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Sustainability and Governance of Microfinance Institutions: Recent Experiences and Some Lessons for Southeast Asia

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ABSTRACT

Microfinance has become an important tool for poverty reduction in many parts of the world, including Asia and the Pacific region. Microfinance institutions (MFIs) target the poor through innovative approaches which include group lending, progressive lending, regular repayment schedules, and collateral substitutes. This paper reviews the experiences of microfinance institutions in different parts of the world in the areas of sustainability and governance, and draws lessons for Southeast Asian countries.

In microfinance, sustainability can relate to organisational, managerial and financial aspects but the issue of financial sustainability of MFIs has attracted more attention in mainstream analysis. In the region, the South East Asian MFIs fare well in terms of financial sustainability as they earn positive returns on assets and equity, covering much higher cost levels by earning more from their loan portfolios. In contrast, South Asian MFIs have negative returns on assets and equity, despite having one of the lowest expense structures in the world.

MFIs face an apparent tension between achieving financial sustainability and contributing to poverty reduction. Exclusion of the poorest from microfinance schemes is a well-known challenge. While some of the poorest fail to participate in such schemes either because of their lack of awareness or inability to overcome their social exclusion, many more are excluded because of arbitrariness in the selection of beneficiaries and inadequate flexibility in the design of the scheme.

If MFIs have to serve the poor in remote rural areas, it may be difficult for them to achieve financial self-sufficiency. In such a case, some level of subsidy may be justified if they can be shown to be more effective than alternative strategies to reduce poverty. Nonetheless, these MFIs should strive to achieve financial sustainability by reducing operational costs and charging market rates of interest. The higher the degree of self-sufficiency, the greater the extent to which an MFI can leverage donor and government funds to expand outreach.

INTRODUCTION

There is a general consensus that access to financial services is important for the poor to raise productivity, create assets, generate income, and achieve food security. Up to the 1970s, formal institutions in the public sector had been the main providers of financial services to the poor—mainly small and marginal farmers—usually at subsidized interest rates (Matin et al. 2002). High risks associated with lending to this group of the rural

poor, together with other institutional weaknesses, resulted in formal institutions (including private ones) failing to deliver financial services effectively (World Bank 2001).

The period between 1980 and 1996 witnessed the emergence of semi-formal financial institutions which focused their attention on poor women micro-entrepreneurs with no collateral. To reach the poor, new lending approaches, collectively known as microfinance, were developed by non-government organizations (NGOs) and banks with special

charter (e.g., the Grameen Bank in Bangladesh and the village banks of the Bank Rakyat Indonesia). These institutions, now commonly known as microfinance institutions (MFIs), target the poor through a diversity of innovative approaches. These approaches, which help maintain high repayment rates, include group lending, increasing loans over time ("progressive" lending), regular repayment schedules, and collateral substitutes.

Microfinance involves small-scale credit, savings, and insurance to meet the needs of poor producers. Microfinance programs also provide skill-based training to enhance productivity and organizational support, and consciousness-building training to empower the poor. It has become an important tool for poverty reduction in many parts of the world, including Asia and the Pacific region. Recent studies show that access to microfinance contributes to poverty reduction, particularly for women participants, and to overall poverty reduction at the village level (e.g., Khandkar 2005). It also contributes to women's empowerment by inducing higher levels of mobility, political participation, and decision-making (Hashemi et al. 1996).

Government-owned banks are important suppliers of microfinance services in countries like India, Indonesia, Sri Lanka, and Vietnam. Many of these institutions are dependent on large amounts of subsidy for their operation. One major exception is Bank Rakyat Indonesia (BRI) whose unit desa system allows it not only to be financially self-sufficient but also to lend to the "better off" poor and nonpoor households (Morduch 1999). BRI does not use a group lending mechanism and requires individual borrowers to put up collateral, thus effectively excluding the poorest borrowers. However, credit operations remain small-scale and collateral is often defined loosely, thereby allowing staff some discretion to increase the loan size for reliable borrowers. With over 3,200 units, BRI serves a large number of households, including poor households; in May 2000, it had 16.6 million ordinary savings accounts with a total outstanding savings of \$1.25 billion (Fernando 2002).

In Bangladesh, Cambodia, Nepal, Philippines, and Sri Lanka, NGOs are important suppliers of microfinance services. In Bangladesh alone, more than 1000 NGOs are providing microfinance services to more than 10 million households (Haque 2006). However, the three largest NGOs—Bangladesh

Rural Advancement Committee (BRAC), ASA, and Proshika—account for 73% of the total outstanding loans of NGOs. Similarly, in other countries, less than 20% of NGOs account for over 80% of the market share of the NGO sector. The Grameen Bank of Bangladesh, drawing on lessons from informal financial institutions, was set up in the mid-1980s to lend exclusively to groups of poor households. Group formation is voluntary, and while loans are made to individuals, all members in the group are held responsible for loan repayment. The Grameen Bank has 7.5 million borrowers, 97% of whom are women, and repayment rates average 98% (Grameen Bank 2008). This group lending model has been replicated worldwide, including China, India, Malaysia, Philippines, Sri Lanka, Thailand, and Vietnam.

