Seibel, Hans Dieter

Working Paper

Enhancing the Resilience of Microfinance Institutions and Programs: Lessons Learned from the Asian Financial Crisis

Working paper / University of Cologne, Development Research Center, No. 1998,4

Provided in cooperation with:
Universität zu Köln

University of Cologne
Development Research Center
Universität zu Köln
Arbeitsstelle für Entwicklungsländerforschung

Enhancing the Resilience of Microfinance Institutions and Programs: Lessons Learned from the Asian Financial Crisis

by
Hans Dieter Seibel

Abstract

The evidence from selected Asian countries shows that:

- Microfinance on the whole has weathered the crisis well. The strongest of the microfinance systems in the region, the BRI unit system in Indonesia, has emerged from the crisis even stronger than before, characterized by a surge in savings deposits and continued excellent repayment performance.
- Demand for microcredit has not increased; there are some cases, as in the BRI units, where it has declined; in other cases, as among some Grameen replicators in the Philippines, neither the demand for, nor the supply of, microcredit seem to be affected.

The resilience of microfinance in crisis situations, just as in normal times, appears to be most strongly influenced by three major factors:

- the institutional autonomy and self-reliance of MFIs in terms of internal resource mobilization and operational terms and conditions
- negatively by financial repression, comprising interest rate regulation, a lack of legal forms for MFIs, and a preponderance of subsidized targeted program credit which in one form or the other has persisted in every country
- positively by the deregulation of interest rates, institutional liberalization and the provision of appropriate legal forms for MFIs, accompanied by prudential regulation and effective supervision (the lack of which was a major factor in the downfall of the banking sector in the affected Asian countries).

Governments tend to respond to the crisis by a return to past repressive practices, particularly subsidized targeted credit channeling, which will keep MFIs from evolving into healthy institutions which grow dynamically on the strength of their own resources. Instead, governments should concentrate on providing a fully adequate policy and legal environment and focus on assistance to MFIs to build their own networks with apex organizations for effective guidance, supervision, training and consultancy services, the dissemination of strategies geared to viability and sustainability and of product innovations, liquidity exchange, and last-resort-access to sources of refinance. Lack of adequate guidance and supervision of MFIs seems to be the biggest shortcoming in every countries, particularly with regard to microfinance NGOs and financial cooperatives.

Donors may utilize the opportunities offered by the crisis to refocus their role on:

- strengthening the institutional autonomy of MFIs, with an emphasis on viability and sustainability;
- building apex organizations of MFIs, with an emphasis on prudential self-regulation and effective supervision of adherence to performance standards;
- preventing well-meaning but ill-conceived government interventions.

Particular donor interventions must be tailor-made for each particular country, based on given conditions in the policy and legal environment, the microfinance infrastructure, the opportunity structure of low-income groups, and their effective demand for financial services. Standardized replications of single strategies or institutional models are to be avoided. This requires a careful analysis of the situation in each country first.

With regard to Indonesia as an example preliminary observations in October 1998 led to the following tentative suggestions:

a. Following the example of the BRI units and other market-oriented SFIs, all the institutions, formal or nonformal, must strive to mobilize their own resources, cover their costs from the interest rate margin and finance their further expansion from their profits
b. The Government is to implement effectively its own policies of avoiding, or phasing out, interest rate subsidies, loan channeling and agricultural price controls, which all undermine rural financial and factor markets
c. The capacity of existing small financial institutions (such as BRI units, rural banks and other SFIs) is to be strengthened to provide a full range of financial services at market terms to all segments of the population including small farmers, micro-entrepreneurs and the landless
d. New local financial institutions (such as financial cooperatives and the self-help groups under IDT, PHBK, P4K and others) are to be assisted to evolve into self-reliant financial intermediaries under effective guidance and supervision
e. Viable and sustainable forms of rural and peri-urban microfinance are to be expanded through systematic cooperation between the staff of the financial institutions and the field extension workers of the various other line agencies
f. Innovative financial strategies, schemes and products (encompassing savings, credit and insurance products) geared to higher agricultural and microenterprise incomes are to be collected and disseminated
g. Bank Indonesia is to take responsibility for effective financial guidance and supervision of SFIs including financial cooperatives and self-help groups, which may be delegated to duly supervised second-tier regulatory authorities as apexes of MFI networks.

To further strengthen rural finance, support may be given in the form of equity grants to SFIs, grants for institution-building, and technical assistance for disseminating financial innovations, developing apex structures, facilitating linkages with higher-level financial institutions including commercial banks, and strengthening the supervision of SFIs.

1. The challenge of the Asian financial crisis

Years of steady economic growth, expanding banking and microfinance sectors and declining poverty turned a number of Asian countries into models of development. Among them were South Korea, Malaysia, Thailand and Indonesia. When the financial crisis broke out, the Asian miracle appeared to be over. It was feared that the gains of past decades might be lost within months. Indonesia, with over 200 million inhabitants the largest of the affected countries, was hit hardest. Previously a model case of prudential deregulation, expanding banking services, the attainment of rice self-sufficiency, economic diversification, and massive poverty alleviation from 60% of its population in 1970 to 11.5 % in 1996, it now suffered from a triple crisis: the collapse of its currency, a prolonged drought, and the breakdown of its political system. There is a danger that in Indonesia alone up to 100 million people may sink back into poverty.

A crisis is also an opportunity: to reexamine the strengths and flaws of the system; uncover its cracks and moot points; devise strategies of strengthening the health of the system and its institutions; and prevent similar future crises in other countries. Our core concern in this context is to draw lessons from the crisis in order to build resilient microfinance systems with sustainable services for low-income groups.

Two types of crises need to be analytically separated: those arising from financial and economic mismanagement; and those arising from natural disasters such as droughts and floods. In the case of Indonesia, the effects of both are confounded. The main emphasis in this paper is on the financial and economic crisis, which requires more fundamental responses. Natural disasters are basic risks which may be dealt with in a more technical manner in terms of insurance-type contract savings, risk management and reinsurance on the one hand and emergency aid on the other hand.

Past regulatory practices have resulted in policy environments, legal frameworks and financial infrastructures that have created both opportunities and impediments for microfinance. These need to be examined first before the impact of the crisis can be fully understood.

2. The policy and legal framework

The lessons of financial repression

Most Asian countries have gone through a period of financial repression, characterized to varying extents by rigid state control over the establishment and expansion of financial institutions, widespread state ownership of banks, regulated interest rates, government control over foreign exchange, and directed credit programs. Domestic resource mobilization was discouraged. Credit by government-owned development finance institutions remained severely restricted; and savings deposit facilities to the rural and urban poor were largely absent. Repayment rates to agricultural development banks like ADBN in Nepal, BRI in Indonesia or Land Bank in the Philippines tended to fluctuate below 50%.

Indonesia is the country where the turn-around in 1983 away from financial repression was most proncouned. Before 1983, interest rates were regulated; the financial sector was dominated by state-banks; and the establishment of new banks and bank branches was severely restricted. Only semiformal financial institutions, of which over 5,000 had been set up under provincial law since the 1970s with an initial capital injection by local government, were allowed to mobilize their own resources through the income earned from a range of

high-yielding loan products. In the formal financial sector, the principal source of funds for agricultural and small enterprise credit was Bank Indonesia (BI), the central bank. Guided by the triple development goal of *Equity, Growth and Stability,* Indonesia used its oil revenues to provide between 75 and 100% of the funding for a vast array of priority programs. It might be that this had a positive impact on economic development and distributional equity as indicated by the attainment of self-sufficiency in food production in 1984 and a substantial reduction in poverty. However, as surveys showed that rice harvests improved more in areas where BIMAS loans were not available, it appears that preferential credit directed resources to low-yielding investments and that the progress achieved might have been due to other factors. When at the beginning of the 1980s oil prices dropped and a world recession set in, it became increasingly costly for Indonesia to maintain its repressive financial regime and cover the huge losses of its state banks and preferential credit programs. The GNP growth rate dropped from a five-year average of 8% during 1977-81 to 2.2% in 1982; balance of payment and current account deficits soared, and government banks had become dependent on central bank liquidity as their chief source of funds. At the beginning of the 1980s, savings and time deposits as a proportion of GDP was below 4%, and money supply (M_2) below 15% of GDP.

Financial repression turned out be costly. During a ten-year period for which World Bank data are available, a single small enterprise credit scheme (KIK/KMKP) absorbed unrecovered subsidies amounting to $1.6 billion. Directed targeted credit failed to reach sufficient numbers of low-income groups; national economies failed to build up their domestic resource base; institutions failed to evolve as self-reliant financial intermediaries; and small farmers, microentrepreneurs and the poor failed to strengthen their self-help and self-financing capacity. There is evidence that most of subsidies were grabbed by the non-poor, and that any additionality effects (in terms of additional investments as a result of credit) are highly questionable. One lesson that may be drawn from the negative experience with subsidized targeted credit is that a return to such practices at times of crisis is unlikely to be beneficial; to the contrary, it may further undermine the health of MFIs already weakened by the crisis.

