

MICROFINANCE INDUSTRY IN ASIA¹

- CURRENT STATUS, RECENT TRENDS AND SOME THOUGHTS ON THE FUTURE

**Nimal A. Fernando
Senior Project Economist – Microfinance
Asian Development Bank, Manila, Philippines**

I. Introduction

1. Close to 900 million of the world's poor – those who survive on less than \$1 a day – live in the Asian and Pacific region. Most of the region's poor or more than 670 million people (about 135 million households), live in rural areas, although urban poverty is also a growing problem in virtually all countries in the region. Most rural people are engaged in agricultural activities as laborers or small-scale farmers. Many are also involved in a variety of microenterprises to supplement their meager and volatile incomes from other sources. Urban poor are engaged in a variety of nonfarm activities including petty trading. These poor households have few assets other than their labor, and they have little access to formal financial services such as savings, credit and insurance. Many of them rely on self-finance, informal sources or combinations of these two to meet their demand for financial services. Self-finance has obvious limitations.² The informal sources are also limited in their capacity to fully meet this demand efficiently. It is in this context that the current status and the future of the microfinance industry in the Asian and Pacific region will be discussed in this presentation.

¹ The views expressed in this paper are entirely those of the author and do not in any manner reflect the views of the Asian Development Bank.

II. Current Status of the Microfinance Industry

2. The region is highly heterogeneous in terms of population density, per capita income, incidence of poverty, economic structure and social development. Also, physical and financial infrastructure facilities, macroeconomic stability and the policy environment for growth in general, and microfinance in particular, vary substantially across countries in the region. These factors together with the legal framework have a significant bearing on the current status of the microfinance industry.

3. Despite being in poverty, the poor and low-income households and their microenterprises have a strong demand for deposit services. The positive response of the poor to voluntary savings programs of a number of rural and microfinance institutions (MFIs) clearly demonstrate this demand. The rapid growth in small deposits in rural financial institutions such as the Bank Rakyat Indonesia's Unit Desa system, cooperative rural banks of Sri Lanka and the Association for Social Advancement (ASA), a microfinance NGO in Bangladesh, provide strong evidence of this demand.

4. The extensive and frequent reliance of the poor on various informal mechanisms, such as rotating savings and credit associations, to save money and the still widespread practice of hoarding cash at home in almost all developing countries of Asia are other evidence of this demand. A study of financial services in urban slums in India showed that a safe place to accumulate savings is the "financial service most in demand by the urban poor".³ Slum dwellers in some Indian towns even pay deposit collectors in the

² McKinnon, R.I. 1973. *Money and Capital in Economic Development*. The Brookings Institutions: Washington DC. p. 13

³ Rutherford, S. and S.S. Arora. 1997. *City Savers*. Urban Poverty Office. New Delhi: Department for International Development.

informal sector for their services, indicating the high value they place on the service. In most developing countries, the poor keep a substantial proportion of their savings in non-financial assets. A UNDP/UNCDF survey in Lao PDR in 1996 estimated the total savings in the rural sector at \$328 million equivalent at the time of the survey: about 74 percent of these savings was in the form of livestock while another 15 percent was in precious metals.⁴ In many other countries, saving in non-financial assets is still ubiquitous among the poor.

5. There is a large demand for microcredit as well. This demand is heterogeneous. The poor households demand microcredit for consumption smoothing, to meet expenses related to life-cycle events such as sickness in the family, death of family members, education of children and for investment purposes. The poor also have a strong demand for other financial services, particularly insurance.

6. Despite the massive demand for a broad range of financial services, microfinance service providers in Asia still meet only a very small proportion of the demand. First, in terms of the households, the industry does not reach more than 22 million households. If we take 170 million households as the potential market size (leaving out about 10 million poor households), this would be about 13 percent of the potential clients. Interestingly, about 64 percent of the 22 million households with access to institutional financial services are concentrated in two countries: Indonesia and Bangladesh. It is interesting to note that Asia's two largest countries in terms of the absolute number of poor have the least number of households with access to institutional financial services. These two countries are India and the People's Republic of China (PRC). India has about 90 million

⁴ The UNDP/United Nations Capital Development Fund. 1997. *Microfinance in Rural Lao PDR: A National Profile*. Vientiane.

poor households while PRC has about 45 million poor households. However, the proportion of poor households with access to institutional microfinance in India is less than 3 percent while in PRC it is less than 8 percent. While this is a dismal picture, it illustrates the enormity of the problem faced by these two countries in expanding the microfinance industry in the future and the extreme unevenness of the expansion of the industry within the region.