The self-help group model (SHG) was developed by NGOs (e.g., MYRADA) in India and is promoted by both MFIs and banks. This model is also used in parts of South East Asia including Indonesia, as well as in Africa. SHGs have around 20 members each and are based primarily on the principle of lending their members' savings. They also seek external funding to supplement their resources. The groups themselves fix the terms and conditions of credit to members. This model is uniquely suited to combining microfinance with other programs like health and education.

Cooperatives constitute the major providers of microfinance service in countries like India, Philippines, Sri Lanka, Thailand, and Vietnam. In Sri Lanka alone, there were 1,418 cooperative rural banks at the end of 1999, with 5.3 million deposit accounts and 1.23 million loan accounts (Fernando 2002). In addition, there were 8,400 thrift and credit cooperative societies with a membership of 786,000 that included a significant number of poor households.

In recent years, private sector financial institutions have assumed a significant role in the area of microfinance. For example, in Indonesia, a number of private sector, for-profit financial institutions (Bank Perkreditan Rakyat or People's Credit Banks) provide microfinance services. Likewise, private sector banks in India like the ICICI Bank, UTI Bank, and HDFC Bank have ventured into microfinance and introduced innovative approaches. The ICICI Bank has piloted a scheme wherein NGOs or MFIs, as well as traders

or local brokers, serve as intermediaries or service providers for loans to groups of small and marginal farmers. Loan appraisal, processing, management, and collection tasks are given to NGOs or MFIs; nevertheless, the bank gives loans directly to borrowers without the involvement of NGOs or MFIs. An initial loan is provided to an NGO or MFI to develop SHGs but the NGO or MFI is required to repay the loan in a few years time and become a viable unit by charging service fees to the groups.

MICROFINANCE COVERAGE IN THE REGION

By the end of 2005, the total number of MFIs operating in Asia and the Pacific numbered 1,652, which reportedly serviced 96.7 million clients, of which 74.3 million or roughly 77% were the poorest families¹ (Microcredit Summit 2006). The number of poorest women clients totalled 63.9 million, representing 86% of the total poorest. During the last seven years, the Microcredit Summit has attempted to verify the data reported by its largest members. According to the State of the Microcredit Summit Campaign Report 2006, the data from 420 practitioner-institutions were corroborated by at least one other organization (Annex 1). These 420 institutions reported reaching 64.1 million poorest at the end of 2005, or 78% of the total number of poorest clients reported worldwide.

Of these 420 MFIs, 43 are from Southeast Asia. These 43 MFIs reported reaching a total of 17.8 million clients at the end of 2005, of which 10.6 million were the poorest clients². The total number of clients in Thailand, Indonesia, and Vietnam exceeded 5 million each. The percentage of poorest clients was 100% in Thailand, 42% in Indonesia, and 34% in Vietnam. The largest number of MFIs among Southeast Asian countries was in the Philippines.

DIVERSITY OF MICROFINANCE IN SOUTH EAST ASIA

In Southeast Asia, there is considerable diversity in the systems of microfinancing and the institutional forms developed for them. In Malaysia, which has a relatively higher level of per capita income and low incidence of poverty, microfinance service for people without access to conventional financial institutions is seen within the framework of a redistributive social policy involving substantial subsidies (Conroy 2003). Amanah Ikhtiar Malaysia, an NGO with strong political backing, is the major microfinance provider in the country. It was set up in 1987 to disburse small loans on reasonable terms exclusively to the very poor households to finance additional income-generating activities (Gibbons and Kasim 1990). However, it has, for practical reasons, focused on the Bumiputera, the indigenous peoples of Malaysia. In 2005 it had a total of 120,600 clients, of which 30% were the poorest.

In Thailand, there is a pattern of market segmentation in the delivery of financial services in rural areas. According to Meyer and Nagarajan (2000), “commercial banks serve large farms and agroindustries; the Bank of Agriculture and Agricultural Cooperatives (BAAC) largely serves small and medium farmers, cooperatives, and associations; the poor and landless are served mainly by informal finance and a few government programmes and NGOs. Agricultural cooperatives and village level credit unions may also reach poorer segments of the rural populations.” NGO involvement in the provision of microfinance services is extremely limited in Thailand.

BAAC is a government-owned bank established in 1966 to support agricultural cooperatives’ on-lending service to their members. It has adopted a gradual reform process in its lending by moving

¹ MIX database reports total active borrowers of only 21 million in Asia and the Pacific. Two factors explain the difference in the number of borrowers between the two sources. First, MIX database includes only those MFIs which have more than 5,000 borrowers. Second and more importantly, the Microcredit Summit data also include borrowers of three large networks: the National Bank for Agriculture and Rural Development (NABARD) in India with roughly 28 million total clients; the Association of Asian Confederation of Credit Unions (ACCU), which has 5 million clients; and the Bangladesh Rural Development Board (BRDB) which has 4 million total clients.