3. Macro-level reforms of the policy and legal framework: lasting foundations?

The Indonesian experience

Indonesia, unlike Thailand, is the country started deregulation with the financial sector in the lead, progressing in clearly delineated steps. In June 1983, it boldly embarked onto the road to a market economy. With the objective of diversifying its production, strengthening its export sector and unleashing its domestic resources, it gradually deregulated its financial system and foreign trade regime. Since then and up to the outbreak of the Asian financial crisis in 1997, prudential deregulation of interest rates, the easing of the conditions to set up new banks and branches, macroeconomic stability (a key factor preceding financial deregulation!) and close communication between the government and the banking and MFI sector have greatly contributed to financial deepening, economic growth, the development of the financial infrastructure, and increased access to financial services by low-income groups. Deregulation of the monetary and banking system proceeded in the following steps:

- 1983: Interest rate autonomy was given to all banks, state-owned and private. Bank Indonesia (BI) as the central bank dropped direct interest rate controls and adopted market-oriented monetary policies. Between 1983 and 1990 savings mobilization increased 6.7-fold, bank loans outstanding 6.4-fold. From 1990 to 1995 savings mobilization increased 2.5-fold, bank loans outstanding 2.4-fold.
- 1988: BI deregulated the institutional framework by easing the establishment of new banks and the opening of branch branches. A new rural banking law permited the establishment of rural banks (BPR) with an equity capital of Rp. 50 million, requiring that

the existing semiformal financial institutions be eventually transformed into banks (BPR). 1,643 rural banks (BPR) were established until 1995. The total number of registered small financial institutions grew from 8,003 in 1990 to 9,271 in 1995; the number of commercial banks from 171 to 240; and the number of their branches from 3,563 to 5,191.

- 1990: BI abolished most of the interest rate subsidies, terminating 32 out of 36 directed credit programs.This forced banks to rely almost fully on resources mobilized from the public. To absorb the shock of the abrupt liquidity withdrawal on the small enterprise sector, BI required commercial banks to allocate 20% of their portfolio to the microeconomy, either directly or through MFIs.
- 1991: In response to some spectacular bank failures, BI stepped up bank supervision and imposed a capital adequacy ratio.
- 1992: A new banking act deregulated bank ownership. Only two types of banks were recognized: commercial banks und rural banks (BPR) with a paid-in capital of Rp10b (US$. 4.82m, at 1992 exchange rates) and Rp50m ($24,100), respectively.

In response to the change in the policy environment, banks engaged in vigorous campaigns of savings mobilization and credit delivery at market rates of interest. To attract deposits, banks competed with each other by offering a variety of savings products with different terms and highly positive real returns. This led to an upsurge in domestic resource mobilization, reversing at the same time the outflow of capital. From 1982, the last pre-deregulation year, to 1996, the last pre-crisis year, savings and time deposits (excluding demand and foreign exchange deposits) increased 67-fold in nominal and 21-fold in real terms. Savings deposits, which are mostly held by low-income groups, grew 126-fold in nominal terms and 39-fold in real terms - much faster than time deposits, in which the rich hold their money, which increased 54-fold in nominal and 17-fold in real terms. (**Annex 1**) This shows that, (a) the poor, or low-income people, do save; and (b) the poor respond to opportunities and incentives to save. The banking crisis disrupted this pattern of steady growth: During the 18-months period, Jan. 1997 to June 1998, savings and time deposits nominally increased by 59% but fell by 15% in real terms. During the same period, the ratio of M_2/GDP, a standard measure of financial deepening, increased from 17.5% to 54.2% (**Annex 2**). The shape of the curve presents visual evidence that policies work: The curve shows a definite incline after 1984, the first full year after interest rate deregulation. 1986 is the year of a major devaluation of the Rupiah, resulting in some leveling-off of the curve. This is followed by a sharp incline of the curve after 1988, the year of banking liberalization and the enactment of the new rural banking law. In 1990 it started to level off when Bank Indonesia pulled the tight money policy breakes.

4. Lessons of the Asian crisis: the pitfalls of deregulation without supervision

While many Asian countries have started to deregulate their financial and economic systems, none has done so completely; and none has fully abandoned practices of interference generally recognized as detrimental. Virtually every country has maintained a number of directed credit programs (over 70 in the Philippines, and a moderate four in Indonesia); and none has fully exhausted its domestic resource potential.

Indonesia seems to present the clearest case of a flawed system. While deregulation was successful, banking supervision of the fast-growing financial institutions proved inadequate, causing a financial, economic and political crisis of alarming dimensions. Weaknesses in bank supervision had been apparent all along, to which BI responded in 1991, though ineffectively. The fact of politically instigated lending was also known, but not its excessive extent. The belief was upheld that in a climate of rapid economic growth, the healthy portion of the

banks‘ portfolio might outgrow the nonperforming portion. However, within the framework of an autocratic political economy without democratic controls, this belief turned out to be erroneous.

The situation was aggravated by a second flaw which had gone largely undetected by Bank Indonesia: the extent of foreign exchange exposure particularly of corporations directly endebted to foreign banks; and its short-term structure. Given a relatively high level of domestic interest rates, corporations found it cheaper, or more convenient, to borrow abroad rather than to borrow domestically (ignoring the exchange rate risk), or to raise funds on the capital market, respectively. When the crisis spread from Thailand, panic broke out, resulting in a flight of foreign investors and a bank run of domestic depositors, with spiraling effects. The Rupiah slumped from around 2,500 to the dollar in mid-1997 to 15,000 in mid-1998. Inflation went up from single digit figures (7.0% in 4/1993-3/1994, 8.6% in 1994/95, 8.9% in 1995/96 and 5.2% in 1996/97) to 34.2% in 4/1997-3/1998, with an unprecedented peak of 12.7% in 2/1998, slowing down to monthly rates around 5% between March and June 1998. In 1998, the inflation rate may reach as much as 80%.

Aggravated by two successive droughts in 1997 and 1998 and worsened by runs on rice stores to hoard the scarce commodity, food prices increased even more drastically, culminating in a tripling of the price of rice, the staple food in Indonesia. The rise in food prices had two effects: an incentive effect for agricultural producers, particularly on export crops, diminished at the same time by the scarcity and soaring costs of imported inputs (particularly fertilizer, chemicals and animal feeds); and soaring costs for food particularly among the rural and urban poor, with the new urban unemployed the most disadvantaged.

There are three regulatory reform measures which form an essential triad for sustained financial and economic growth: macroeconomic stability, prudential deregulation, and effective bank supervision. Indonesia performed well on stability (until mid-1997) and deregulation, but failed on bank supervision. This, in the wider framework of the Asian financial crisis of 1997, led to a bank run, the collapse of the Rupiah, soaring inflation, massive unemployment, and, last but not least, political instability. Microfinance was least affected, indicating that MFIs at the local level applied sound banking practices and avoided political influence. The chief lesson of the Indonesian experience is that financial deregulation without adequate bank supervision can be disastrous; and furthermore, that financial liberalization within an autocratically ruled political system may open up new and uncontrolled avenues for political interference.

5. Microfinance in Indonesia

5.1 Origins and development

Indonesia has one of the most differentiated microfinance infrastructures, with colonial origins dating back to the end of the 19th century[1]. The recent history of microfinance in Indonesia progressed in three major phases. In **first phase**, after the upheavals of 1965, the government, building on pre-war foundations, established **two types of rural and microfinance institutions:**

[1] Documented by L.Th. Schmit, Rural Credit Between Subsidy and Market: Adjustment of the Village Units of Bank Rakyat Indonesia in Sociological Perspective. Leiden Development Studies No. 11. Rijksuniversiteit Leiden Leiden (Belgium) 1991; Richard H. Patten & J.K. Rosengard, The development of Rural Banking in Indonesia. ICS Press, San Francisco 1991

(a) a centralized system of so-called village units (*unit desa*), which are actually subdistrict (*kecamatan*) units, of a government-owned agricultural development bank, Bank Rakyat Indonesia (BRI), to channel subsidized credit under BIMAS to small farmers targeted at rice self-sufficiency.
(b) a decentralized system of semiformal financial institutions under provincial law, which were supposed to be guided and supervised by regional development banks (BPD) and BRI. Some of the best-known provincial networks are the BKK (owned by local government) in Central Java, the LPN (owned cooperatively) in West Sumatra and the LPD (owned by the village community) in Bali.[2]

The Government's strategies in setting up these two systems differed in essential ways:
(a) In the case of BRI, it fully funded the creation of a formal infrastructure under a special law of over 2,000 (now over 4,000) BRI units and the concomitant selection and training of staff. It also provided the loanable funds and an annual budget for subsidies on interest rates and operational costs. Given repayment rates around 40%, the Government also picked up the substantial loan losses. While the program turned out to be unsustainable, the Government had made at the same time a lasting initial investment in the rural financial infrastructure.
(b) The semiformal financial institutions were set up outside the formal financial sector and therefore not subject to interest rate regulation. Equipped with a small seed capital grant (rather than a loan, which would have caused excessive transaction costs and moral hazard) by the Government, these small financial institutions (SFIs) were essentially designed to be self-reliant providers of microcredit. They mobilized their own resources not through savings but through high interest rates while their administrative costs were low. These SFIs show how governments may set up viable and sustainable SFIs in a financially repressive environment: through exemptions from interest rate regulation and reliance on internal resource mobilization after a pump-priming seed grant.

In response to the world recession of the early 1980s, the Government initiated a **second phase** through the deregulation of interest rates in June 1983 and the discontinuation of the BIMAS program. Faced with the prospect of closing down the units and dismissing their staff, BRI, under new leadership (Kamardi Arif), decided to build up a microfinance scheme on commercial terms, operational as of 1984. With the long-term technical assistance of HIID and a start-up World Bank loan, BRI developed two highly successful financial products: a savings product with a lottery component and positive real returns, SIMPEDES; and a single village-level credit product, KUPEDES, with interest rates designed to cover all costs and finance its expansion, universal monthly instalments without a grace period and highly effective incentives for timely repayment. This made BRI one of the world's most successful microfinance providers: viable and fully financially self-sufficient since 1989. The BRI units, which are profit centers with staff incentive schemes, mobilize their own loanable resources plus a rapidly growing amount of excess liquidity; they are the only profitable part of BRI; and they are so profitable that the have made the whole bank profitable: the only one among all government banks in Indonesia. One of the less conspicuous, but perhaps most important aspects of BRI's microfinance operations is their integrated banking software, financial monitoring and supervision system, producing daily results at the unit level and monthly results at the national level.