7. Who are the major suppliers of microfinance services in Asia? There are three major categories: government-owned banking and other institutions; nongovernment organizations (NGOs); and cooperatives. The government-owned banking institutions are important suppliers in Indonesia, India, Viet Nam and Sri Lanka. However, except BRI-Unit Desa's, government-owned banks involved in microfinance in most other countries are sustained only with large amount of subsidies. Many of these institutions are not managed as business organizations and do not have a commercial orientation. Their current status cast serious doubts about their ability to sustain the operations without continued injection of subsidies on a regular basis. In many countries of Asia, still government non-banking institutions also continue to provide microcredit. Their overall performance however is unsatisfactory from the point of view of outreach, service quality and financial viability. The operations of these institutions continue to undermine development of sustainable microfinance in these countries and encourage rent seeking by their staff as well as clients.⁵ The scale of government involvement in provision of subsidized microcredit is perhaps the most disappointing characteristic of the

⁵ India's Integrated Rural Development Program (IRDP) is a case in point. IRDP, launched in 1978 for poverty alleviation, provides heavily subsidized credit and disbursed about \$4.6 billion equivalent between 1978 and August 1996. The Program is reported to reach about 2 million households each year and have loan recovery rates less than 50 percent.

microfinance industry in Asia and one that distinguishes it from the Latin American microfinance industry.

8. BRI- Unit Desa is a completely different story. BRI is a state-owned commercial bank and Unit Desas are its rural financial services arm. With over 3,200 Units, BRI serves a large number of poor households, particularly with convenient deposit services. In May 2000, the Units had 16.6 million ordinary savings accounts (Simpedes) with a total outstanding savings amount of \$1.25 billion equivalent and average outstanding deposit amount of about \$75. Although disaggregated data are not available, low ratio of average loan size to GNP (about 54 percent) suggests that Unit Desas' loan portfolio includes a significant number of loans to poor households and microenterprises. The Unit Desas have also been making profits every year consistently from about 1987.

9. NGOs are dominant suppliers of microcredit in Bangladesh, Cambodia, Philippines, Sri Lanka, and Nepal. In Bangladesh, over 500 NGOs are involved in providing microcredit or microfinance services. These NGOs had an outstanding portfolio of about \$365.0 million equivalent at the end of 1999.⁶ This was much higher than the amount of formal credit supplied by the regulated financial institutions excluding the Grameen Bank. However, the three largest NGOs (Bangladesh Rural Advancement Committee, ASA, and Proshika) accounted for 73 percent of the total outstanding loans of the NGOs. In most other countries also, less than 20 percent of the NGOs account for over 80 percent of the market share of the NGO sector.

10. The third major category of suppliers is the cooperatives. The cooperatives are important service providers to the poor and low-income households in India, Sri Lanka,

Viet Nam, Philippines and Thailand. For example, in Sri Lanka, there are 1,418 cooperative rural banks (CRBs). CRBs had 5.3 million deposit accounts with an average outstanding deposit amount of \$32.0 equivalent and 1.23 million loan accounts with an average outstanding loan balance of about \$78.0 at the end of 1999.⁷ Also, at the end of 1997, there were 8,400 thrift and credit cooperative societies with a total membership of about 786,000 in Sri Lanka which include significant numbers of poor households. Although cooperatives in India are believed to be dominated by non-poor, a significant number of poor households are members of the financial cooperatives.

11. A major feature of the current landscape of the institutional microfinance industry in Asia is the insignificant involvement of the profit-seeking private sector financial institutions with private-risk capital. Again, Indonesia is an exception to this. In Indonesia, there are number of private sector for-profit financial institutions - (Bank Perkreditan Rakyat or People's Credit Banks, known generally as BPRs) - involved in the microfinance industry. Despite the growth of the microfinance industry during the last two decades, many Asian policy makers and practitioners continue to believe that the industry should not aim at profit because its clients are poor households. This notion appears to have a very strong influence on the speed with which the microfinance industry in Asia will move toward a higher level of financial sustainability. It is also this notion that distinguishes the Asian microfinance industry from that of Latin America. While many Latin American MFIs charge interest rates high enough to cover costs, and some explicitly take inflation into account in determining interest rates, most Asian MFIs, particularly those in South Asia, show a strong reluctance to charge cost recovery interest rates. Rarely an Asian MFI takes note of inflation in their decisions concerning

⁶ Credit and Development Forum, December 1999. Microfinance Statistics of NGOs and Other MFIs, Vol. 9.

⁷ Central Bank of Sri Lanka. Annual Report 1999. Colombo. Central Bank of Sri Lanka.

interest rates on credit. Easy access to subsidized funds from Governments and funding agencies have indirectly contributed to the persistence of this notion. In some countries such as Viet Nam and PRC, ceilings on interest rates on microcredit are based on the explicit assumption that “poor are too poor to bear cost recovery interest rates”.