² MIX database reports only 4.7 million active borrowers in East and South East Asia.

from short-term agricultural loans, through medium to long-term farm lending, to non-farm micro and small enterprise lending (Donaghue 2004). With the addition of deposit services in the mid-1980s, it has achieved a major transformation, with deposit-to-loan ratio of nearly 100% being reached within a decade, suggesting that rural lending in Thailand can be self-financing. BAAC is the dominant provider of rural financial services, with 2.7 million active loan clients in 2002 and 9.6 million savings accounts. More than 90% of farm households in Thailand are registered as BAAC clients (Haberberger et al. 2003). Since its inception, BAAC has remained financially viable but the level of profitability has declined over time, along with the dwindling access to cheap government funds. Although its increased capacity to fund operations through savings mobilization has reduced its dependence on government funds, it is still subject to political direction, as demonstrated by its involvement in a recent debt relief program (Steinwand et al. 2003).

In Indonesia regulated financial institutions, both public and private, have been able to provide sustainable financial services in rural areas, reaching many of the poor. NGOs commonly use solidarity group-based lending approaches. However, most microfinance services are provided on an individual basis due to the dominance of the sector by regulated financial institutions. One of the largest commercial banks, Bank Rakyat Indonesia, (BRI) operates a retail-level unit in rural areas, which has successfully adopted elements of microfinance. In 2005 BRI served a total of 3.3 million microfinance clients of which 17% were the poorest (Annex 1).

In the Philippines, NGOs have played a major role in the delivery of microfinance services in rural areas. The Grameen Bank Approach (GBA) of service delivery has had a strong influence among the NGOs. Most microfinance NGOs in the Philippines are financed through grants and have difficulty accessing loan capital from commercial sources. They also have limited capacity to fund their operations through savings mobilization. As a result, most microfinance NGOs are neither viable nor sustainable (Llanto 2001). On the other hand, the government has created a favorable regulatory environment for the operation of small

regulated banks suitable for microfinance. Because microfinance has been included among its poverty reduction strategies, the government has encouraged NGOs to develop sustainable microfinance programs. It is also promoting the transformation of successful microfinance NGOs into regulated financial institutions (Conroy 2003).

In Cambodia, the international NGOs were largely instrumental in introducing microfinance from the early 1990s. A number of MFIs set up by donor agencies have now become independent Cambodian organizations. The government has developed a policy, regulatory, and supervisory framework for microfinance and has accorded a formal status and role to MFIs. It has also established the Rural Development Bank, a second-tier institution to act as a wholesaler for MFIs.

In Vietnam, the Vietnam Bank for Agriculture and Rural Development (VBARD) was established in 1988 for lending to the agriculture and rural sector. In 1995, the Vietnam Bank for the Poor (VBP), another policy bank, was set up to perform specialized lending to the poor. In addition, there are about a thousand People's Credit Funds (PCFs). There is also a semi-formal sector, which includes the microfinance operations of mass organizations of the state. These organizations can disburse government-funded loans under a range of programs. NGOs also provide limited microfinance services, mainly with donor support.

Laos has the least developed microfinance sector in Southeast Asia. In 1993 the Agricultural Promotion Bank was established to be the primary agricultural lender. It was estimated that only 15% of households in Laos had access to formal financial services by 1996 (Kunkel and Seibel 1997). Outside the formal financial sector, the Lao Women's Union (LWU) has 650,000 members, which represent half of the total adult female population in the country. With a total staff of 20,000 women and volunteers in all villages, LWU has tremendous potential for outreach in microfinance. The main objectives of LWU are income generation and improved access to credit and it has established 1,650 Lao Credit Associations, which focus on women and the poor.

The main objective of this paper is to review the experiences of microfinance institutions in different parts of the world in the areas of sustainability and

governance and draw lessons for Southeast Asian countries.

SUSTAINABILITY

In microfinance, sustainability can be considered at several levels—institutional, group, and individual—and can relate to organizational, managerial, and financial aspects (Sa-Dhan 2003). However, the issue of financial sustainability of microfinance institutions has attracted more attention in mainstream analysis at the expense of the sustainability of the client/borrower.

Financial Performance and Sustainability

Two degrees of self-sufficiency for MFIs have been defined by the “Guiding Principles for Selecting and Supporting Intermediaries” agreed upon by donor agencies (McGuire et al. 1998). They have also established indicative timetables for the period over which MFIs should be able to

achieve them. These definitions have been further clarified by the Consultative Group to Assist the Poor (CGAP). Operational self-sufficiency requires MFIs to meet all administrative costs and loan losses from operating income. It is computed by dividing operating income by operating expenses. It is suggested, based on international experience, that successful MFIs should be able to achieve operational self-sufficiency within three to seven years.