[2] Seibel, H.D., Finance with the Poor, by the Poor, for the Poor. Financial Technologies for the Informal Sector, with Case Studies from Indonesia. Social Strategies vol. 3 no. 2. Basel University, CH-4051 Basel, 1989

The **third phase** was initiated by the passing of an act (PAKTO27) in 1988 liberalizing the establishment of new banks and bank branches. It also provided a new legal status for the establishment of formal sector rural banks (BPR) at subdistrict level with an equity capital of Rp 50 million (approx. $25,000 at 1988 exchange rates, $5,000 at Oct 6, 1998, exchange rates) under central bank supervision. At the same time, this law opened up mandatory avenue for the upgrading of semiformal to formal financial institutions within a five-year period, which has been successively extended. The law offered two types of BPR ownership: private or cooperative (excluding community ownership). Under the restrictions imposed on cooperatives (KUD) by a presidential decree until early 1998, the vast majority of the over 2,000 BPR established between 1988 and 1998 were private banks.

5.2 The microfinance infrastructure

Indigenous origins, private initiatives and government interventions have produced a highly differentiated financial infrastructure of over 6,000 financial institutions and offices belonging to the formal financial sector; over 5,000 semiformal financial institutions reporting to Bank Indonesia; over 5,000 other semiformal financial institutions, some 900,000 self-help groups registered with some government agency, plus an infinite number of informal financial institutions (among them the ubiquitous rotating savings associations, *arisan*)– all catering for the financial needs of various layers of low-income groups. (Table 1) The **rural and microfinance infrastructure** thus comprises five major subsectors:

a. **Bank Rakyat Indonesia (BRI),** a government-owned commercial bank with a rural and agricultural mandate, was recently reorganized into four divisions: a Treasury and Investment Division, a Corporate Banking Division for loans above Rp 3 billion ($300,000) including dollar loans; a Retail Banking Division with 323 branches which offer savings deposit services, provide loans on commercial terms from Rp 25 million to Rp 3 billion ($2,500-300,000), and handle the remaining subsidized targeted credit programs; and a Micro Banking Division, the only profit-making part of BRI, with 4,085 outlets (2,566 village units, 379 village posts and 1,220 peri-urban units. Mobile units for (peri-) urban areas are under preparation. The BRI units account for more than half the total assets of some 15-16,000 SFIs. The units, which are profit centers with a staff of 4 to 11, offer passbook savings and time deposit services; and individual non-targeted KUPEDES loans with monthly instalments and market rates of interest) ranging from Rp 25,000 to Rp 25 million (unadjusted in size since the crisis), or $2.50-$2,500. No group loans are disbursed by the units. Interest rates under KUPEDES are being adjusted as of 1 October 1998 from a flat rate of 1.5% per month (33% eff. p.a.) + a refundable timely-repayment incentive of 0.5% (received by 95% of the borrrowers) to 2.2% p.m. (48% eff. p.a.) + a refundable timely-repayment incentive of 0.73%. The majority of customers of the rural units are small traders, small farmers and other microentrepreneurs. Of the customers at the peri-urban units, over 50% belong to the informal sector. As of 8/1998, the BRI units had:

   20.93 million savings deposit accounts with Rp 15.13 trillion ($1.51 billion) balances;
   2.51 borrowers with Rp 4.61 trillion ($0.46 billion) loans outstanding.

b. There are 2,227 (6/1998), mostly private, **rural banks** (BPR), with over 6 million customers. Minimum capital requirements (Rp 50 million, which were approx. $25,000 in 1988, now $5,000) have remained unadjusted since the crisis. Their assets are on average around Rp 1.5 billion ($150,000 at the 6 Oct. 1998 exchange rate), with a relatively strong equity base of 23% before the crisis. With average loan sizes of Rp 1 million ($100) and average savings balances of Rp 130,000 ($ 13), they serve the lower microfinance market.

(Reille & Gallmann 1998:11-12)[3]. In 6/1998, total assets amounted to Rp 2.93 trillion, total savings deposits to somewhat over Rp. 1.5 trillion and loans outstanding to somewhat below Rp 2 trillion.

c. There are over 7,000 **semiformal financial institutions**: 5345 Badan Kredit Desa (BPR-BKD) and 1809 Lembaga Dana Kredit Pedesaan (LDKP) under the supervision of BRI and provincial development banks (BPD), respectively (6/1998). They are all included in BI's reporting system.

d. There are over 2,000 private **credit unions** (KOPDIT) under the Credit Union Coordinating Office; plus **savings and credit cooperatives** (koperasi simpan pinjam) under the Ministry of Cooperatives which since the deregulation of the cooperative sector in 1998 (INPRES No. 18) are expected to grow dynamically. Their financial supervision is not controlled by Bank Indonesia and practically inexistent: presumably the biggest hindrance to their development into sound SFIs.

e. Below this is a vast number of **financial SHGs**, among them an unknown number of indigenous groups, several thousand groups under NGO guidance, some 50,000 groups under P4K/MoA, some 25,000 groups (KUBE) under the Ministry of Social Affairs, some 15,000 groups linked to 819 bank offices (mostly BPR) under PHBK/BI (with a portfolio of Rp 36.8 billion in 5/1998), 136,000 groups in 28,376 poor villages under IDT/BAPPENAS, and 667,000 women's groups with secondary financial activities under BKKBN. The IDT groups (Lembaga Keuangan Alternatif, LKA) receive seed revolving grants and are to evolve into savings & credit cooperatives as self-reliant intermediaries. BAPPENAS expects that by coordinating eight line ministries with their self-help group structures under IDT, a network of local financial self-help institutions will eventually cover all 65,000 villages of Indonesia, with an apex structure of rural banks (BPR) at sub-district level. According to BAPPENAS sources, effective financial management mechanisms are to be developed to bring their financial supervision, which is separate from their institutional supervision, under the authority of Bank Indonesia.

Figures on those institutions which report to BI are summarized in Table 1.

Table 1: Financial services of rural financial institutions reporting to Bank Indonesia, 6/1998

Financial institution		Savings deposit accounts (millions)		Borrowers (millions)		Deposits[2] & equity (trillion Rupiah)[3]		Loans outstanding (trillion Rupiah)	
Type	No.	Number	Percent	Number	Percent	Number	Percent	Number	Percent
BRI units[1]	4,085	20.06	78.0	2.57	52.2	13.58	85.7	4.59	68.7
BPR	2,227	4.96	19.3	1.57	31.9	2.07	13.1	1.97	29.5
BKD	5,345	0.71	2.8	0.78	15.8	0.20	1.3	0.12	1.8
Total	11,657	25.73	100.1	4.92	99.9	15.85	100.1	6.68	100.0

Sources: BRI: Monthly monitoring data; BPR and BKD: Bank Indonesia 10/1998

[1] Data for the number of BRI units include village posts

[2] The term deposits includes passbook and other savings and time deposits

[3] In the figures for BRI units equity is excluded

The BRI units and small financial institutions differ in terms of **source of loanable funds**: BRI's units are totally savings & deposit-driven, without an equity component or commercial borrowings. Their main source of funds are passbook savings, accounting for 73.4%; the remaining 26.6% are generated by time deposits. BRI's most successful savings product is SIMPEDES in rural areas (53.0% of all funds) and SIMASKOT in peri-urban areas (11.0% of all funds), both passbook savings with a lottery component. At the other extreme are the

[3] Xavier Reille (CRS) & Dominique Gallmann (GTZ/PHBK), The Indonesian People's Credit Banks (BPRs) and the Financial Crisis. Second Annual Seminar on New Development Finance, Frankfurt, 9/1998

BKDs, which are equity-driven: 87.2% of their funds are equity, 8.4% passbook savings and 4.4% borrowings. The BPR are also savings & deposit-driven, but not exclusively: 35.5% of their funds are generated by time deposits and 22.8% by passbook savings, together 58.3%. Equity accounts for another 21.3%, and bank borrowings for 20.3%. (Table 2)

Table 2: Sources of loanable funds of rural financial institutions reporting to Bank Indonesia (in percent), 6/1998

Source of funds	BRI	BPR	BKD
Passbook savings	73.4	22.8	8.4
Time deposits	26.6	35.5	0
Bank borrowings	0	21.3	4.4
Equity	0	20.3	87.2
Total percent	100.0	99.9	100.0
Amount in Rp trillion	13.58	2.59	0.21

Source of raw data: BRI: Monthly monitoring data; BPR and BKD: Bank Indonesia 10/1998

The BRI are units are the biggest provider of rural financial services (Table 1). The three types of financial institutions which report to Bank Indonesia probably account for around 90% of total rural finance. Of these, BRI holds 78% of all savings deposit accounts and 52.2% of all loan accounts. In terms of volume, BRI accounts for 85.7% of all savings deposits and 68.7% of loans outstanding**.** Second in importance are the rural banks (BPR) which account for around 30% of borrowers and loans outstanding; their share of savings deposit services is smaller: 19.3% in terms of number of depositors and 13.1% in terms of the volume of deposits. The vast number of semiformal village institutions, BKD (excluding the LDKP, which do not report to BI) carry little weight, except in terms of number of borrowers.

As of 6/1998, the BRI units and the rural banks (BPR) together held over 4 million loan accounts and 25 million savings deposit accounts, with an increase to 26 million by 8/1998. They were held by about 24 million individuals or perhaps 18-20 million households: an outreach to almost half the population.

