deposits from the general public are not subject to prudential regulation or supervision by a government agency in any country included in the study. There are also no compulsory reporting requirements designed specifically with the needs of MFIs in mind. This situation is appropriate. It is generally agreed that where MFIs do not accept deposits from the public, it is unnecessary to subject them to full prudential regulation and supervision.

Nevertheless, it is clear that at present, most MFIs do not have adequate standards. The challenge is to find cost-effective ways of improving the standards, in terms of both performance and reporting, of the large numbers of MFIs that are not currently operating on a sound basis.

In those countries with second tier microfinance institutions, these institutions can play a very important role in developing standards for the microfinance sector. Such institutions have an effective mechanism through their lending programs for enforcing any standards that they develop. Standards should be based on results achieved rather than the model used, have a proactive role in facilitating improvement in the performance of the microfinance sector over time, and should be developed through a process of wide consultation with MFIs. There is a broad range of experience that second tier institutions can draw on in establishing standards.

Another approach to establishing performance and reporting standards for MFIs is through self-regulation. At this stage, however, it is doubtful that any country has an apex body for MFIs with the necessary resources or authority to monitor and enforce a comprehensive system of self-regulation. Hence, self-regulation may need to be reinforced with some legal or quasi-legal system of incentives or compulsion.

In general, MFIs are not permitted to accept deposits from the general public unless they establish regulated banks. In terms of mobilising savings from members, in most countries the situation is somewhat ambiguous. Generally, regulatory authorities tend not to intervene so long as MFIs mobilise savings from members only, but MFIs do not have a clear legal basis for doing so.

Laws should be clarified to make it clear that MFIs are permitted to require loan-linked deposits or compulsory savings as a condition to receiving a loan, and to use them in their lending programs. Some MFIs also offer voluntary savings facilities. It would generally not seem appropriate to permit MFIs to use voluntary savings in their lending programs unless effective protections are in place. One option is to permit MFIs to mobilise voluntary savings from members if they establish an earmarked account with a regulated financial institution.

### *Regulation of banks*

There is considerable scope for regulated banks to become involved in microfinance. Some specialist MFIs may wish to establish regulated banks, and some traditional banks may wish to become involved in microfinance.

One critical factor affecting the extent to which regulated banks become involved in microfinance is the scope for the establishment of small banks. Of the countries in the study, only two have a permissive policy environment for the establishment of small banks. Governments in other countries should ensure that the minimum capital requirements for establishing banks are realistic for small banks operating at the local level, and that there are no other restrictions preventing the establishment of small banks. Another critical factor is interest rates. Interest rate ceilings on small loans by banks should be removed, or at the very least set at levels that are sufficient to enable banks to operate microfinance programs sustainably.

Capital adequacy ratios should be higher for small microfinance banks than for standard commercial banks, reflecting higher risk and other factors. Microfinance banks should also provision their overdue loans, based on time overdue, more aggressively than conventional banks, but provisioning requirements must accept that microfinance loans are generally unsecured. There are a number of other prudential standards sometimes applied to commercial banks that may not be appropriate for small microfinance banks.

[Abstracted from Getting the Framework Right: Policy and Regulation for Microfinance in Asia]

### *Financial crisis affects Bina Swadaya*

The East Asian financial crisis has hit Indonesia much harder than any other country. The rupiah has depreciated by around 83 per cent from 2,342 to the US dollar in 1996 to 13,850 as at 6 July 1998. Inflation has escalated to 29.7 per cent over the year to the March quarter 1998, and short term interest rates have risen to a massive 60 per cent. Recent forecasts suggest that the economy will contract by 15 per cent in 1998.

The crisis is also having serious social impacts. The World Bank suggests that the incidence of poverty, which had fallen to 11 per cent in 1996, could increase to as much as 20 per cent. Mr Bambang Ismawan, president of Bina Swadaya and chairperson of the BWTP Network, agrees that poverty has increased substantially. In three Bina Swadaya branches for which data are available, 16 per cent of clients have gone bankrupt.

Bambang also reports that repayment rates have dropped sharply since the onset of the crisis. In seven branches for which data are available, between 20 and 70 per cent of borrowers are in arrears. Bina Swadaya has been forced to extend loan repayment terms or reschedule loans, in agreement with borrowers. It is also being more cautious in extending loans to new customers.