MFIs achieve financial self-sufficiency when they are able to cover all administrative costs, loan losses, and financing costs from operating income, after adjusting for inflation and subsidies and treating all funding as if it had a commercial cost. Successful MFIs are expected to achieve financial self-sufficiency within five to ten years.

Sustainability Performance

Table 1 shows the performance indicators of MFIs for various regions of the world in 2005.

Table 1. Performance indicators of MFIs in various regions of the world, 2005.

Indicators	Africa	EAP	ECA	LAC	MENA	SA
Profitability and Sustainability						
Return on Assets (%)	-5.7	0.9	5.3	2.9	3.6	-2.3
Return on Equity (%)	-37.6	5.9	14.6	8.1	5.0	-6.6
Operational Self Sufficiency (%)	97.7	117.5	128.9	115.8	117.2	105.5
Revenue						
Financial Revenue Ratio (%)	25.2	28.6	30.4	31.2	22.7	18.5
Profit Margin (%)	-37.3	1.9	6.2	8.4	-13.6	-19.6
Expenses						
Total Expense Ratio (%)	30.7	27.2	24.3	27.6	19.0	20.7
Financial Expense Ratio (%)	2.8	5.0	2.4	6.3	1.0	5.1
Loan Loss Provision Expense Ratio (%)	2.2	1.2	1.1	2.2	-0.1	1.2
Operating Expense Ratio (%)	25.7	21.0	20.7	19.1	18.2	14.4
Efficiency						
Operating Expense/Loan Portfolio (%)	60.6	32.1	28.4	26.5	35.1	22.0
Cost per Borrower (USD)	232	58	326	155	130	25
Productivity						
Borrowers per Staff Member	149	139	72	139	120	219
Savers per Staff Member	206	179	27	95	-	81
Portfolio Quality						
PAR> 30 Ratio (%)	7.9	5.6	2.1	4.8	2.9	7.6
Loan Loss Reserve Ratio (%)	6.9	3.7	2.0	5.0	3.4	4.2
Risk Coverage Ratio (%)	139.5	5660.8	413.4	255.5	155.8	315.5
Write Off Ratio (%)	3.5	2.5	1.2	1.8	2.2	0.5

Source: MIX, CGAP and World Bank. 2006. Performance and Transparency: A Survey of Microfinance in South Asia.

Note: EAP=East Asia and the Pacific; ECA=Eastern Europe and Central Asia; LAC=Latin America and the Caribbean; MENA=Middle East and North Africa; SA=South Asia

Table 2. Performance indicators of MFIs in South East and South Asia, 2005.

Indicators	Asia	South Asia B'desh	India	Pakistan	SE Asia Cambodia	Phil
Profitability and Sustainability						
Return on Assets (%)	-0.7	2.6	0.9	-9.0	2.6	-0.8
Return on Equity (%)	-1.4	10.6	35.8	-21.6	5.6	-3.5
Operational Self Sufficiency (%)	109.9	131.2	107.0	70.9	126.1	114.1
Financial Self Sufficiency (%)	100.6	113.5	104.7	53.7	115.2	97.6
Revenue						
Financial Revenue Ratio (%)	24.1	21.1	20.9	11.2	30.3	31.6
Profit Margin (%)	0.6	11.5	4.5	-86.8	13.2	-2.5
Expenses						
Total Expense Ratio (%)	25.6	18.6	22.9	26.4	26.3	31.0
Financial Expense Ratio (%)	6.1	6.3	7.0	6.9	5.2	5.6
Loan Loss Provision Expense Ratio (%)	1.8	0.8	1.9	1.7	0.3	3.9
Operating Expense Ratio (%)	15.1	10.6	10.1	12.2	18.6	20.1
Efficiency						
Operating Expense/Loan Portfolio (%)	22.8	13.5	13.9	37.2	22.2	29.0
Cost per Borrower (USD)	38	9	15	48	38	56
Productivity						
Borrowers per Staff Member	142	204	217	111	133	114
Savers per Staff Member	137	106		74	4	174
Portfolio Quality						
PAR > 30 Ratio (%)	2.8	1.2	0.7	2.9	0.6	6.9
Loan Loss Reserve Ratio (%)	2.1	1.1	1.9	2.1	0.2	3.5
Risk Coverage Ratio (%)	0.8	3.0	1.5	0.8	3.9	0.7
Write Off Ratio (%)	2.4	1.5	2.0	2.1	0.5	3.9

Source: MIX. 2006. Benchmarking Asian Microfinance 2005: A Report from the Microfinance Information Exchange, Inc. November 2006.

Overall, Southeast Asian MFIs fare well, with an average operational self-sufficiency of 117.5%. They earn positive returns on assets and equity, covering much higher cost levels by earning more from their loan portfolios. In contrast, South Asian MFIs have negative returns on assets and equity, despite having one of the lowest expense structures in the world.

