Chapter 4

Review of International policies and experience

In Asia and the Pacific, a later ADB study found a variety of approaches to microfinance, reflecting the fact that microfinance has evolved differently in different countries. Each country provides special context in terms of policy environment, regulatory mechanisms as well as social scenario, which may include the degree and depth of poverty, the role and participation of women. There has been increasing awareness and realization among developing countries of the Asia-Pacific, Latin America and Africa that financial services to the poor and disadvantaged, particularly women, hold the key to their mainstreaming with the development of the country. While the formal banking sector in most of these countries may not be in a position to provide such services in a cost-effective way, financial intermediation by various agencies in the non-formal sector has gained urgency and importance in these countries. Successful microfinance interventions in these countries are closely studied and replicated in some cases by the institutions in India. Replication of the Grameen, perhaps leads such initiatives.

Microfinance has been given due recognition by various world bodies and the Micro-credit Summit held in Washington in 1997 resulted in 137 countries gathering together to launch a campaign for reaching 100 million of the world's poorest families, especially the women from such families, with credit for self-employment along with other financial and business services by the year 2005. In the wake of this, a number of initiatives have been taken by the government, banks and financial institutions and the voluntary sector to enhance the flow of credit and other financial services to the poor. The budget announcement of the Hon'ble Union Finance Minister of India in 2005 is a step in that direction.

The early interests in were mostly triggered by the apparent success of some well-known overseas programs (Bhatt and Tang, 1998 a&b, Auwal, 1996). For example, the Grameen Bank, which started in 1974 by disbursing $30 in loans to 42 basket weavers to help them purchase bamboo, has grown into an economic development giant. Since its establishment, the bank has disbursed more than $1.5 billion in credit to more than 2.4 million borrowers.

4.1 Latin America

ACCION International's Latin American operations have lent over $1 billion to micro entrepreneurs in the last four years. In addition to their large outreach, these overseas programs are also famous for their high repayment rates of, say, over 97 percent. Reflecting on the reasons for the success of some of these micro credit programs, Otero and Rhyne (1994) note:

> *First, innovators found that they could reduce risk not by analyzing loans more thoroughly or by requiring more collateral but by giving clients strong motivation to repay... Second, innovators found ways to slash their administrative costs: they drastically simplified and decentralized loan applications, approvals and collection processes. Solidarity group programs gave borrowers responsibility for much of the loan approval process. The function of loan officers was transformed so that each loan officer could handle many more clients." (p.3)*

These operational innovations have apparently caught the imagination of many in the development community. Some observers see micro credit as a community building tool that can empower disadvantaged individuals; some see it as a poverty eradication weapon that can "transition" individuals from welfare to work; and yet others see it as a vehicle for job creation and economic development (Morduch, 1998).

4.2 Indonesia

Within the last decade, a new, sustainable approach to microfinance has been developed by the Bank Rakyat Indonesia (BRI), and has been demonstrated successfully throughout Indonesia, the world's fourth largest country. The shift there from government-subsidized credit delivery to profitable financial intermediation at the local level has enabled, for the first time,the demand for microfinance to be met on the large scale. Earlier were no large-scale examples of commercial microfinance in any developing country.[1]Derived from supply-leading finance theory, the 'old paradigm' of subsidized credit for lower-income borrowers in rural areas was well entrenched in Indonesia during the 1970s, as in most of the developing world.

Microfinance as a commercial institutional activity was generally perceived by policymakers and by the formal financial sector as unimportant for the economy, unprofitable for financial institutions,and unnecessary for the poor. This remains the prevailing view in most developing countries today. However, the 'new microfinance' - profitable, sustainable financial intermediation with services delivered at the local level at full cost was pioneered in Indonesia, and is beginning to be adapted elsewhere. The new ideas are spreading rapidly.