'This reduction in outreach, at the same time as the number of poor people is growing rapidly, means that the poor will be left behind'

Bina Swadaya has increased lending rates by between 0.5 and 0.75 percentage points per month to cover increased operational costs and loan losses.

The crisis has also badly affected the rural banks, with many depositors withdrawing their savings from rural banks and depositing them with commercial banks. This is partly because the government has guaranteed the deposits of commercial banks, but not rural banks. It is understood that the government is also considering increasing the minimum capital requirement for rural banks.

It is important that policy reactions to the crisis do not threaten the operations of the rural banks, which enable the formal financial system in Indonesia to have much greater outreach among the poor than in other countries in Asia.

#### New-look BWTP website

After a long period of hibernation, the BWTP website has re-emerged at a new address and in a much more attractive form. The new address is as follows: <http://www.bwtp.org>

The site contains lots of information about the Network. It includes executive summaries or abstracts of all the publications on microfinance that have been produced by the Foundation for the Network. In fact the entire text of Getting the Framework Right can be downloaded from the site, along with four recent articles. Publications can also be ordered by email straight from the website.

The site also includes information about the microfinance activities of most BWTP members and associated institutions. **All members and associated institutions are requested to provide updated information on their microfinance activities for posting to the site, together with high quality copies of their logos where these are available.**

All back issues of the BWTP newsletter are now on line. Also included is information on the structure and governance of the Network, with a copy of the constitution, a brief history of the Network, details of the mission and executive committee, and a report of the fourth regional workshop.

Finally, the site contains links to key microfinance sites, including CGAP, the USAID Microenterprise Innovation Program, the Microcredit Summit and the Grameen Bank.

The site is being maintained by Doing I.T., a small information technology firm based in Brisbane, and will be updated regularly. We welcome your comments and suggestions.

#### Philippines NGO research

Professor Ronald Chua of the Asian Institute of Management in the Philippines has recently completed two research reports on microfinance in the Philippines. The reports were commissioned by the Foundation on behalf of the BWTP Network, and were financed by AusAID.

The first report is entitled **Impact of Access to Credit on the Poor: Research Design and Baseline Survey for a Longitudinal Study**. This report presents the baseline survey for a study of the impact of microfinance services offered by Alalay sa Kaunlaran sa Gitnang Luzon, Inc (ASKI), a member of the BWTP Network.

There have been comparatively few studies in the Philippines of the impact of microfinance on poor clients. Moreover, in the Philippines as elsewhere, very few studies have featured a longitudinal design. This study is designed to address that gap.

The report sets out in detail the research design for the study. The dependent variables, which are to be measured over time to indicate impact, cover matters such as income, expenditure, assets, land and housing, level of economic activity, saving and borrowing behaviour, role in household decision-making, and participation in community activities. There are also a number of contextual variables covering matters such as age and educational attainment. A sample of 420 was used, consisting of 150 clients, an on-site comparison group of 120, and an off-site comparison group of 150.

The baseline survey was conducted in May-June 1997. Most clients operated their microenterprises from home, and provided self-employment and employment for family members rather than wage employment. Trading was the predominant form of activity. Average net take-home pay from the microenterprises ranged from Ps3,550 to Ps 4,940 (US\$135 to\$189) per month.

Professor Chua recommends that a follow-up survey be conducted around 24 months after the initial interview, in May-June 1999. The Foundation will seek further support for this survey.

The second report is called **The Performance and Sustainability of Two Philippine Microfinance Institutions**. This study reviews the performance and sustainability of ASKI and Kabalikat para sa Maunlad na Buhay, Inc (KMBI). It builds on the

findings and addresses some of the limitations of the transaction costs study by Llanto and Chua (1996) which was also commissioned by the Foundation on behalf of the BWTP Network.

The study assesses performance against a number of criteria relating to responsiveness, outreach, loan portfolio quality, efficiency, financial viability, financial structure and funds mobilisation.