5.3 Directed credit programs: their functions and dysfunctions

There are four directed credit programs, which were left after Bank Indonesia discontinued 32 out of 36 subsidized targeted credit programs in 1991. They are handled by private and government banks including BRI at the branch (not unit!) level, but not by rural banks (BPR):

KUT, a program for members of informal farmers groups to increase food production (Rp 399 billion outstandings as of 6/1998)

KKUD, a cooperative (KUD) credit program (Rp 139 billion outstandings)

KKPA-TRI, a program for cooperative (KUD) members for sugar intensification (Rp 219 billion)

KKUD-Umum for general loans to cooperative (KUD) members (Rp 1447 billion)

In addition there are projects (Rp 23 billion outstandings) like P4K, a poverty alleviation program for small groups of farmers and the landless initially funded by IFAD. Total directed credit outstanding amounts to Rp 2.23 trillion (6/1998), Rp 2.06 of this for agriculture. In addition, there exists a rice distribution and stabilization program, BULOG, which is handled at the BRI corporate level.

The directed credit programs are determined by government agencies. Sound procedures of creditworthiness examination are lacking; no market terms and conditions are applied. Interest rates are a fraction of the current rural market rates: 14% to KUT and 16% to the other three programs, a third of the interest rate charged by the BRI units and about a quarter of the

current commercial bank rate. Bank Indonesia has now also been directed to refinance BPR, which have lost part of their liquidity, at an interest rate of 30% which is above the costs of passbook savings but far below the costs of fixed deposits, which micht have a discouraging effect on the mobilization of higher-cost domestic savings.

Program credit bypasses the existing rural SFIs and confronts them with an unfair competition of ultracheap credit. Program lending has suffered from high arrears up to 60% in the past. According to official statistics, arrears (amount overdue divided by loans outstanding) were 31% for KUT, 18% for KKUD and 13% for KKPA (7/1998). The Government recently wrote off Rp 117 billion of defaulted KUT loans for 1985-1995; another Rp 165 billion of KUT loans disbursed during 1995-97 are being rescheduled. It is expected that in 1998/99, an additional budget of Rp 4.3 trillion will be available for fresh KUT loans, which may vastly surpass the delivery capacity of the institutions and the absorptive capacity of the farmers. At the same time, the BRI units have a surplus liquidity around Rp 10 trillion which they are unable to re-lend at village level with their present delivery system. Moreover, SFIs have successfully devised instruments of domestic savings mobilization and credit delivery at market rates, with yet a vast unexhausted potential. As long as there is surplus liquidity in the rural financial sector (Rp 10 trillion in the case of the BRI units!) and the SFI potential for resource mobilization is far from being exhausted, there is thus **no justification for injecting targeted subsidized loanable funds.** The real challenge is the deepening of financial services by the existing SFIs and the development of financial cooperatives and self-help groups into effective financial intermediaries with sustainable financial services to all small farmers and microentrepreneurs.

6. The impact of the crisis on microfinance in Indonesia

The impact of the crisis on MFIs has not been uniform, bringing out both the strengths and the weaknesses of different subsectors. However, one basic observation applies to the sector as a whole: While the commercial banking sector is at the verge of collapse, microfinance has weathered the crisis well. This testifies on the one hand to the strength of the legal and institutional foundations of the microfinance sector, its self-reliance, and the public's trust in MFIs; and on the other hand to the absence of the two fundamental problems of the commercial banks: political interference in lending decisions; and excessive foreign exchange risk exposure of the banks and their clients. In contrast, microfinance institutions have mobilized their own resources domestically; and most of them have applied sound lending practices.

6.1. Rural banks

On a more detailed level, the impact of the crisis has been somewhat negative on rural banks (BPR) and many semiformal SFIs, which together account for less than half of the rural microfinance portfolio, and stunningly positive on the BRI units, which account for more than half the portfolio. From 6/1997 to 6/1998, total assets of **BPR** remained nominally stable, decreasing by a mere 0.6% from Rp 2.95 trillion to Rp 2.93 trillion. Loans outstanding decreased by -7.6% and savings and term deposits by –9.6% (Reille & Gallmann 1998:12). However, given an inflation rate of 48% during that period, this is a substantial decline in real terms. The crisis has brought those **BPR** to the brink of bankruptcy which were already weak before the crisis, particularly in the area around Jakarta. Many BRP have experienced a liquidity crunch due to two factors: the transfer of part of their liquidity (estimated at 20%) to commercial banks under government deposit guarantees; and the drying up of borrowings from illiquid commercial banks which were required, since 1991, to lend a 20% quota of their

portfolio to microenterprises or SFIs. It is interesting to observe that both factors are a direct result of government interference. In response to BPR requests, the government has now extended its deposit guarantees to BPR (at the risk of moral hazard) and provided for their access to Bank Indonesia liquidity at 30% (at the risk of discouraging local resource mobilization and distorting rural financial markets).

6.2. Linkage banking

PHBK/BI's 15,000 SHGs experienced a decline in the repayment rate (mostly to BPR) from 96% (principal only) before the crisis to 90% in 6/1998. Loan losses as of 5/1998 reportedly were 0.9%, testifying to the overall resilience of linkage banking under Bank Indonesia's supervision (with GTZ TA).[4] Compared to the experience of P4K (see below), which solely relies on BRI as a source of (re-) finance, it appears that the PHBK management was right in shifting from BRI and other commercial banks to rural banks (BPR) as local partners of SHGs.

6.3. Bank Rakyat Indonesia

Total savings deposits in BRI almost doubled during the crisis year 9/1997-8/1998: in the BRI units from Rp 7.98 trillion in 8/1997 to Rp 15.13 trillion in 8/1998 (+89.6%); and in all of BRI from Rp 17.86 trillion to Rp 35.17 trillion (+96.9%): an increase well above the inflation rate (46.7% for 9/97-6/98, estimated at 56% for 9/97-8/98). During the three-month period June-August, 1998, after Indonesia had been hit by both a drought and an economic crisis, 1.29 million new savings deposit accounts were opened (bringing the total up to 20.93 million accounts by approx. 18-19 million clients) in BRI units; and an additional Rp 2.84 trillion ($284 million at the Oct. 6, 1998, exchange rate) were deposited there. During the same time period, total deposits in BRI as a whole increased by Rp 3.72 trillion to Rp 35.17 trillion. It is assumed that part of these savings are deposited in the BRI units by farmers who profit from high agricultural prices. There is no simultaneous increase in the credit portfolio, which stood at Rp 4.61 trillion in 8/98 (up only 4.5% from Rp 4.41 trillion in 8/97). The BRI units have more than Rp 10 trillion in **excess liquidity**, indicating a capacity for domestic resource mobilization which the rural banks and other SFIs are still far from having exhausted.

It has been noted that because of uncertainty over future developments, people have been cautious to take up new loans. Accordingly, the number of BRI KUPEDES borrowers which has been steadily increasing from 640,746 in Dec. 1984 to 2,615, 696 in Dec. 1997, has now stagnated. During 1998 it has actually declined every single month: from a peak of 2,628,559 in January to 2,508,049 in August: a decrease of -4.6% for that eight-month period; and.a decrease of –1.4% since August 1997. The amount of loans outstanding has continued to increase slowly in nominal terms from Rp. 4.41 trillion in August 1997 to Rp 4.69 in Dec. 1997. After a nominal peak of Rp 4.75 trillion in January 1998, it declined to Rp 4.55 trillion in May and reached Rp 4.61 trillion in August 1998. The amount of loans outstanding has thus decreased by 3.0% during the first eight months of 1998; since August 1997, it has increased by 4.5%.

Since 1989, the BRI units have produced excess liquidity of an ever widening gap. In August 1998, savings deposits in the BRI units were more than three times the amount of loans

[4] In its survey on the impact of the crisis on microfinance, the Foundation for Developmenu Cooperation notes that "Repayment rates for the PHBK program ... have been relatively stable. The monthly on-time repayment rate for January 1998 was 96.6 per cent, slightly higher than the 96.0% per cent recorded in June 1997." B.W.T.P. (Banking With The Poor) Network Newsletter No. 11, June 1998, p. 4)

oustanding: savings of Rp 15.13 trillion exceeded loans outstanding of Rp 4.61 trillion by Rp 10.52 trillion ($ 1.05 billion by the Oct 6, 1998, exchange rate).

The proportion of **agricultural lending** by BRI units has increased only slightly from 17.8% in 1/1997 to 18.8% in 12/1997 and 19.3% in 7/1998. The increase is somewhat more pronounced in terms of monthly disbursements: from 18.9% during 1/1997 to 23.9% in 12/1997 to 23.4% in 7/1998. However, given the fungibility of money, the actual increase might be higher, as loans for small trade and other micro-enterprise activities, which are easier to obtain, and the profits thereof may be invested to a larger extent in agricultural activities which are now far more profitable than before. This issue of agricultural financing within the economies of households requires further study.

The crisis had **no negative effect on repayment** in BRI's microfinance operations, testifying to the resilience of both the BRI village units and their farmer and microenterprise customers. The 12-month loss ratio (2.16%) during the crisis period (9/1997-8/1998) is virtually identical with the long-term loss ratio since 1984 (2.17%). In 8/1998, BRI experienced an unprecedented negative one-month loss-ratio (-0.21%): more than what was due was repaid.

6.4. P4K

P4K, an IFAD-funded poverty alleviation project in the Ministry of Agriculture (MoA), appears less affected by the crisis than by its internal weaknesses.[5] Key data are presented below.