12. While outreach of Asian MFIs are relatively impressive when compared with Latin American region, most nongovernment MFIs in Asia have not reached operational self-sufficiency and a very few has achieved financial self-sufficiency. More importantly, most MFIs do not seem to show a significant commitment to achieve a reasonably high level of operational and financial self-sufficiency. This lack of commitment of the majority, however, is overshadowed by commendable efforts being made by a few MFIs in this direction. Most MFIs do not adopt industry best practices. Accounts of most MFIs cannot be analyzed meaningfully without major adjustments. In many cases, loan recovery rates are not measured and reported in a meaningful way. Loan loss provisions are not made in accordance with best practices in the industry. Under-provisioning is the rule rather than the exception. Many NGO-MFIs in Asia include non-operating income in their operating income and thereby overstate operational self-sufficiency and profits. Subsidies received from various sources are not accounted in an appropriate manner. It is unlikely that most of these MFIs will ever achieve financial self-sufficiency.

13. Continued high degree of dependency on concessional funds is another major characteristic of the microfinance industry in Asia. In Bangladesh, such funds accounted for about 43 percent of the loanable funds of the industry at the end of 1999. In most other countries where NGOs and government institutions play a dominant role, the dependency on concessional funds is much higher. A corollary to this dependency is the low reliance on commercial borrowings and public voluntary deposits. The low reliance

on public deposits as a source of funds is directly related to the dominance of NGOs in the industry which are legally not allowed to mobilize voluntary deposits and to a lesser extent the presence of government non-banking institutions that are not allowed to rely on commercial markets for their funds.

14. The Asian microfinance industry is largely supply-driven. Despite the massive demand for deposit services, the industry continues to have a significant credit bias. The notion that credit is more important for the poor households than savings services is widespread and dominant. In many cases, initial loan amounts and subsequent increases are pre-fixed and applied uniformly to all borrowers (one-size- fits- all approach). The menu of credit products is not diversified to reflect the diversity of demand. The term structure of the loans is heavily biased toward loans with a maturity of one year or less. In many cases loans are not given for purposes such as housing, education and consumption. The savings services of most MFIs in Asia are still confined to compulsory savings. The industry provides little or no insurance and money transfer services. Leasing is also an insignificant activity in the industry.

15. The Asian microfinance industry, unlike its Latin American counterpart, is focused on rural areas. Most MFIs, including government programs providing microcredit target rural clients. This is perhaps best illustrated by the situation in Bangladesh where the outreach of institutional microfinance is the largest in the region. In Bangladesh, urban clients account for only 2 percent of the total MFI clients, and MFIs reach only about 10 percent of the potential market in urban areas. In most other countries, urban sector clients are almost entirely left to the informal sector service providers.

16. The Asian microfinance industry continues to rely heavily on group-lending technology for providing microcredit. Most Asian countries have adopted the Grameen Bank's group lending technology with some variations and continue to use this as the dominant technology. While the methodology appears to have offered some advantages at the initial stages of development, its limitations have become increasingly clear over time. Lack of flexibility, pre-determined loan sizes, locked-in savings, regular meetings and joint liability impose high transaction costs on the group members and raise the effective interest rates they pay on loans. As a result, client desertion has become a significant problem for many MFIs, although the actual incidence of the problem is not known.

III. Recent trends in the industry

17. The supply-driven characteristics of the microfinance industry in Asia are gradually changing. A small number of major MFIs in the region which adopted this approach to the provision of services have begun to be more demand-driven than in the past. Some of these institutions have recently introduced voluntary savings products. ASA is a case in point. ASA introduced a number of savings products during 1997-1999 period. On the basis of the experience with these products, in January 2000, ASA introduced a composite savings account which combined locked-in savings and voluntary savings. Some others have also begun to experiment with new savings products. Similarly, some large NGOs in Bangladesh have begun to offer larger loans to microenterprises adding some diversity to their menu of credit products. Microinsurance is also being looked at as a possible institutional service by some institutions. The trend is toward a more diversified scope of services in the industry. The MFIs that are making an effort to diversify the scope of their services, however, are realizing the limitations of

their institutional designs, operational systems, institutional culture and institutional capacity, particularly skill levels of staff as well as the need to make drastic institutional changes to ensure the diversity in scope of services.

18. Although many MFIs in the region are still adopting the group-lending technology, there is increasing awareness among suppliers of the limitations of this technology and the actual effectiveness of it to ensure high repayment rates, particularly when their clients' economic status improves over time. As a result, some MFIs are beginning to introduce individual loans for microenterprises and to clients who require larger loans.

