# Banking with the Poor Newsletters - No. 13

## July 1999

### Editorial

In this edition of the *BWTP Newsletter*, we report on the publication of an important study on the commercialisation of microfinance. This was conducted by Ruth Goodwin-Groen with the cooperation of BWTP Network institutions, primarily in India and the Philippines. Ruth notes that two of our Network members, BRI in Indonesia and Hatton National Bank in Sri Lanka, are among the very few banks in Asia engaged profitably in microfinance. She has identified a number of key success factors for profitable microfinancing by commercial banks (see this page).

BWTP Network members have recently responded to a request from the Asian Development Bank to comment on the Bank's *Interim Action Plan* for microfinance. The Bank's future role in supporting microfinance in Asia and the Pacific will be discussed at a regional workshop in Manila in September. Some of our Network members are likely to attend this meeting. We hope to be able to organise an informal BWTP meeting on the 'fringe' of the ADB seminar.

The major item in this issue is a debate on the subject of second-tier microfinance institutions. This is between FDC Program Officer Paul McGuire and Professor Claudio Gonzales-Vega of Ohio State University. Gonzales-Vega was reacting to Paul's article on second-tier institutions, published last year in the journal *Small Enterprise Development*. The BWTP Network includes a number of such institutions, and they are playing a leadership role in funding and guiding retail MFIs.

I'm sorry to report that Paul McGuire has left FDC after three extremely productive years. Paul remains in Brisbane and is still closely associated with the BWTP Network. His replacement is Ms Robyn Cornford. A profile of Robyn will appear in the next issue.

### Commercial banks in microfinance

A new publication entitled *The Role of Commercial Banks in Microfinance: Asia-Pacific Region* was published in December 1998. The report was prepared by consultant Ms Ruth Goodwin-Groen, and funded by AusAID.

The study was based on in-depth interviews with over 40 bankers from 22 banks in India, the Philippines and Australia, and from speaking with 17 other banks in the other seven countries in the BWTP Network.

The study found that only four commercial banks in the region had profitable microfinance businesses. Two of these are Network members Bank Rakyat Indonesia (BRI) and Hatton National Bank in Sri Lanka. In 1996-97, BRI made loans of $1.7 billion to 2.5 million clients through its *Unit Desa* system, making a profit of $170 million. The success of this system can be attributed primarily to the adherence to the fundamentals of banking and finance for rural microentrepreneurs, including the provision of competitive savings services.

By contrast, the majority of commercial banks that undertook microfinance lending did so only because it was required of them by their governments. These programs can only be considered as failures. These commercial bankers distrust the poor and NGOs. They experience poor repayment, look at the high costs, and assume that the problem is with the poor rather than with the design or delivery of their bank's products.

The study found that the most effective way for governments to encourage commercial banks to become involved in microfinance is to maintain sound macroeconomic policies and ensure an appropriate regulatory and prudential framework. It is particularly important that there be no interest rate caps, and low minimum capital requirements that enable small commercial banks to be established.

The study also identified a number of key success factors for microfinance in commercial banks:

- create a small specialised bank or a separate microfinance unit within a large commercial bank;
- treat savings as equally important to lending;
- charge interest rates to cover all the costs of the lending products;
- ensure excellent management information systems and portfolio management;
- recruit staff from outside the bank and/or give staff specialist training; and
- find a champion or visionary who will see the program through to success.

### Debate on second tier institutions

The recent article by FDC Program Officer Paul McGuire on *Second-tier Microfinance Institutions in Asia*, which appeared in the June 1998 edition of *Small Enterprise Development*, has given rise to considerable debate. This newsletter reproduces in abridged form some comments by Professor Claudio Gonzalez-Vega, Director of the Rural Finance Program at Ohio State

University, together with a reply by Paul McGuire. Both the comments and reply were posted on the DEVFINANCE newsgroup, an email discussion group on microfinance moderated by Ohio State University.

**Comments by Professor Gonzalez-Vega**

I have carefully read Paul McGuire's paper on *Second-tier Microfinance Institutions in Asia*. The paper derives several useful lessons, but the evidence presented by the author fails to support his optimistic statement about apex mechanisms.

McGuire's paper attempts to accomplish three tasks:

- to provide a conceptual justification for the conclusion that, "where they operate well, second-tier microfinance institutions can be a very effective means for governments and donor agencies to channel support for MFIs";
- to examine several "administrative, political and technical difficulties" that explain why in many instances apex mechanisms do not operate well; and
- to illustrate these issues with reference to apex mechanisms in several Asian countries.