Table 3: Key monitoring data on P4K, Income-Generating Project for Marginal Farmers and the Landless, Indonesia (June 1998)

Total number of SFGs formed:	49,917
Total SFGs with bank savings	34,853
Total SFGs with group savings:	20,542
SFGs with credit outstanding:	16,104
SFGs with arrears	6,848
Percentage of groups with arrears	42.5%
Number if SFGs without arrears	9,256
Loans outstanding:	Rp. 21.20 billion
Arrears (amount overdue by loans outstanding):	23.4%
Bank deposits:	Rp 6.34 billion
Bank deposits in percent of loans outstanding	29.9%
Group savings:	Rp 1.95 billion
Number of intergroup associations:	1,805
Number of groups in associations:	8,996
Average size of associations:	5 groups

50,000 small farmer groups (SFGs), comprising 35.0% men's, 37.5% women's and 27.5% mixed groups, were formed, mostly during the past ten years by MoA field extension workers, responding to material incentives to establish SFGs of 10 poor members each. Groups are required to deposit compulsory savings in BRI branches (not units!) and submit a business plan to be eligible for a loan by BRI. Only somewhat over two thirds of the groups (69.8%) have deposited compulsory savings in BRI; and less than one third (32.3%) have loans

[5] Further research would be needed to disaggregate the effects of the crisis and structural weaknesses of the project.

outstanding. Far less than half the groups (41.2%) have internal group savings. Bank deposits and group savings together are equivalent to 39.1% of total loans outstanding. 42.5% of the groups have arrears, amounting to 23.4% of loans outstanding. As much as half the groups may be dormant. The actual number is unknown, as there is neither a drop-out policy for groups which do not qualify for credit; nor a graduation policy for groups no longer in need of credit. BRI and P4K do not report on the number of groups waiting (perhaps in vain) for credit. About 9,000 groups have taken the initative of organizing themselves in a total of 1,805 intergroup associations, which are self-organized local financial intermediaries of five groups on average. This may be the hard-core of active groups; some of them may stand on their own feed and no longer have loans outstanding.

It appears that the crisis is bringing out the strengths and weaknesses of the project as indicated by the author during the 1993 IFAD evaluation and the 1994 UNDP consultancy. The main **weakness** lies in the loan channeling approach through BRI, which handles the loans on behalf of the government and without any commercial interest of its own through its branches, which unlike the units are far from the people. When arrears in a given village or subdistrict exceed 5%, BRI stops credit disbursement in that respective area. There are cases where two out of 32 SFGs are in arrears, but due to BRI's policy the 30 SFGs in good standing are also excluded from further access to credit. This in turn leads to a spreading unwillingness to repay. As BRI continues to restrict the volume of new loans, the loan portfolio shrinks, which leads to an increasing arrears ratio, despite the fact that the absolute amount of arrears may remain constant or even decrease at a slower rate. The loan channeling concept has further implications. Despite the widespread existence of local SHGs in Indonesia, project staff, inspired by Grameen practices, insists on establishing new groups of an artificial size of 10 members, and on terms and conditions (such as interest rates, loan and installment periods) set up by the project and not by the members themselves. Such groups lack the autonomy and minimum size to act as local financial intermediaries which mobilize their own resources and strive for institutional viability and self-reliance. At the same time, group lending is forced upon BRI, which it has detested since its disastrous BIMAS experience, despite its positive experience with PHBK. As a result, BRI keeps the groups and their members away from its units, which are much closer to the people than the branches. No track record is thus established for members as reliable savers and borrowers that may provide a basis for the graduation to KUPEDES clients of the units.

The main **strength** of the project lies exactly in the opposite of all these weaknesses: namely in the initiative taken by 9,000 groups to establish a total of 1,800 associations. These are informal financial intermediaries of a larger size established by the people themselves outside the project's design. Here people meet weekly, contribute savings, obtain short-term loans (mostly for 1-3 months) on terms decided by each association autonomously, and make weekly instalments. Some of the associations have grown to a much larger size, the biggest with 500 clients. The associations lack legal recognition and an apex structure through which technical support may be organized. The P4K monitoring system reports on the number of associations, but not on their activities and financial standing.

The project, which operates on its on logic, has failed to take any of the **two avenues towards microfinance sustainability:**

- either full integration into the operations of the BRI units, which would require submission under the units' terms including individual lending; in this case, the MoA field extension workers might act as assistant loan officers of the staff of the BRI units, which on average have one loan officer for every 400 borrowers;

- or the strenghtening of the associations as autonomous local financial intermediaries of an appropriate legal status, with an apex structure of their own, or integrated into an existing apex structure of other types of SFIs, for guidance, supervision, training, liquidity exchange and supplementary bank linkages. In this case, the original concept of small solidarity groups, which does not seem to have taken root in the people's local culture, may be abandoned.

7. The experience of the Philippines

7.1 Rural banks and their regulatory environment.

The Philippines is one of the very first countries to provide a legal form for microfinance institutions and deregulate its financial system. In 1952, the Rural Banking Act was passed. The rural banks served mainly as a channel for government credit. Deregulation of the financial sector started in the early 1980s. However, failing to carry out its land reform to provide a basis for a more equitable access to the productive resources of the country, reforms remained haphazard. Until the late 1980s, regulation on bank entry and branching was highly restrictive. Restrictions comprised the prohibition of new banks; the branching into areas categorized as overbranched; increased reserve requirements; and increased capitalization requirements. Between 1988 and 1994, these restrictions were gradually removed, leading to an increased level of competition and relative improvement in efficiency of the banking system. This had positive effects on the expansion of the banking system including rural banks. However, deregulation also entailed the withdrawal of much of the cheap and easy money the government had provided to the rural banks. As a result, all those rural banks that had failed to create their own resource base came under distress, from which some rural banks are still trying to recover. Liberalization had overall positive effects on the growth of the banking sector, which had shrunk somewhat between 1986 and 1989. During the liberalization period, 1989-93, the number of banking offices grew rapidly: from 3,565 to 4,657, or 29.8%, and continued to grow thereafter. This growth has been stronger among commercial banks than among rural banks which suffered from the withdrawal of liquidity, with growth rates of 14.6% during 1989-93 and only 12.6% 1993-95.

Table 4: Offices of bank and non-bank institutions in 1986, 1989, 1993 and 1995

Type of financial institution	1986		1989		1993		1995	
	No.	% ch.[1]	No.	% ch.[1]	No.	% ch.[1]	No.	% ch.[1]
Commercial banks	1,766	·	1,765	-0.2	2,377	+34.7	3,047	+28.2
Rural banks	1,083	·	1,043	-3.7	1,195	+14.6	1,346	+12.6
All banks	3,614	·	3,588	-0.7	4,657	+29.8	5,569	+19.6
Non-bank FIs	2,283	·	3,465	+51.8	5,035	+45.3	6,575	+30.6
All FIs	5,979	·	7,135	+19.3	9,809	+37.5	12,266	+25.0

[1] Change in percent Adopted from: Bangko Sentral Pilipinas, The Philippine Financial System Fact Book 1995

Unfortunately, the central bank of the Philippines, unlike that of Indonesia, is slow in processing data on the financial system. There is thus only impressionistic evidence on the impact of the crisis. There is a slowdown of economic growth from 5.7% in 1996 and 5.1% in 1997 to 1.7% during the first quarter of 1998. The Philippines are thus much less affected than Indonesia where GDP growth rates dropped from 8.0% in 1996 to 4.7% in 1997 and –7.9% during the first quarter of 1998.The inflation rate is going up in the Philippines, from a low of 5.1% in 1997 to 7.3% during the first quarter of 1998 with estimates of 40% for 1998; but not as drastically as in Indonesia where the rate for the first quarter of 1998 is 25.13% and

theestimate for 1998 around 80%.[6] A general economic slowdown is expected; but it is not clear whether MFIs might be seriously affected. At least this did not appear to be a serious concern of credit NGOs during the *Coalition for Microfinance Standards National Summit* on August 20-21, 1998, nor of rural bankers during their annual meeting on 28 August, 1998, which the author both attended. Calls by some rural banker for government liqidity support during the crisis were less related to the crisis as such than to the central bank's response to the crisis, namely an increase in minimum capital requirements, which are difficult to comply with by weak rural banks and particularly by those in marginal areas. At the same time these calls for government support by some were countered by others with a reminder of the ill effects of such dependency during the 1980s.

7.2 Microfinance NGOs

The microfinance NGOs[7], at their summit on standards, noted that of 600 credit NGOs established in the late 1980s only about 300 were left; and of these only about 30 were of any significance. A single one so far has availed of the opportunity of registering as a rural bank. The coalition is an informal gathering of the 30 major credit NGOs which has formulated standards of viability and financial self-reliance (self-sustainability) for credit NGOs[8] and carried out a survey on microfinance standards in credit NGOs in the Philippines.[9] There was agreement among the members on the usefulness of standards; but they were not willing to formalize the coalition into a self-regulatory supervisory body.

7.3 Grameen replicators

A special issue in the Philippines is Grameen replication, which in this country has found strong support. While the overall picture is rather dismal, the two case studies carried out by the author in August 1998, one of them recently converted into a rural bank, show that,

- the Grameen discipline can be a powerful force in generating near-perfect repayment;
- that the development of the two replicators studied in detail, one an NGO and one an NGO-turned-bank, appears entirely contingent upon internal factors and unimpeded by the Asian financial crisis;
- that viability can be reached;
- but that financial self-sufficiency will remain out of reach as long as donors provide loanable funds as a convenient source of easy and cheap money.

The study is attached in **Annex 3**.