In 2005, a sample of 101 Asian MFIs (from five countries, namely, Bangladesh, Cambodia, India, Philippines, and Pakistan) was studied to assess performance and to identify challenges and opportunities facing Asian microfinance. The performance indicators of these MFIs are shown in Table 2.

MFIs in Asia depend heavily on external funds to continue their expansion. In Southeast Asian countries, savings mobilization plays an important role in raising fund. For example, rural banks in the Philippines source all of their funds for on-lending from commercially-priced debt, mainly raised from customer deposits (MIX et al. 2006). In contrast,

MFIs in India secure significant quantities of debt in borrowing, as they are not allowed to mobilize savings. NGOs continue to depend on soft funds from public institutions (e.g., PKSF in Bangladesh) and lack access to commercial markets. As MFIs increasingly borrow from capital markets for their financing, it is important to build a strong capital base to ensure that they are able to meet their debt obligations without scaling back operations. Many Asian MFIs have slim returns and are unable to build up institutional capital and are leveraged well beyond international capital adequacy standards.

With the average asset base yielding a loss of 0.7%, Asian MFIs are close to breaking even (Table 2). Of the two regions represented by the five countries studied, both regions had mixed results in terms of performance. MFIs from Cambodia (Southeast Asia) and Bangladesh and India (South Asia) have positive return to assets whereas MFIs from the Philippines (Southeast Asia) and Pakistan (South Asia) report losses. Almost half of the MFIs in the sample are financially self-sufficient whereas

another quarter covers at least four fifths of costs on an adjusted basis. Although overall cost and revenue indicators for Asian MFIs are generally similar to other regions, their greater dependence on external debt, subsidized and commercial, leads to a higher blended cost of funds that eats into profitability (MIX et al. 2006).

Asian MFIs adopt two different strategies towards achieving profitability goals. MFIs in Southeast Asia set higher prices to overcome more costly operating environments whereas those in South Asia try to minimize costs to offset their low yields. Cambodia and the Philippines are examples of the high-yield strategy that is prevalent in Southeast Asia, while Bangladesh and India adopt the low-cost, low-yield strategy. In dense markets like Bangladesh and India, median costs per dollar outstanding are lower than 15%, indicating both higher productivity and lower labor costs. Due to this advantage, MFIs in Bangladesh and India charge a median 25% or less on their loan portfolio, whereas those in Cambodia and the

Philippines charge between 35 and 45% to cover their costs (MIX et al. 2006). In the Philippines, NGOs follow the high-cost, high-yield approach whereas the banks fall in the middle between the two approaches.

As in other regions of the world, well-managed and profitable MFIs in Asia have greater access to the debt market than the non-profitable MFIs and are able to extend their services to increasingly more borrowers. MFIs that achieved profitability in 2004 increased their median outreach by 28% to over 60,000—four times as many as those covered by their unsustainable counterparts (MIX et al. 2006). Except in Pakistan, the majority of borrowers in the MIX sample across Asia had access to sustainable financial services. MFIs in Asia that are above the threshold of two million dollars in assets achieve significant gains in efficiency (Table 2). Loan management cost per dollar declines from 38 to just over 22 cents, indicating the inability of very small service providers to realize profits. The economies of scale appear to be the highest for banks and

Table 3. Performance indicators of different types of MFIs in Southeast and South Asia, 2005.

Indicators	Bank	NBFI	NGO	Rural Bank
Profitability and Sustainability				
Return on Assets (%)	-1.0	-3.1	0.6	-0.9
Return on Equity (%)	-3.9	-6.4	7.0	-6.8
Operational Self Sufficiency (%)	102.7	106.7	109.1	116.6
Financial Self Sufficiency (%)	97.5	91.5	104.3	96.4
Revenue				
Financial Revenue Ratio (%)	14.9	23.6	27.2	21.4
Profit Margin (%)	-2.7	-9.8	4.1	-3.7
Expenses				
Total Expense Ratio (%)	18.3	24.3	28.9	21.8
Financial Expense Ratio (%)	5.8	7.0	6.1	5.1
Loan Loss Provision Expense Ratio (%)	0.7	1.3	1.9	4.5
Operating Expense Ratio (%)	8.1	15.4	20.1	11.9
Efficiency				
Operating Expense/Loan Portfolio (%)	13.1	22.9	29.0	17.8
Cost per Borrower (USD)	31	28	27	68
Productivity				
Borrowers per Staff Member	170	161	147	97
Savers per Staff Member	128	15	117	216
Portfolio Quality				
PAR> 30 Ratio (%)	2.6	0.9	2.4	7.5
Loan Loss Reserve Ratio (%)	1.6	1.5	1.2	3.2
Risk Coverage Ratio (%)	0.5	0.8	0.9	0.7
Write Off Ratio (%)	2.8	1.6	1.6	3.2

Source: MIX. 2006. Benchmarking Asian Microfinance 2005: A Report from the Microfinance Information Exchange, Inc. November 2006.