The examples of BRI and of other self-sufficient institutions that provide finance to large numbers of lower-income households are of significance globally for three reasons. First, it has been demonstrated within the last decade that commercial financial institutions can provide credit profitably from about 5 to 20 percent of the interest rates that lower-income borrowers can obtain from the informal commercial credit market. Second, the massive demand for institutional microfinance worldwide is far too large to be met by donor or government funds. Third, we now

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[1] *The Paradigm Shift in Microfinance: A Perspective from HIID*
Marguerite Robinson

know that it is possible for commercial institutions to provide microfinance profitably in widely varied contexts. What is essential is an enabling macro-economic and regulatory environment, a reasonable level of political stability, and a sufficient population density and degree of monetization.

National Policy and Strategy for Microfinance Development in Indonesia

Vision

The policy vision has at its core the sustainable access to quality financial services, i.e., savings, deposits, loans, payments and insurance products by every household in every village on every island all over the wide Indonesian archipelago. This creates opportunities to increase wealth of the population by reducing vulnerability, enhancing business activities, generating employment and increasing income of poor and low-income households. To achieve this vision, the Government of Indonesia and all relevant stakeholders jointly aim to work on removing the limitations for microfinance development.

Objectives

Further development of the microfinance sector shall be recognized as a development goal in itself within the framework of the Indonesian White Paper for Economic Policy. To this end, a more complete financial system needs to be put in place that can expand access to financial services for poor and low-income households in the medium and long run. Such a system consists of: an enabling legal framework, institution(s) that issue prudential regulation and supervise its implementation, institutions that provide technical support and assistance, institutions that provide financial services to microfinance institutions. This will be achieved in a market-oriented financial sector where the government provides the enabling environment leveling the playing field for the efficient functioning of the market and the participation of the private sector institutions.

Policy Elements

To realize the Vision and Objectives the National Policy and Strategy on Microfinance builds on the principles laid out in the Yogyakarta Communiqué 2004 and recognizes the need to/for:

a) Reorientation of the role of government- by phasing out programs with interest rate subsidies and targeted credit schemes;

b) A conducive environment for viable microfinance

- By creating a range of different types and tiers of microfinance institutions beyond banks and financial cooperatives to meet the diversity of demand for financial services especially in rural areas and provinces outside Java and Bali;
- By legalizing the activities of non-cooperative and non-bank microfinance institutions, including deposit taking from the public within certain geographical limits and thresholds;
- By integrating microfinance into the overall financial system and treat it with priority;

c) Improved prudential regulation and more effective supervision to

- Create a level playing field for microfinance institutions and prevent regulatory arbitrage
- Protect small depositors by promoting prudential regulation, supervision
- Enforcement of those regulations;

d) Institutional development and capacity building· concentrate government efforts on creating and supporting institutional development and capacity building.

4.3 Philippines

Microfinance is the Government's central strategy for poverty reduction under the Social Reform and Poverty Alleviation Act. Although the Philippines has achieved good progress in promoting microfinance, more than two-thirds of the country's poor, or 17 million people, still do not have access to microfinance services. Instead, the poor rely heavily on self-finance or informal sources that may be very costly, limiting their ability to participate in and benefit from development opportunities and income-generating activities.

ADB is lending US$150 million to help reduce poverty in the Philippines by improving access of the poor to financial services. The loan agreement was signed by Finance Secretary Margarito Teves and ADB President Haruhiko Kuroda.

The program is part of a pipeline of projects endorsed by ADB's Board of Directors in July for consideration during 2005-2007. ADB's pace and sequencing of policy-based support is linked to continued progress of macroeconomic and fiscal reforms in the country. The continued fiscal consolidation in the Philippines paved the way for endorsement of the program.

The Microfinance Development Program will support the Government's program for expansion of a sound microfinance sector that will encourage private-sector participation in the delivery of micro financial services, address systemic weaknesses, and promote access to sustainable, competitively priced financial services for the poor and their micro enterprises. The program will reinforce the National Strategy for Microfinance developed by the National Credit Council, chaired by the Department of Finance.

The program aims to remove restrictions on competition, improve governance, and promote efficient operations and expansion of private-sector-led microfinance institutions . Transparency and truth-in-lending will be introduced to all types of

MFIs is to ensure that borrowing costs are fully disclosed to the poor, while the tax regime for MFIs will be clarified.