[6] Source of data on Indonesia and the Philippines: Bank Indonesia, Indonesian Financial Statistics, August 1998, p. 166-7

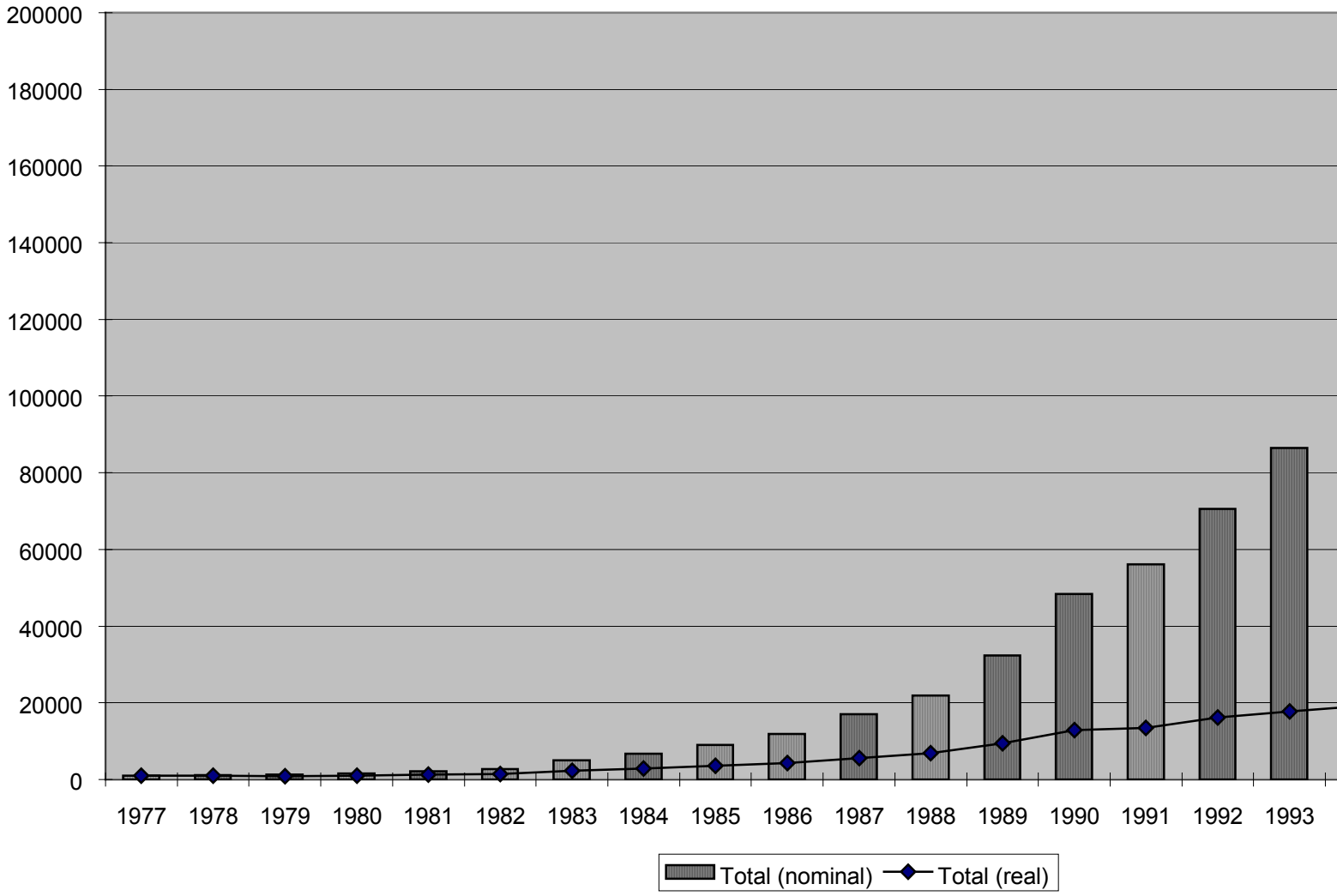
[7] This is a new term which is now replacing the old term *credit NGOs*.

[8] Coalition for Microfinance Standards & USAID, The NGO Microfinance Standards toward Outreach and Sustainability. Manila, 8/1998. The standards are largely identical with: The SEEP Network/CALMEADOW, Financial Ratio Analysis of MFIs. PACT Publications, NYC 1995

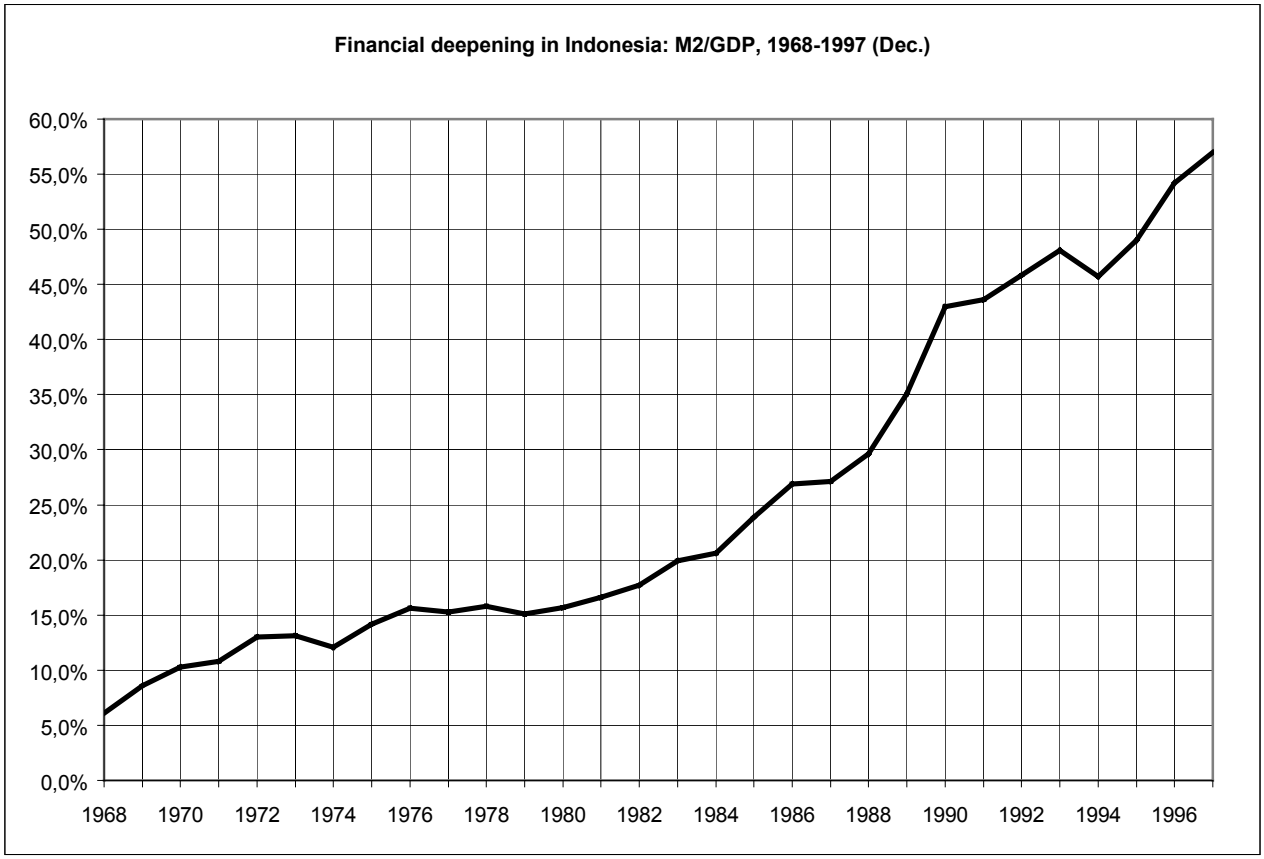
[9] Coalition for Microfinance Standards & USAID, Profile of Philippine Microfinance NGOs: A Nationwide Survey. 8/1998

Annex 1

Time and savings deposits in nominal and real terms, 1977-1997



Annex 2


Financial deepening in Indonesia: M2/GDP, 1968-1997 (Dec.)
60,0%
55,0%
50,0%
45,0%
40,0%
35,0%
30,0%
25,0%
20,0%
15,0%
10,0%
5,0%
0,0%
1968
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996

Annex 3

Grameen replicators in the Philippines: a case study
by
H.D. Seibel
9/1998

Grameen replicators in the Philippines: struggling for donor funds...

Our analysis is based on studies in the Philippines of 27 replicators by ACPC[10] in 1993; six replicators by APDC/UNDP[11] in 1996; three replicators by GTZ[12] in 1997; and two supplementary case studies by Seibel in August 1998. ACPC, a government institution, examined its own experience as program executing agency with the 27 Grameen replicators in the Philippines, reduced by attrition to 23, as per 6/1993. While highlighting some positive aspects, such as a "significant impact on the standard of living of its beneficiaries", "high repayment rates from 94% to 98% (averaging 96.8% in 1993)"[13], and "the poor are capable of saving on a regular basis" (p. 85), the facts yielded a rather dismal picture: In a country with a diversified MFI infrastructure of, at present, over 800 rural banks, 3000 credit cooperatives and 600 credit NGOs, 23 Grameen replicators (including banks, cooperatives and NGOs) had a negligible outreach, in 1993, of 4766 individuals (89% of them active borrowers, 184 on average), even after an expansion to 16,432 participants in 12/1995 (95% of them active borrowers). The program was found to be donor-driven; internal resource mobilization was minimal; interest rates were inadequate; and costs, shared about equally between government and replicators, were exorbitant, amounting to P0.47 per Peso lent and P1.70 per Peso saved, plus the costs of institution-building (p. 77). The operational self-sufficiency ratio was 0.24 or lower.[14] Noting that "excessive brokering of low-cost funds may discourage savings mobilization", the authors (pp. 85-88) recommended:

- to offer attractive deposit interest rates and vigorously mobilize savings;
- to charge loan interest rates that cover at least the transaction costs;
- to cancel the program guarantee fund;
- to provide start-up assistance only; and
- to focus government support on "institution-building, training and management rather than on supplying cheap credit." (p.85-88)

They concluded that "... any attempt... to replicate or expand it (the program) should be carried out with great caution".