NGOs. NGO MFIs spend one-third more than non-bank MFIs on their operations and two-thirds more than rural banks (Table 3). Because of their exceptionally low loan balances, these NGOs incur 29 cents in operating expenses for every dollar lent. Therefore, NGOs need to increase their scale of operation to attain efficiency gains and improve financial performance.

Table 4 shows the six MFIs from Southeast Asia which met or exceeded two important benchmarks for MFIs in 2004: scale (at least 10,000 very poor served), and financial sustainability (at least two consecutive years of operational self-sufficiency greater than 100%). Of these, four are from the Philippines and one each from Indonesia and Cambodia. They are among the 41 microfinance programs worldwide which met these criteria; 28 of these programs are from six countries of Asia.

Sustainability of the Grameen Bank Model

Past studies have shown that the Grameen model was able to reach poor borrowers but was not financially self-sufficient (Morduch 1999; 2000). Although the bank reported profits of \$1.5 million between 1985 and 1996, Morduch (1999) showed that these profits depended on \$16 million of direct grants, \$81 million of implicit subsidies through soft loans, \$47 million of implicit subsidies through equity holdings, and \$27 million in delayed loan loss provisions. However, a more recent paper claims that the Grameen bank is financially self-reliant and makes a profit (Morshed 2006). The Grameen Bank plans to reach 12 million borrowers by 2010 and claims that its expansion is taking place with its own deposits, mobilized from its members and the public (Yunus 2006). Through

donor funding, Grameen Trust has so far supported 138 programs replicating the Grameen Bank model in 37 countries in Asia and the Pacific, Africa, and Latin America. It is reported that, as of mid-2006, 44 of Grameen Trust's partners have achieved operational self-sufficiency and 36 have achieved full financial self-sufficiency (Morshed 2006).

The replication of the GBA in the Philippines has shown that institutional sustainability and rapid increase in outreach to the poor are not only compatible but also mutually reinforcing (IFAD 2003). Box 1 provides important lessons of a project, which promoted the GBA in the Philippines.

Sustainability of the SHG Bank Linkage Model

As the number of SHG formed has increased dramatically in India in the last 15 years, the number of SHGs linked to banks has increased from just 500 in the early 1990s to over 800,000 by 2004 (Basu and Srivastava 2005). The National Bank of Agriculture and Rural Development (NABARD), the main promoter of SHGs in India seeks to establish a million SHGs serving 20 million households by 2008. Since the SHG model is being replicated in other countries including those from Southeast Asia, the issue of sustainability of this model is of interest.

An important concern about the sustainability of the SHG Bank Linkage relates to the lack of clarity over the main responsibility of promoting and maintaining groups to ensure quality, and how the costs of doing so are to be met. In the early phase of the movement, these functions were carried out by NGOs. As NABARD was expanding the program to reach the goal of linking one million SHGs to banks by 2008, the quality of groups had

Table 4. Financial sustainability of selected MFIs in Southeast Asian countries, 2004.

MFI	Number of very poor clients	Years
OSS>100%		
BRI Indonesia	321,625	6
CARD Philippines	109,580	8
TSPI Philippines	97,021	5
ALCEDA Cambodia	91,556	8
NEGROS WTF Philippines	52,120	6
ASI Philippines	21,272	3

Source: Dunford, C. (2006). Evidence of Microfinance's Contribution to Achieving the Millennium Development Goals. Freedom from Hunger, USA, September 2006.

**BOX 1. Sustainability and Outreach of the GBA:
The Experience of the Rural Micro-Enterprise Finance Project (RMFP) in the Philippines.**

RMFP was supported by the Government of the Philippines through the Department of Finance and Land Bank of the Philippines (LBP) and executed by the People's Finance and Credit Corporation (PCFC). The Asian Development Bank (ADB) and International Fund for Agricultural Development (IFAD) provided the financial support. The project aimed at poverty reduction, the creation of employment opportunities, and the enhancement of rural incomes of the bottom 30% of the rural population. It supported two components: an MFI-support component comprising the establishment and strengthening of Grameen replicators, and on-lending to final borrowers through NGOs, cooperatives, and local banks.