Both ASKI and KMBI have demonstrated substantial progress towards increasing outreach and sustainability. Both have grown very rapidly both in client reach and the value of their loan portfolio. They have been able to evolve services that were fairly responsive to meeting the credit requirements of the poor.

Transaction costs did not show a consistent pattern over time, due to the interplay of factors such as the efficiency of new staff, salary adjustments, stage of expansion, and changes or adjustments to the lending methodology. The study shows that changes in methodologies, clientele and internal systems can have a negative impact on loan portfolio quality, and need to be tested thoroughly.

Despite the progress that has been made, ASKI has not yet reached operational self-sufficiency. KMBI reached operational self-sufficiency in 1997, but has not yet reached financial self-sufficiency. Viability scenarios are used to estimate the required levels a number of variables, in order to attain self-sufficiency and earn a 10 per cent return on equity. The study finds that these scenarios are within the reach of both NGOs.

Both reports can be purchased from the Foundation, along with the individual studies of ASKI and KMBI that were prepared as background papers for the performance and sustainability study.

### Microcredit Summit: Meeting of Councils

The Microcredit Summit Meeting of Councils was held in New York City from 25-27 June 1998. The BWTP Network was represented by executive committee member Mr Zulfiqar Ahmad of Sarhad Rural Support Corporation in Pakistan. Mr Ahmad was sponsored to attend by the Australian Agency for International Development (AusAID).

A number of other Network members were also represented at the Summit, including Association for Social Advancement, Shakti Foundation, NABARD, Bina Swadaya and TSPI Development Corporation.

Mr Ahmad's report of the Summit meeting follows:

In the Microcredit Summit Meeting held in February 1997 in Washington DC, a nine year campaign was launched to reach the 100 million of the world's poorest families, especially the women of those families, with credit for self-employment and other financial and business services by the year 2005.

To pursue this goal of the Summit, a meeting of "Councils" was held in New York City from June 25 to June 27. The councils included NGOs, banks and commercial financial institutions, bilateral donor agencies, corporations, domestic government agencies, international financial institutions, parliamentarians and practitioners. More than 1000 members of these councils gathered in New York City to discuss the fulfilment of the Summit's goal, to share best practices in microcredit and to network.

Speakers at the opening plenary session included President Alberto Fujimori of Peru, James D. Wolfensohn, President, the World Bank and Muhammad Yunus, Managing Director, Grameen Bank. They emphasised the importance of microcredit for the alleviation/eradication of poverty. Special mention was made of the United Nations-General Assembly Resolution 52/194 which resolved to pursue microcredit programmes and to include future discussions of the role of microcredit under the item entitled, "Implementation of the First United Nations Decade for the Eradication of Poverty (1997-2006)."

The Microcredit Summit Secretariat has made special efforts in preparing a directory of institutional profiles. These profiles, along with the institutional action plans, provided the participants with a rare opportunity to exchange each other's approach towards achieving the objectives that they shared to reach the poor and help them increase their income with credit for self-employment. All the participants took keen interest in the literature displayed by the different organizations and the Secretariat itself. Extended meal breaks provided the delegates with ample opportunity to introduce one another, share experiences and depart with promises to keep in touch. Like myself, everyone tried to meet at least the people from the same regions, same backgrounds and often took keen interest in introducing themselves and others to new ideas in microcredit and microenterprise.

Discussions on best practice in microcredit encompassed the following main themes:

*Reaching the poorest families through targeting poor clients in a cost-effective manner in both developing and industrialized countries*

*Adopting policies that ensure microcredit programs empower women, both staff and clients*

*Assessing impact, especially for women and children*

*Integrating holistic transformation into microenterprise development programs that are financially sustainable*