---

[10] Agricultural Credit Policy Council, An Evaluation of the Grameen Bank Replication Project in the Philippines. ACPC, Manila 10/1995. ACPC monitors the Grameen replicators periodically, but does not any formal sense supervise them. As NGOs, the Grameen replicators are unsupervised.

[11] I. Getubig, J. Remenyi & B. Quiñones, eds., Creating the Vision: Microfinancing the Poor in Asia-Pacific. Asian and Pacific Development Centre, Kuala Lumpur, 1997
H. D. Seibel, G. M. Llanto, E. Garcia & R. Callanta, Microfinance in the Philippines, Economics and Sociology Occasional Paper No. 2367, Dept. of Agricultural Economics, Ohio State University, Columbus

[12] Dorothee Rojahn & Karl Osner, Report on the Self Evaluation Workshop of the Replications of the Grameen Bank Methodology in Asia. GTZ, Eschborn 5/1998

[13] As of 12/1995, the repayment dropped to 93%. The lowest rate was found among cooperative societies (86%), the highest among cooperative banks (98%), with NGOs in-between (98%).

[14] Calculated on the basis of Annex 15 of income and expenses in the ACPC report, plus a loan loss provision of 3%. The actual ratio might be lower as it is not clear whether financial costs are included in the expenses. The ratio is 0.29 for cooperative banks, 0.24 for cooperatives and 0.20 for NGOs. No data are provided to calculate the financial self-sufficiency ratio.

... or struggling for viability?

In 1996, APDC, with UNDP support, carried out an assessment of microfinance institutions (MFIs) in eleven Asian and Pacific countries, including seven MFIs in the Philippines: one cooperative bank and six NGOs. Six of the MFIs in the Philippines use the Grameen technology, but not all of them exclusively. As of end-1995, outreach ranged from 1,260 to 7,000 clients in the seven MFIs, averaging 3,000: a substantial (almost 15-fold) increase over the average for mid-1993. 90% of them were women; 94% were classified as poor. Average loans outstanding ranged from $30 to $467 among the poor and from $1,500 to $2,600 among the non-poor. Savings mobilization continued to be weak, with a savings-to-loans outstanding ratio ranging from 0.05 to 0.41 and averaging 0.14.

Table1: Viability indicators of seven MFIs in the Philippines,1995

	Cost per average Peso of loan outstanding	*Degree of operational self-sufficiency in %*	*Degree of financial self-sufficiency in %*
A	1.30	21	19
B	1.00	8	7
C	0.71	51	42
D	0.48	67	48
E	0.19	134	118
F	0.29	113	93
G	0.34	66	.

Another remarkable development had occurred since 1993: a widening of the range between good and poor performance. Transaction costs per average Peso of loan outstanding varied from 0.19 to 1.30; the operational self-sufficiency ratio varied from 0.08 to 1.34; and the financial self-sufficiency ratio (including adjustments for subsidies received and inflation) varied from 0.07 to 1.18. The cooperative bank (E in Table 1) performed best of all seven institutions. Two of the institutions learned a lesson and applied for a rural bank license: CARD (C in Table 1), which since has been transformed into a bank; and TSPI (F in Table 1), which failed to meet recently increased equity capital requirements. Two of the institutions (A and C in Table 2) are the subject of case studies reported below.

The case of Ahon Sa Hirap Inc. (ASHI): repayment through Grameen discipline

ASHI, the first Grameen replicator in the Philippines, started in 1989 as a social science research project of the University of the Philippines in Los Baños, with a grant of $50,000 from Cashpor, the regional network of Grameen replicators. In 9/1991, ASHI was registered as a non-profit, non-stock corporation, serving 100 beneficiaries in Laguna Province. At the same time, it provided Grameen consultancy services to various parishes. In 1992, the founder left the Philippines. By 1993, ASHI ran out of resources, depleted by administrative expenses and a drop of the repayment rate of its 1329 borrowers to 58%. For every Peso lent, ASHI spent P1.23; its operating and financial self-sufficiency ratios stood at 0.16 and 0.14, respectively. A crisis of policy and management ensued.

ASHI first decided to fully concentrate on Grameen banking and gave up its consultancy services. For reasons of economies of scale, it increased its branch network to five by taking over the Grameen activities of parishes it has previously assisted. As ASHI was not the only

Grameen replicator in jeopardy, Cashpor organized a conference in the Philippines in 1994; GTZ of Germany and ACT of Belgium got involved; a *Moment of Truth* was defined; and a rehabilitation project was decided for three replicators. For six months, ASHI was practically run by a Cashpor consultant, who revamped the organization branch-by-branch and center-by-center, while the number of borrowers was allowed to drop to 1.226. He retrained all staff and rigidly *restored the essentials of Grameen Banking* which constitute the self-regulatory Grameen social capital, including regular attendance of weekly meetings, punctuality, pledge, seating arrangements and - absolute insistence on on-time repayment! In 1995, the headoffice moved to a more central location, Quezon City, from where it runs an excellent up-to-day MIS. The number of branches grew to seven, with a growth in all-female membership to 3,521 (3,210 or 91% of them borrowers) in 1996; 4,698 (4,447 or 93% borrowers) in 1997 and 5,955 (5,717 or 96% borrowers) in 7/1998.

As a result of the restored Grameen discipline, the repayment rate soared from 64.4% in 1994 to 99.0% in 1995, hovering around 97-98% thereafter (1996: 96.6%; 1997: 97.9%; 7/1998: 97.9%). Transaction costs were drastically lowered: from P1.23 per Peso lent in 1993 to P0.25 in 1997. Accordingly, the operational self-sufficiency ratio steadily increased from 0.16 in 1993 to 0.58 in 1997, paralleled by an increase in the financial self-sufficiency ratio from 0.14 to 0.54 – still far from satisfactory, but on a promising course. With 60% of its loanable funds from grants and soft loans, financial self-sufficiency is not in sight.

Table 2 ASHI performance data, 1993-7/1998

Year	No. of borrowers	Borrowers per field staff	Repayment rate	Cost per Peso lent	Operating self-sufficiency ratio	Financial self-sufficiency ratio
1993	1329	87	58.0	1.23	0.16	0.14
1994	1226	120	64.9	0.91	0.19	0.15
1995	2437	140	99.0	0.77	0.29	0.22
1996	3210	153	96.6	0.52	0.42	0.41
1997	4447	156	97.9	0.25	0.57	0.54
7/98	5717	·	97.9	·	·	·

Source: ASHI Annual Report 1997; Monthly Statement, 7/1998

ASHI, though barred by law from mobilizing savings, is now trying to strengthen its deposit base. In addition to the usual compulsory savings and loan deductions, it has introduced a two-year children's savings scheme, with weekly deposits of P50 or P100 at 4% interest p.a.[15] Loans of 6-12 months start with P2,000 ($46 by the 8/1998 exchange rate) and increase up to P10,000 in the fifth cycle. To increase its profitability, ASHI has added loans ranging from P15,000 to P50,000 ($345-$1150); and it is increasing its interest rate from 20% flat (approx. 37% effective) to 25% flat (approx. 46% effective) p.a.[16] Another new product is a one-month loan of P3-5000 with weekly instalments, at a flat interest rate of 6%. With viability and sustainability its future goal, ASHI considers to convert the compulsory 5% capital build-up deduction from all loans into shares and, within five years, transform the NGO into a cooperative bank owned by ASHI members and staff.[17]

[15] At an inflation rate of 7.4%, this is equivalent to negative real returns of 3.4%

[16] For the larger loans, ASHI carries out creditworthiness examinations. At the time of the field visit, Mrs. D., after having received and repaid a number of loans from ASHI totaling P87,000, had submitted a new application for a livestock loan of P50,000, for which ASHI calculated a profit rate or 158%.

[17] Special microfinance training courses, including the preparation of custom-made training materials and operational manuals, may be arranged by ASHI through INSOL (ahon@i-manila.com.ph).

The case of CARD: a viable Grameen Rural Bank in the Philippines

Inspired by the onset of a new era after the downfall of the Marcos regime, the Center for Agriculture and Rural Development (CARD) was one of numerous new NGOs established in 1986 and thereafter. With two grants of P150,000 each, CARD, as of 1/1988, organized the poor in mixed groups of 15-45 members, registered them as associations (including some spouses to reach the required minimum number of 21 members) and channeled short-term loans (3-6 months) of P1,000 to each member. With negotiable repayment schedules, this turned out to be a false start. After eight months, only the two groups which had opted for monthly instalments had repaid their loan. The remaining five, with lump sum repayment upon maturity, defaulted. The overall repayment rate during that year was 68%. Under donor pressure, CARD was either to close or revamp its operations.