First, the main advantage of domestic apex mechanisms, according to McGuire, is their ability to screen and monitor MFIs according to "standard criteria", compared to inconsistent "ad hoc" evaluations of individual MFIs by donors and government agencies. Support based on "uniform standards" would create a level playing field, while common reporting requirements would contribute to more professional MFIs. The author argues that performance and reporting standards matter a lot, particularly because MFIs are not subject to prudential supervision.

I agree with McGuire's view that the development of standards matters both for improvement of the MFI industry and the allocation of donor funds. Clearly, indiscriminate donor support of MFIs without concern for their sustainability and efficiency is counterproductive. I also agree that apex organisations are well-positioned to enforce standards of performance through their lending operations.

Successful implementation of this objective assumes, however, that a set of MFIs already exists and that a sufficiently large number of them are sustainable or potentially sustainable. In this case, the task of the apex organisation would be to screen and monitor MFIs for the donors, to separate the sustainable from the unsustainable. Large numbers of MFIs are needed to generate the expected economies of scale. If no sustainable MFIs exist, then this argument for creating an apex is not valid.

Successful implementation also assumes that the apex has the expertise to design a set of rigorous criteria for sustainability, and it has the political willingness to lend to sustainable MFIs only. Moreover, "disbursement pressures" do not lead to weaker eligibility criteria or to lack of implementation of the standards. I agree with McGuire's statement that "ineffective supervision is likely to do more harm than good". And successful implementation assumes that donors that do not agree with the standards enforced by the apex organisation will not go ahead and still fund unsustainable MFIs on their own. Unfortunately, however, this happens too often, and when it does, it dilutes the disciplining effect of the standards enforced even in countries where apex organisations already operate.

Second, McGuire identifies circumstances under which apex mechanisms do not work well. He cites pressures to disburse, repressive interest rate structures enforced by the apex, and politicisation of the apex. I agree with these concerns. Moreover, I believe that rather than being exceptional shortcomings, these problems tend to be intrinsic to apex organisations, and that the exception is their absence.

Third, McGuire's report on the experience of apex organisations tends to confirm my less optimistic view. Except in one case, the set of eight Asian apex organisations reviewed does not support McGuire's basic recommendation. I agree that, among this set, PKSF in Bangladesh is the most successful, but this is the exception, not the rule. One reason is that in Bangladesh there is already a large, well-developed microfinance sector. PKSF has been able to select some prominent MFIs and a few among a large number of MFIs operating on the fringes of a market dominated by prominent MFIs. Moreover, despite government ownership, the independence of PKSF and its keen pursuit of sustainability have resulted from the individual stature of prominent members of its Board.

In contrast, the three Indian apex organisations (RMK, SIDBI, and NABARD) have a poor record and their policies actually jeopardise rather than promote the expansion of microfinance. Potentially sustainable MFIs find it difficult to compete with the subsidised and unsustainable programs supported by these apex organisations. The record of NDTF in Sri Lanka also seems poor, and politicisation has been a key problem. The development of MFI standards by the Philippine Coalition for Microfinance Standards is a positive step, but this has occurred independently of the activities of a financial apex. In Philippines, the goal to move microfinance programs from government agencies to a privatised apex organisation is well-intentioned, but the usual shortcomings of apex organisations must be understood to minimise the threats. Other experiences in Thailand and Nepal are equally discouraging. From this perspective, plans to create an apex in Pakistan, where no microfinance sector exists to begin with, are unrealistic. In contrast, it is somewhat puzzling that Indonesia, where microfinance has been most successful, did not use any apex mechanism in the development of this sector.

McGuire's paper shows that an apex organisation may play some role for the donors when a microfinance sector exists. There is, however, no evidence whatsoever in his paper that an apex organisation can play any useful role in developing a microfinance sector from scratch. Indeed, it may be "more efficient for one institution to monitor and evaluate MFIs than for different government and donor agencies to conduct their own analysis". What this assumes is that there are already sustainable MFIs to be evaluated. Several other mechanisms may be better alternatives to apex organisations as instruments for the development of a market of sustainable retail microfinance organisations.

**Reply by Paul McGuire**

Professor Gonzalez-Vega's comments are constructive and well-argued, and I agree with a number of the points that he raises. Nevertheless, I remain more positive about the role of apex institutions than he is.

One of Gonzalez-Vega's main arguments is that "successful implementation ... assumes that a set of MFIs already exists and that a sufficiently large number of them are sustainable or potentially sustainable. ... Large numbers are needed to generate the expected economies of scale. If no sustainable MFIs exist, then this argument for creating an apex is not valid". I agree with this observation. It was hinted at in the article, but perhaps not brought out clearly enough.

Gonzalez-Vega also notes that successful implementation assumes "that donors that do not agree with the standards enforced by the apex organisation will not go ahead and fund unsustainable MFIs on their own". But he argues that this happens too often. While this is true, it is not an argument against apex organisations. In fact, it is an argument for greater reliance on apex organisations, at least where they are operating effectively.