A prominent feature of the project has been its ability to learn from experience and leave leeway to participating institutions for experimentation and adjustment. Some freedom to modify the design, in line with lessons learned, has been important to allow the methodology to be adapted to the organizational culture of each MFI and the characteristics of local clients. In the process, the GBA has moved from creed to financial product, adopted by rural banks in increasing numbers. Among the modifications are product diversity, variability in interest rates and loan terms, group size and rules of loan release, and meeting cycle. Several important lessons can be drawn from this project, which are of relevance to the debate on sustainability and outreach:

- Mainstreaming GBA as a product of regulated financial institutions is feasible;
- GBA, as a product of healthy financial institutions, can be highly profitable and can achieve significant outreach;
- The high profitability is due to the high repayment of women and high interest rates;
- Outreach can be substantially increased by stronger support to branching-out through institutional loans;
- The restriction of loans to productive purposes and micro-enterprises (e.g. excluding agricultural and educational loans) interferes with institutional autonomy;
- GBA as a group lending methodology is flexible: clients may stay in the groups, graduate to individual lending, or do both;
- Institutional sustainability and rapid increase in outreach to the poor are not only compatible, but also mutually-reinforcing; and
- The most fundamental innovation of the project lies in its commercial approach and the mainstreaming of microfinance. Rural banks and NGO-turned-rural banks played a crucial role in the process.

Source: IFAD (2003).

begun to suffer. An APMAS survey in 2002 showed that only 17% of all groups were of adequate quality for bank linkage.

Another concern is about the financial sustainability of the SHG Bank Linkage. The main players in SHG banking—state-owned commercial banks and regional rural banks—have been increasing their lending to SHGs, without adequate attention to the actual costs of doing business with SHGs. These banks have been lending to SHGs at interest rates of between 12% and 12.5%, whereas the all-inclusive costs of lending to SHGs could range between 15% (the rate charged by private banks like ICICI) and 28%. Since the SHG portfolio constitutes only a small part of these banks' total lending, they may be able to cross-subsidize this

operation. However, unless these banks charge interest rates to recover their full costs, the SHG model's of financial viability and long-term sustainability may be at risk.

It is also important to ensure the proper targeting of clients, first, by clearly determining who are being targeted and defining eligibility rules. Grameen and BRAC in Bangladesh serve households who own less than half an acre of land. In Indonesia, BRI focuses on all low-income households, which also include those who are above the poverty line.

Designing appropriate products is another means of ensuring good targeting. One of the important factors for Grameen's success was the creation of a loan product that allowed borrowers

to repay loans in small, weekly instalments. BRI in Indonesia encouraged the poor to save by allowing low minimum balances (US\$0.57) and low minimum deposits for opening accounts. Although BRI required borrowers to put up collateral to obtain loans, it was very flexible in what it accepted, so that collateral was not a major constraint for the poor to borrow. It has also designed products that do not require any collateral for loans up to 2 million rupiahs (US\$225).

The partnership between government, NGOs, and different types of rural banks (commercial banks, RRBs, cooperative banks) was instrumental in the past success of the SHG Bank Linkage model. Further gains in outreach and financial sustainability can be achieved by involving private sector banks in SHG Banking.

Financial Sustainability and the Financial Crisis

A true test of the sustainability of any microfinance institution lies in its ability to weather financial crises. A survey of Indonesia, Philippines, Malaysia, and Thailand showed that MFIs in general fared better than the commercial banking systems during the Asian financial crisis of 1997-98 (McGuire and Conroy 1998). The crisis seemed to have more adverse impact on institutions catering to small business clients than on specialist MFIs serving the poor, and that the adverse impact on microfinance was most severe in those countries where it was linked most closely to the formal financial system. Those microfinance programs, including Grameen Bank replications, which targeted the poorest, were least affected by the crisis. In contrast, those MFIs, which relied on government and donor agencies for resources, fared better. However, it does not mean that microfinance should not be more integrated into the formal financial system. In order to expand its outreach and serve the poor, MFIs have to establish such linkages. What it indicates is that such linkages make MFIs more prone to cyclical fluctuations.

The experience of BRI during the Asian financial crisis of 1997-98 provides unique lessons for sustainability. The financial crisis in Indonesia started in mid-1997 when its central bank decided that its foreign exchange reserves were inadequate to support the exchange rate prevailing that time:

Rp2,450 to the US dollar. The exchange rate dropped to Rp14,900 to the US dollar by mid-1998. During the financial crisis and drought, BRI's micro-enterprise (KUPEDES) borrowers continued to pay back more than 97% of everything that had fallen due (Patten, Rosengard, and Johnston 2001). The excellent performance of micro-enterprise borrowers compared to small, medium and large enterprise borrowers during the financial crisis demonstrated dramatically the essential features in the design of a sustainable microfinance institution (Box 2).

Financial Sustainability, Outreach, and Poverty Reduction

In discussing the sustainability of MFIs, some distinguish between two schools of thought, namely: 1) the intended beneficiary – which is more concerned with the impact of microfinance on the client households, and 2) the intermediary – which focuses on the outreach and institutional sustainability of MFIs (Hulme and Mosley 1996). Microfinance institutions come under pressure to increase the number of beneficiaries so that economies of scale can be achieved and the cost of servicing numerous small transactions starts to fall. These MFIs face major organizational and management problems as they scale up their operations.