"Access to microfinance services can help the poor build viable businesses and pursue livelihood activities," says Julie Rogers, an ADB Principal Financial Sector Specialist. "As such, access to microfinance services can improve household incomes, and thus reduce poverty."

Bangko Sentral ng Pilipinas' (BSP's) initiatives to encourage the banking sector to provide microfinance services to the poor will be supported under the program. This includes the relaxation of bank branching regulations and the increased use of cell phone-based technology for low-cost money transfers and payments, particularly remittances from overseas Filipino workers. The program will promote the introduction of new financial products and the mobilization of savings in MICRIFINANCE, providing a cheaper source of finance, which in turn will lower the cost of credit for the poor.

To increase their efficiency, MICRIFINANCE will be trained to meet the new uniform set of performance standards formulated by the NCC and its technical working group of public and private-sector representatives. The performance standards set benchmarks that will enable MICRIFINANCE to compare themselves with international best practices.

As part of the Government's continuing privatization program, ADB assistance will also be provided to help prepare a privatization plan and divestment options for the Philippine Postal Savings Bank. With the private sector at the helm, the Postal Bank will play a vital role in encouraging savings and providing greater credit access to micro entrepreneurs in the countryside.

The program will also support efforts to improve the regulatory environment for savings and credit cooperatives, which can play a key role in reducing poverty. Government will issue prudential rules and regulations - such as minimum qualifications for boards of directors and management - to ensure safe and sound operations of more than 4,500 savings and credit cooperatives. Regional consultations are underway on the draft rules and regulations that have been prepared by the Government and cooperative sector representatives.

Through the National Anti-Poverty Commission (NAPC), the program will support a nationwide financial literacy program to increase awareness of the basic concepts and importance of microfinance and managing financial resources. To increase consumer protection for the poor, NAPC will set up a website that will allow the public to easily access information, make inquiries and refer alleged violations to the proper regulatory agencies. "These activities should help empower the poor and reduce their vulnerability to illegal and unsound practices," adds Ms. Rogers.

A $500,000 grant from the Japan Special Fund, funded by the Government of Japan, will help promote financial literacy, build viable MICRIFINANCE, and establish a consumer protection framework. The Government will provide $215,000 equivalent for staff and office facilities. ADB's loan, which comes from its ordinary capital resources, carries a 15-year term. Interest will be determined in accordance with ADB's LIBOR-based lending facility.

The Department of Finance is the executing agency for the program. Implementing agencies include the Bangko Sentral ng Pilipinas, the Cooperative Development Authority, Bureau of Internal Revenue, Securities and Exchange Commission, Philippine Postal Savings Bank, and NAPC, which is mandated to oversee development and strengthening of the microfinance sector.

4.4 Nigeria [2]

In Nigeria, the formal financial system provides services to about 35% of the economically active population while the remaining 65% are excluded from access to financial services. This 65% are often served by the informal financial sector, through

[2] *Microfinance policy, regulatory and supervisory Framework for Nigeria Central bank of Nigeria, Abuja, December 2005*

Non-Governmental Organization (NGO)-microfinance institutions, moneylenders, friends, relatives, and credit unions. A microfinance policy which recognizes the existing informal institutions and brings them within the supervisory purview of the CBN not only enhances monetary stability, but also expand the financial infrastructure of the country to meet the financial requirements of the Micro,Small and Medium Enterprises (MSMEs). Such a policy creates a vibrant microfinance sub-sector that would be adequately integrated into the mainstream of the national financial system and provide the stimulus for growth and development. It also aims to harmonize operating standards and provide a strategic platform for the evolution of microfinance institutions,

THE MICROFINANCE POLICY

Policy Objectives

The specific objectives of this microfinance policy are the following:

- Make financial services accessible to a large segment of the potentially productive Nigerian population which otherwise would have little or no access to financial services;
- Promote synergy and mainstreaming of the informal sub-sector into the national financial system;
- Enhance service delivery by microfinance institutions to micro, small and medium entrepreneurs;
- Contribute to rural transformation; and
- Promote linkage programmes between universal/development banks, specialized institutions and microfinance banks.