Gonzalez-Vega agrees that pressures to disburse, repressive interest rate structures enforced by the apex, and politicisation of the apex are all cause for concern. Moreover, he believes that rather than being exceptional shortcomings, these problems tend to be intrinsic to apex organisations, and that the exception is their absence. I accept that it may be extremely difficult to overcome these pressures, but I would not go so far as to say the problems are intrinsic to apex organisations.

One relevant issue here is the question of regulation of apex organisations themselves. Should apex organisations, as financial institutions in their own right, be subject to prudential regulation and supervision by the central bank? In practice they are not, but PCFC in the Philippines is providing regular reports to the central bank, and is moving in this direction. Another relevant issue is whether these pressures, or non-market/ bureaucratic failures, are more pronounced in the case of apex institutions than in the case of alternative mechanisms for channelling funds to retail MFIs. Gonzalez-Vega seems to acknowledge that these or similar pressures often apply to donor agencies as well. They may be just as difficult to overcome with respect to donor agencies as they are with apex institutions.

Gonzalez-Vega also argues that the three Indian apex organisations (RMK, SIDBI, and NABARD) have a poor record and their policies actually jeopardise rather than promote the expansion of microfinance. It is true that the three apex institutions in India take an overly bureaucratic/regulatory approach. But this applies to the financial system in general, and is certainly not confined to apex institutions. The approach adopted by apex institutions is in my view a symptom, rather than a cause, of the problems. In my view, there probably needs to be a significant overhaul of the policy and regulatory environment if microfinance is to attain significant outreach in India, regardless of the role of apex institutions.

I agree with Gonzalez-Vega that the development of MFI standards by the Philippine Coalition for Microfinance Standards is a positive step. While the apex institution in the Philippines (PCFC) did not initiate the process, it has been an active player. Moreover, while self-regulation has been very successful in developing standards, it remains to be seen how the standards will be implemented. Who will conduct the ratings? What incentives and/or sanctions will there be to encourage MFIs to submit to a rating process and to work to improve their ratings over time? As an apex institution lending to a large number of MFIs, PCFC is in a strong position to be involved in actually implementing the standards.

Finally, Gonzalez-Vega comments that it is somewhat puzzling that Indonesia, where microfinance has been most successful, did not use any apex mechanism. In my view, the very different approach to rural financial systems development/microfinance in Indonesia makes it difficult to compare Indonesia to other countries in Asia. The emphasis on regulated financial institutions rather than NGOs means that the task of establishing and enforcing performance and reporting standards, that may otherwise have been undertaken by an apex organisation, has been undertaken by the central bank (albeit imperfectly, as recent events have shown). Also, while the extensive outreach of BRI *unit desa* and the rural banks has been very positive (and commented on very favourably by the Foundation), their programs are rarely poverty targeted and their clients are not necessarily directly comparable to those of MFIs which use means tests to specifically target clients in poverty.

**Network members visit Japan**

Five representatives from the BWTP Network visited Japan in March. The trip was conducted in collaboration with two Japanese organisations, Citizen's Bank(Tokyo), and Women's Work Banking, Japan. A full report of the visit will appear in our next issue.

**ADB Microfinance Strategy**

The Asian Development Bank is currently undertaking consultations to develop a microfinance strategy for the Bank. This strategy will guide the Bank's lending programs in Asia-Pacific countries in future. The ADB has asked the BWTP Secretariat to conduct a survey of BWTP members. This is to test their reactions to ADB's *Interim Action Plan* for microfinance, which has been circulating in the Asia-Pacific region. Initial coding and analysis of responses to the survey have now been completed and reported to the Bank. The *Newsletter* will carry a report on the findings in its next issue.

**Philippines Impact Study**

AusAID funding will enable Professor Ron Chua to undertake a follow-up study of microfinance services offered by Alalay sa Kaunlaran sa Gitnang Luzon, Inc. (ASKI), a BWTP member. This study follows a baseline survey conducted by Professor Chua in May-June 1997. Very few studies have had the opportunity to employ a longitudinal design, with on- and off-site control groups, as this one will do. Fieldwork has been completed and data collation and analysis are now being carried out.

**Membership News**

With funding assistance from AusAID, BWTP Chairman, Mr Bambang Ismawan, represented the BWTP Network at the Microcredit Summit meeting in Cote d'Ivoire in June. Two Philippine members have announced personnel changes. TSPI has a new Executive Director, Mr Jody Delacruz. He comes to TSPI with a background in commercial and private investment banking. KMBI has also appointed a new Executive Director, Mr Bong Alcoba. He has been with KMBI for a number of years, most recently as Deputy Executive Director. We wish both new appointees much success.