*Cost-effective methods to monitor impact on the lives of clients in industrialized countries*  
*Serving very poor young people*  
*Refugees/returnees and access to credit*  
*Mobilizing savings and ensuring their safe use*  
*Managing information systems that support success*  
*Recruiting, training and retaining excellent staff, including trainers.*  
*Graduation from informal microfinance to commercial practices was discussed from many different angles which included:*  
*Conversion from informal NGO status to formal financial institutions*  
*Developing partnerships between commercial banks and microcredit programs in developing countries*  
*Designing efficient NGO-friendly lending that contributes to the fulfilment of the Summit's goal*  
*Franchising microfinance for the poorest*  
*Guarantee funds and other routes to commercial funds*  
*Identifying a program's readiness for commercial funds.*  
*To strengthen microfinance/microcredit, to enhance its recognition and to muster support for it, separate sessions were held to discuss:*  
*Developing and strengthening microfinance networks in developing countries*  
*Building broad-based public support for the Summit's goal*  
*The role of domestic government agencies in contributing to the fulfilment of the Summit's goal*  
*Designing efficient, NGO-friendly grants that contribute to the fulfilment of the Summit's goal*  
*The role of parliamentarians, advocates and other leaders in affecting policy and funding changes that contribute to fulfilment of the Summit's goal.*

Frank discussions were held in a most candid atmosphere. Participants came out with their strengths and weaknesses, resolved to learn from each other's experiences and were prepared to help one another through access to all the resources available with them. Such forums have been an immense source of support to the cause of poverty eradication through microcredit. In a very short span of twenty years, microcredit has become a universally recognised instrument of reaching the poorest of the world in a most cost effective manner.

The day may not be far away when poverty is eradicated completely from the face of the earth. As Dr Muhammad Yunus of Grameen Bank says, "Poverty does not belong to a civilised human society. Its proper place is the museum. That's where it would be."

I am most grateful to the Banking with the Poor Network, the Foundation for Development Cooperation and AusAID for providing me with the opportunity to participate in the "Meeting of Councils" of the Microcredit Summit campaign. It will go a long way in contributing to my knowledge in the field of microfinance and will help me contribute more to the Banking with the Poor Network. It will also help me contribute more to my organization, Sarhad Rural Support Corporation, which has given small loans to more than 10,000 clients amounting to Rupees 60 million, and has established successful linkages between poor rural clients and commercial banks for access to credit, and has now accessed commercial banks to wholesale their funds to SRSC for retailing to poor clients.

### **News briefs**

Newsletter No 11 translated into Japanese

BWTP Newsletter no 11 on The Asian Financial Crisis - Implications for Microfinance has attracted a great deal of interest. It is the first analysis of this important issue that we are aware of. The very positive response we have received shows how timely it was.

One indication of this interest is that the newsletter has now been translated into Japanese by the International Development Center of Japan (IDCJ), and circulated widely within Japan.

The cover of Japanese edition is reproduced on page 8 of this newsletter. Dr Norimichi Toyomane, General Manager of IDCJ comments in his foreword to the Japanese edition that:

'By the courtesy of FDC, IDCJ was able to translate it and is pleased to send this report to those who have an interest in microfinance. We hope that many Japanese institutions can refer to this report.'

The translation of the newsletter into Japanese furthers the collaboration between the BWTP Network and our colleagues at IDCJ, Citizens Bank and the Foundation for Advanced Studies in International Development in Japan, to help develop a constituency for microfinance in that country.

FDC staff to visit the region

FDC staff are currently visiting a number of countries in the Asian region. Program Officer Paul McGuire has just returned from visiting the Philippines (28 July-1 August), Bangladesh (1-6 August) and Thailand (6-8 August). Executive Director John Conroy is visiting Indonesia from 11-16 August.

The main purpose of the visits is to conduct research for a chapter in a major new book on microfinance to be published by UNDP. The chapter will be entitled *Fostering Financial Innovation for the Poor: The Policy and Regulatory Environment*.

Mr McGuire and Dr Conroy also hope to update the work the Network has done on the implications of the Asian crisis for microfinance. They are also taking the opportunity to hold informal discussions with members of the BWTP Network.

### **Second-tier microfinance institutions**

An article by FDC program officer Paul McGuire, called *Second-Tier Microfinance Institutions in Asia*, appeared in the June 1998 edition of *Small Enterprise Development*. It is based on research undertaken as part of the study of the policy and regulatory environment for microfinance.

The article reviews the experience of second tier institutions in five countries in Asia. It finds that they can be a very effective means for governments and donor agencies to channel support to MFIs. Moreover, second tier institutions can contribute to a more efficient microfinance sector by setting and enforcing appropriate performance and reporting standards. The article is on the BWTP Network website, or can be purchased from the Foundation.