Policy Targets

Based on the objectives listed above, the targets of the policy are as follows:

- To cover the majority of the poor but economically active population by 2020 thereby creating millions of jobs and reducing poverty.

- To increase the share of as percentage of total credit to the economy from 0.9 percent in 2005 to at least 20 percent in 2020; and the share of as percentage of GDP from 0.2 percent in 2005 to at least 5 percent in 2020.
- To promote the participation of at least two-thirds of state and local governments in financing by 2015.
- To eliminate gender disparity by improving women's access to financial services by 5% annually; and
- To increase the number of linkages among universal banks, development banks, specialized finance institutions and microfinance banks by 10% annually.

Policy Strategies

A number of strategies have been derived from the objectives and targets as follows:

a) License and regulate the establishment of microfinance Banks (MFBs)

b) Promote the establishment of NGO-based microfinance institutions

c) Promote the participation of Government in the microfinance industry by encouraging States and Local Governments to devote at least one percent of their annual budgets to initiatives administered through MFBs.

d) Promote the establishment of institutions that support the development and growth of microfinance service providers and clients;

e) Strengthen the regulatory and supervisory framework for MFBs;

f) Promote sound microfinance practice by advocating professionalism, transparency and good governance in microfinance institutions;

g) Mobilize domestic savings and promote the banking culture among low-income groups;

h) Strengthen the capital base of the existing microfinance institutions;

i) Broaden the scope of activities of microfinance institutions;

j) Strengthen the skills of regulators, operators, and beneficiaries of microfinance initiatives;

k) Clearly define stakeholders' roles in the development of the microfinance sub-sector; and

l) Collaborate with donors, coordinate and monitor donor assistance in microfinance in line with the provisions of this policy.

Microfinance banks and their goals

The establishment of microfinance banks has become imperative to serve the following purposes:

- Provide diversified, affordable and dependable financial services to the active poor, in a timely and competitive manner, that would enable them to undertake and develop long-term, sustainable
- entrepreneurial activities;
- Mobilize savings for intermediation;
- Create employment opportunities and increase the productivity of the active poor in the country, thereby increasing their individual household income and uplifting their standard of living;
- Enhance organized, systematic and focused participation of the poor in the socio-economic development and resource allocation process;
- Provide veritable avenues for the administration of the programmes of government and high net worth individuals on a non-recourse case basis. In particular, this policy ensures that state governments shall dedicate an amount of not less than 1% of their annual budgets for the on-lending activities of microfinance banks in favor of their residents; and
- Render payment services, such as salaries, gratuities, and pensions for various tiers of government.

POLICY MEASURES AND INSTRUMENTS IN THE ESTABLISHMENT OF THE FRAMEWORK FOR MICROFINANCE BANKS

Private sector-driven microfinance banks shall be established. The banks shall be required to be well-capitalized, technically sound, and oriented towards lending, based on the cash flow and character of clients. There shall be two categories of Micro Finance Banks (MFBs), namely:

- Micro Finance Banks (MFBs) licensed to operate as a unit bank, and
- Micro Finance Banks (MFBs) licensed to operate in a state.

The recognition of these two categories of banks does not preclude them from aspiring to having a national coverage, subject to their meeting the prudential requirements. This is to ensure an orderly spread and coverage of the market and to avoid, in particular, concentration in areas already having large numbers of financial institutions. An existing NGO which intends to operate an MFB can either incorporate a subsidiary MFB, while still carrying out its NGO operations, or fully convert into a MFB.

(i) *MFBs Licensed to Operate as a unit bank (a.k.a. Community Banks)* MFBs licensed to operate as unit banks shall be community- based banks. Such banks can operate branches and/or cash centers subject to meeting the prescribed prudential requirements and availability of free funds for opening branches/cash centers. The minimum paid-up capital for this category of banks shall be N20.0 million for each branch.