In late 1988, the president of CARD visited the Grameen Bank in Bangladesh. Deeply impressed by the ability of the poor to engage in income-generating activities and repay their loans on time, he decided, upon his return, to adopt the Grameen approach, organizing poor women in groups of 5 and centers of 30. This, however, met with considerable opposition. The complex Grameen discipline, including weekly meetings and weekly instalments, were greatly disliked, particularly by the men. Four of the associations left the project; 89 poor women agreed to participate in a pilot test, from January to December 1989. Credit discipline, which is one of the most outstanding achievements of the Grameen approach, produced repayment rates of 98.0%-100.0% between 1994 and 6/1998 (end-of-year figures; annual averages 96.9-99.7%). This impressed BSP, the central bank, so much that it consented to fully non-collateralized lending when CARD later established itself as a rural bank

But active membership grew only slowly: to 307 in 1990, 468 in 1991, 949 in 1992 and 1,711 in 1993. 1990-96 were years of experimentation to modify the Grameen technology. CARD developed its own training system and operations manual; substituted 6-months first-loans for one-year loans; required a minimum self-financing ratio of 25% from repeat borrowers; introduced a mutual life and accident insurance fund; replaced group funds by center funds; offered multipurpose loans for prime borrowers; added voluntary withdrawable savings (ignoring the law which bars NGOs from deposit taking); and, finally, provided a staff incentive scheme. Active membership soared from 1,711 in 1993 to 6,844 in 1996. By 1996, nonwithdrawable compulsory savings stood at P12m, voluntary savings at P1m. Operational self-sufficiency, which had declined from 0.31 in 1993 to 0.25 in 1994, went up to 0.46 in 1996 and 0.77 in 1996.

In May 1996, CARD submitted its application to establish a rural bank, which was approved in December. This means that CARD Bank now falls under the regulation and supervision of the central Bank, which, according to our hypothesis mobilizes an entirely new quality of CARD's social capital.

After having deposited P5m as paid-up capital with Landbank, CARD Rural Bank (RB) formally opened on 1 September 1997. There are now two institutions: CARD RB for financial intermediation, with 5 branches, and CARD NGO for group formation and guidance including financial intermediation in areas not covered by a CARD RB branch, with 16 branches. Due to legal restrictions, CARD NGO owns only 25% of CARD RB; the rest is owned by five board members and staff, who have entered into a trust agreement with the NGO.

Transformation into a bank appears to have greatly facilitated the growth of group membership, which soared to 10,868 in 1997 and 16,589 as of July 1998. During July 1998 alone, the Bank acquired 1,451 new clients. CARD RB has ambitious goals: 20,000 active members by end-1998, 50,000 by 2000 and 150,000 by 2002.

The Bank offers passbook savings at 5% and fixed deposits, ranging from a minimum of P10,000 for one month at 7% interest to P500,000 for 12 months at 15%: all above the usual commercial bank rates. As of July 1998, the savings deposit balance was P14m. There are five loan products, all with weekly instalments: regular loans increasing from a first loan of P2,000 to a fourth loan of P10,000; asset acquisition loans up to P50,000; housing loans up to P20,000; short-term multipurpose loans up P5,000; and prime-borrower loans up to P100,000. Maturities range from 12-75 weeks; but most are 50 weeks. Interest rates are 20% flat, plus an upfront service fee of 4%; effective annual interest rates are 45.6%-53.8%.

Table 3: CARD performance data, 1988-7/1998

Year	No. of borrowers	Repayment rate	Portfolio at risk	Cost per Peso lent	Operational self-sufficiency ratio	Financial self-sufficiency ratio
1988	150	68.0				
1989	89					
1990	307					
1991	468				0.31	
1992	949				0.25	
1993	1,711				0.46	
1994	3,547	98.0			0.77	
1995	4,240	98.8	0.17	.69	0.46	0.38
1996	6,844	99.2	0.12	.46	0.77	0.52
1997	10,868	100.0	0.00	.33	1.22	0.70
7/98	16,589	99.9	0.09		1.31	

Source: Dolores M. Torres, Managing Delinquency and Quality Portfolio, 8/1998; Monthly Statement, 7/1998

In 7/1998, the loan portfolio of CARD Rural Bank amounted to P32m, that of CARD NGO to P38m. Each of the two entities recently obtained a loan of P15m from the People's Credit and Finance Corporation, PCFC , which is funded by ADB and IFAD, at 12% interest p.a. and a 1% annual service fee on the outstanding balance.

Transformation into a rural bank, which included a preparatory phase in 1996-97, seems to have brought CARD closer to its desired sustainability goals: the cost efficiency ratio (cost per Peso lent) improved from 0.69 in 1995 to 0.33 in 1997; the operational self-sufficiency ratio climbed from 0.46 in 1995 to 0.77 in 1996, 1.22 in 1997 and 1.31 in 7/1998 (with 234 borrowers per field staff); financial self-sufficiency (adjusted for subsidies and inflation) grew from 38% in 1995 to 52% in 1996 and 70% in 1997. CARD branch viability (*operational self-sufficiency ratio of at least 1.0*) increased rapidly: from none out of eight branches in 1995 to four out of ten in 1996 and eight out of 13 in 1997.

Card Rural Bank has proven that outreach to the poor and operational viability are not only compatible: they are mutually reinforcing.[18] As to financial self-reliance and full financial self-sufficiency, the Bank has made great progress in recent years. However, continued access

[18] This is also confirmed by Rojahn & Osner (p. 12) who observed that Grameen replicators which are low in operational viability are also low in outreach, while replicators high in viability are also high in outreach.

to easy donor money may hamper the bank's effort to vigorously mobilize deposits and, in the case of devaluations, inordinately augment the country's external endebtedness in Peso terms.[19]

Conclusions

Is the Grameen approach a type of social capital that can be exported world-wide, with a success similar to that of the Grameen Bank in Bangladesh? Does the Grameen approach provide an optimal solution to the problem of how to provide financial services to the poor? We have looked at two criteria, outreach and institutional viability (ignoring a third, namely impact). In the Philippines, the outreach of Grameen replicators has been negligible compared to the totality of financial services provided by other microfinance institutions. All replications are donor-driven. Donor-dependency has undermined their viability. Only few of the institutions are *operationally self-sufficient,* covering their costs from their income. In some cases, even effective annual interest rates around 50% (or real rates, adjusted for inflation, around 40%) were not sufficient to cover the costs of the Grameen technology. But all of the institutions examined, which are of course only those who have survived, have progressed in this respect and might, eventually, be operationally fully viable.

Sustainability, however, is not in sight in any of the replicating institutions (except where Grameen replication is a side activity). None even remotely approaches an adequate level of internal resource mobilization; nor does anyone earn enough revenues to cover all operating, financial and loan loss expenses and the value of adjustments for subsidies and inflation. The biggest obstacle in the development of the Grameen replicators has been donor support: a powerful incentive to substitute external resources for local savings.[20] Only domestic savings have a chance to grow dynamically; government and donor dole-outs do not. It seems speculative at this point to predict if financial self-sufficiency might ever be reached by any of the institutions. However, those who adhere to the pure and unadjusted Grameen technology and insist on banking with the poor only are unlikely to withstand the growing competition of other MFIs in the long run.

Our question is: do the Grameen replicators reach the poor, and are they sustainable? According to the limited evidence presented in this paper, the answer is: They are not sustainable; and therefore, they do not reach the poor in sufficient numbers. It appears that the Grameen approach is no magic formula, and no *best practice* or unique and optimal solution that may be applied around the world to alleviate poverty. I am not aware that any such optimal solution or best practice ever existed, or may ever be found. However, there may be *sound practices*, which work for a certain time under certain conditions and may compete with other *sound practices.*

There are a number of sound practices which may explain some of the success of some of the replicators. It appears that successful replicators share a least the following three sound practices, constituting perhaps **the hard core social capital of the original Grameen approach:**

---

[19] CARD (card@msc.net.ph) is prepared to share its experience. Since 1996, it has trained 2,500 people in courses of one to two weeks length. Training is conducted in English, at P500 ($11.50) per day.

[20] This conclusion is shared by the authors of a GTZ (Bieding et al. 1998:79) study of the financial sector in the Philippines, who „do not recommend promoting Grameen Bank replicators at the institutional level because the model is not currently implemented in a sustainable manner in the Philippines. This is seen in the context of "the need to revise the system of incentives created by national and international donors. These have accorded precedence to disbursing short-term credit to target groups over the institutional and financial sustainability of the programs and institutions."

- high moral commitment of leaders based on values enforced through training
- peer selection and peer enforcement, precluding adverse selection and moral hazard
- credit discipline, including weekly instalments; rigid insistence on timely repayment; and repeat loans of growing sizes contingent upon repayment performance.

It further appears that the most promising replicators are the innovators who have experimented with modifications to the classical replication model, constituting **additional core social capital dimensions outside of Bangladesh,** among them in particular:

- local bank status (rather than NGO or national bank status)
- deposit mobilization through differentiated products with attractive interest rates
- differentiated loan and insurance products which cover all costs and risks
- client differentiation through larger-size loan and deposit products for non-poor members.

Grameen-type MFIs in the Philippines are only successful to the extent they have implemented these criteria – and unsuccessful to the extent they have failed to do so. We may tentatively consider the seven points listed above as **the essence of the social capital of Grameen-type institutions** in the Philippines and perhaps worldwide. Depending on the policy environment, the legal framework, the microfinance infrastructure, and particular circumstances (such as natural disasters, which may preclude timely repayment), most of these practices may be recommended for emulation, both by Grameen and non-Grameen MFIs, though not for mechanical replication. There is no reason why a Grameen-type MFI, which registers as a bank, mobilizes its own resources through differentiated savings products, offers differentiated loan and insurance products which cover all costs and risks, and provides larger-size loan and deposit products to its non-poor members, should not become viable and financially self-sufficient and offer sustainable financial services to an ever-growing number of poor, and eventually non-poor, clients. However, whether it will do all this, depends on the will of its board and management. There is no regulatory authority supervising and enforcing these requirements of sound Grameen banking, which is perhaps its greatest weakness.