19. In recent years, there has been considerable concern about the fact that the microfinance industry has not reached the poorest households. At the same time, the strong demand for financial viability of MFIs coming primarily from the funding agencies are putting increasing pressure on the microfinance industry. Traditionally the microfinance industry in Asia was not used to this kind of pressure. Many operated with the assumption that access to concessional external funds will continue because their mission is essentially a social mission to serve the poor. The increasing pressure to reach the poorest is forcing some MFIs to take a fresh look at the composition of their clients and a wide array of issues involved in increasing the depth of outreach, including those relating to possible trade-offs between depth of outreach and sustainability.

20. The level of competition in the Asian microfinance industry is gradually increasing. However, this is confined largely to Indonesia and Bangladesh where MFIs have penetrated a significant proportion of the potential market. In Indonesia, the competition is for savings while in Bangladesh it is for credit. In some villages of Bangladesh, clients are able to choose between as many as four major suppliers of

microcredit. This situation has driven many clients into over-indebtedness in the absence of institutional mechanisms for sharing credit information among MFIs. In other countries, because of the limited number of suppliers, similar problems have not yet emerged.

21. The microfinance industry in Asia is also attracting more attention of the central banks and others who are concerned about supervisory and regulatory aspects of the industry. This trend may be explained in terms of several factors. First, absence of a legal charter to mobilize public deposits is becoming an increasing constraint on expansion of some major NGO-MFIs. Second, various stakeholders in the microfinance industry have become more concerned than in the past about safety of poor people's savings being mobilized by NGOs who in fact do not have a legal charter to do so and who are currently not subject to supervision and regulation by the monetary authorities. Third, some funding agencies believe that regulation and supervision is essential to ensure significant outreach of the industry on a sustainable basis. While the interest on regulation and supervision is increasing, no country in the region has so far established an appropriate institutional and legal framework for this purpose. Many issues associated with effective supervision and regulation remain to be resolved.

IV. The Future

22. The future direction of the microfinance industry in Asia will depend on a number of factors. These factors include the speed with which financial liberalization will proceed and the depth of financial liberalization, the extent to which funding agencies supporting the microfinance industry will demand adoption of international best practices by the governments and MFIs that they support, extent of support for capacity building of MFIs

in the region, and improvement in policy, legal, regulatory and supervisory framework for microfinance. However, based on the current status and the emerging trends, a number of predictions may be made.

23. Microfinance industry in Asia will continue to be dominated by non-bank financial institutions. NGOs will maintain their dominant position at least in this decade while cooperatives will increase their market share in the industry because of their ability to legally mobilize deposits from members and use these funds for lending purposes. Many government microfinance programs will see their demise during the decade due to increasing budgetary constraints on continued injection of fresh capital and gradual decline of support from funding agencies to such programs. Private sector risk-capital will enter the market in most countries on a small-scale as the policy and legal environment improves over time. Although it is unlikely that commercial banks will play a significant role in this market during this decade, MFIs with good track records will be able to access funds from commercial banks on an increasing scale. The Asian MFIs will increase their reliance on domestic market resources to meet the demand for loanable funds, but are less likely to tap international capital markets.

24. The increasing knowledge of potential and existing clients about the market will exert pressure on service providers to improve the quality of their services. The diversity of the industry will increase in the future in terms of scope of services. More MFIs will offer voluntary deposit services and a more diversified menu of credit products. Microinsurance services will also expand. The approach of many service providers will shift from pushing their products to meeting clients demand.

25. The number of service providers in the market are likely to decrease in many Asian countries as funding agencies themselves increasingly adopt international best practices and demand firm commitment to achieve financial sustainability from the MFIs they support. Many major MFIs in the region will be compelled to pay more attention to institution design aspects and use of information technology to contain their operating costs at reasonable levels while responding to the rapidly changing market. MFIs that will pay more attention to financial innovation and institutional innovation to address critical issues of transaction costs and risk in pushing the frontier will obtain an obvious edge over those who do not. Those who do not so will be increasingly marginalized.

26. The outreach of services to the poor will expand in the decade together with the quality of services. A significant expansion in outreach is likely to take place in India during this decade. In many countries, consolidation of the industry into a more commercial operation will result in a transitory decline in the outreach mainly because of the demise of many government programs. The outreach will pick-up in many countries after this consolidation period. A small number of star performers will drive the changes in the microfinance industry in the future. Unevenness of the pace of change, however, will continue. The changes will not come about automatically. All stakeholders have to work hard to achieve these.