(ii) *MFBs Licensed to Operate in a State* MFBs licensed to operate in a State shall be authorized to operate in all parts of the State (or the Federal Capital Territory) in which they are registered, subject to meeting the prescribed prudential requirements and availability of free funds for opening branches. The minimum paid-up capital for this category of banks shall be N1.0 billion.

4.5 Canada and United States

Micro credit has increasingly been viewed by policy makers in the US/ Canada as an important instrument for fighting poverty and promoting economic development in disadvantaged communities. A survey that examines a broader array of micro credit programs in California. The survey indicates that micro credit programs occupy a market niche distinct from other alternative loan programs in loan characteristics, and various operational features. Beginning with the "War on Poverty" era in the 1960s and 1970s, alternative credit programs have been used to extend credit to small businesses that were denied access to the traditional banking sector.

The Small Business Administration (SBA) has also been lending to small businesses for many years, especially those run by women or members of minority groups. In addition, various state and local governments have also created loan programs targeting entrepreneurs who have not been able to access the traditional credit markets. The State of California, for example, has established regional programs that provide technical assistance and guarantees for small business loans made by private financial institutions.

At the local level, many cities and counties throughout California have their own community and economic development departments that channel funding from HUD's Community Development Block Grant (CDBG) program to small businesses. While many of these government-run programs target small businesses, the loans they provide are typically in the range of at least $25,000 to sometimes several hundred thousand dollars.

The past decade and a half has seen the emergence of an increasing number of alternative loan programs that specialize in providing micro loans that fall in the range from several hundred dollars to no more than $25,000. Many of these new micro credit programs—run mostly by nonprofits and sometimes by local governments—are inspired by the apparent success of such Third World counterparts as the Grameen Bank and ACCION International. The hope is that these programs will play a key role in poverty alleviation and economic development of disadvantaged communities. With the recent welfare reform, some also see micro credit as a potential tool for moving welfare recipients out of the system[3] .

Some recent studies show that, if effectively run, micro credit programs can help borrowers to improve their economic conditions significantly. For example, a longitudinal study of 405 poor micro entrepreneurs recently completed by the Aspen Institute indicates that 72 percent experienced average household income gains of $8,44, and more than 53 percent moved out of poverty in five years (Clark and Kays 1999). On average, household assets grew by $15,909, while reliance on public assistance was reduced by 61 percent. Other recently completed studies on projects sponsored by the Corporation for Enterprise Development (Raheim, 1997) and ACCION (Himes and Servon, 1998) also revealed positive impacts on borrowers. Despite positive clients impacts reported in these studies, Schreiner (1998) cautions against the tendency of proponents of micro credit to overstate its potential for helping the poor. In particular, he argues that most evaluations done on micro credit programs in the US lack comparisons with control groups, and most fail to undertake any rigorous cost-benefit analysis (Schreiner 1999a, 1999b).

Furthermore, other research indicate that some programs, for example, have experienced substantial difficulties in finding eligible clients and are thus filled with idle capital. Some have been faced with loan losses as high as 60 percent and overhead costs more than three times the size of loan amounts (Bhatt 2000). Research by Servon and Bates (1998) also suggests that by itself is unlikely to help welfare recipients succeed in business. (Hung 1999; Johnson 1998; Servon 1997), programs in the US differ considerably from one another in terms of missions, target clients, and lending methodologies.

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[3] *Stoesz and Saunders 1999*

Since programs differ from one another in many aspects, problems and impacts associated with one type of program may not be the same for another type. To assess fully the potential of as a tool for micro enterprise development, one must draw on the experiences of a larger set of programs with diverse features. Currently, almost all empirical studies on are based on a few non-random cases and often anecdotal evidence. Empirical studies that examine a substantial number of programs of various types at the same time are needed to produce results that may be generalized to the whole population of programs.

As mentioned earlier, much uncertainty remains regarding the impacts of programs on individual borrowers. In an attempt to move beyond this impasse, an alternative approach to program appraisal proposed by Jacob Yaron (1994) has been adopted. Developed initially in the context of developing countries, Yaron's approach employs two key institutional level indicators—outreach and financial sustainability—to analyze program performance. Questions that enable to assess these two performance indicators are asked through surveys. The final research question concerns each program's self-assessment of the current difficulties faced by programs. Most micro loan programs are not stand-alone programs, but part of a larger organization that seeks to encourage micro enterprise development .

Second, programs tend to be less formalized in their lending operations. They are less likely to provide funding in phases, to take legal action against default, and to sell loans in secondary markets. As pointed out by some commentators, such informalities may have caused some micro credit programs to be at risk for higher rates of default and loan losses, because they lack the administrative capacities for evaluating applicants, keeping track of repayment records, and going after defaulters (Bhatt 2000).

Outreach

A major appeal of micro credit in the Third World is its potential for serving large numbers of low-income individuals who have limited access to the traditional banking system[4] . Micro credit programs in the US, however, have much smaller scale than many of the successful Third World initiatives.

Financial Sustainability

Another major appeal of micro credit in the Third World is the ability of some programs to attain relatively high levels of financial self-sufficiency. Most Third World programs that attain high degrees of financial self-sufficiency use decentralized branches to serve numerous borrowers and to involve them in various loan-disbursement activities such as participant recruitment, and loan repayment tracking and enforcement (Otero and Rhine, 1994; Morduch, 1999). These programs are able to control the otherwise high administrative costs associated with making small loans.

In the US, most programs lack access to such reliable and free "help." Another reason for lack of financial sustainability is the unwillingness of managers to charge legally allowable interests and fees, so that Programs may cover as much of the costs and risks as possible. Microloan programs in California charged an average interest rate of 11 percent and fees of $87. Such a pricing structure makes it almost impossible for programs to attain financial self-sufficiency at the current scale. programs in the US are often faced with various constraints that make it difficult for them to take advantage of operational features that have been proven to be successful in the Third World. Part of the reason that fewer programs in the US may have adopted these operational features can be explained by their different circumstances.

First, in many developing countries, borrowing from a program may be the only means for one to develop or maintain a business that provides for one's livelihood.

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[4] *Otero and Rhyne 1994*

Losing one's eligibility for future loans may result in financial disaster. Progressive lending, in the form of increasing credit limits for repeat borrowers in good standing, is a powerful method for encouraging repayment. In US, one's eligibility to obtain a future loan tends to be less critical for one's livelihood, as most people still have the government welfare system to fall back on. Thus progressive lending may not be as powerful a repayment incentive as it would be in a developing country that lacks any social safety net.

Few micro credit programs, however, have linked their lending to any savings requirements, partly because most of their sponsors have neglected the savings side of microfinance. Furthermore, savings arrangements may be governed by various banking regulations that program staff, who generally lack knowledge and background in banking and finance, are reluctant to try.

Third, performance bonuses for staff are a key ingredient of an effective loan collection system for successful Third World programs[5] . Such bonuses are rarely used by US programs, probably because high repayment rates are usually not considered critical for their survival as most of their capital and operational funds are derived from external subsidies. In addition, as the scale of most US programs is very small compared with their Third World counterparts, performance bonuses for staff are unlikely to be offset by additional returns generated by more effective loan collection efforts.

Most programs may not be stand-alone programs, but part of a larger organization that seeks to encourage micro enterprise development through a wide variety of strategies, of which credit is only one of many [6]. Thus the US has had at least several decades of experience in running programs that provide loans for small business development, but programs that specialize in loans for micro enterprise development

[5] *Hulme and Mosley 1996*
[6] *Servon 1997, 1999*

have been a more recent undertaking. While alternative credit programs (defined as having average loan size greater than $25,000) have been created to foster economic development in areas not served by the traditional banking sector, it has been argued by some researchers and practitioners that micro enterprise programs occupy another distinct niche that is not being served by the larger alternative credit programs.

Indian Context

Chapter 5 Experiences and Institutional mapping in Indian Context