This duality reflects the apparent tension between financial sustainability and poverty reduction, that is, whether the financial sustainability of MFIs can be reconciled with the objective of reaching the poorest households. Exclusion of the poorest from microfinance schemes is well-known, although the reasons for their exclusion remain unexplored. There is often a perception that the moderately poor are less likely to default than the poorest of the poor. In such a case, targeting the moderately poor is likely to be more sustainable financially. Therefore, the exclusion of the poor may well be connected with a concern for financial sustainability. For example, a study points out that the "... shifting of the target group to the marginal farmer category (the not-so-poor or the vulnerable non-poor) may be the only way for the MFIs to achieve their twin goals of poverty reduction and financial sustainability" (Sinha 1998, pp 6). Indeed, this is symptomatic of a "... shift in emphasis of

BOX 2 : Essential features in the design of a sustainable microfinance institution.
Ability to repay

- Loan products that are compatible with a micro-enterprise's cash flow to facilitate loan repayment, and that require pay-down of loan principal in scheduled instalments, thereby encouraging reinvestment of profits into the business to decrease loan leverage and business vulnerability; and
- Loan delivery systems that are adapted to local market conditions and clientele, in order to identify market opportunities, cope with market failures, and distinguish fairly cases of customer inability to repay versus willingness to repay.

Willingness to repay

- Development of a long-term banking relationship with borrowers, characterized by mutual respect and adherence to pre-agreed loan terms and conditions; and
- Unrationed future availability of credit for present borrowers who repay their loans on time, and for new applicants who are deemed to be credit-worthy.

Willingness to save

- Savings products that offer security, access, and a fair return, giving customers both a financial cushion during hard times, and an incentive to keep their funds in the bank during periods of economic uncertainty; and
- Products that differentiate between "savings" and "investments", i.e., passbook accounts versus time deposits. Savings tend to be relatively stable and long-term, and are used primarily for lumpy payments or family emergencies; investments are usually more volatile, speculative, and "hot," and chase the highest short-term return.

Source: Patten et al. (2001).

targeted credit programmes from exclusive anti-poverty towards primarily financial sustainability with a bit of poverty reduction on the side". Besley (1997), on the other hand, contends that inclusion of the non-poor may be necessary to a limited degree to prevent them from capturing benefits meant for the poor. But whether, in fact, participation of the non-poor is self-limiting and beneficial to the poor remains to be demonstrated.

A study of the IFAD-funded Maharashtra Rural Credit Project in India offers some insights into the reasons for the exclusion of the poorest in the sample villages (Gaiha 1999). While some of the poorest failed to participate in the project either because of their lack of awareness or inability to overcome their social exclusion, many more were excluded because of the arbitrariness in the selection of beneficiaries by Village Development Councils and the inadequate flexibility in the design of the scheme (more specifically, in repayment requirements). To the extent that the default rate is negligible and self-help groups (SHGs) better represent the poor, further extension of the coverage

of the project mainly through SHGs may well be sustainable provided the special needs of some backward sections (e.g., tribal groups) stemming from their social exclusion are systematically addressed³.

A related issue highlighted by this study from the point of view of any (potential) trade-off between a better coverage of the poorest and financial viability of a project is the efficiency in the use of the assets financed by the scheme. The study points to the difficulties faced by the poorest in the repayment of loans due to seasonal fluctuations in yields (e.g., fishing) and contingencies (e.g., sickness). Another concern is whether the type of training given to the poorest enables them to make productive use of their assets.

³ Sudha Kothari of Chaitanya, an NGO associated with the project, highlighted the neglect of backward villages in the interior by the participating banks. This was confirmed by the representatives of NABARD and Bank of Maharashtra. In addition to the difficulty with which the limited personnel can cover remote and inaccessible areas, it was indicated that it takes up to five years for an SHG in a tribal village to be viable compared to 2-3 years in most other villages.

Some see the need to reconsider the conventional wisdom that all MFIs should necessarily achieve financial self-sufficiency. They argue that there may be a case for subsidizing MFIs, provided the benefits of such subsidies exceed the costs, and donors remain committed to the cause (Morduch 1999). The failure to achieve financial self-sufficiency does not in practice necessarily mean that programs will operate on a limited scale. For example, the Grameen Bank and the Bangladesh Rural Advancement Committee together covered around 4 million borrowers in 2000, although both were not financially self-sufficient (Morduch 2000).

This point of view deserves serious attention. Experience from around the world shows that it is very difficult for MFIs to achieve financial self-sufficiency, particularly if they have to serve the poor in remote, rural areas (Webster and Fidler 1995; Bennett et al. 1996). There may be a justification for well-managed programs to receive some level of subsidy if they can be shown to be as effective or more effective than alternative strategies to reduce poverty. For example, Khandker (1998) reported a cost-benefit ratio of 0.91 with respect to improvements in household consumption via borrowing by women from the Grameen Bank, compared to the ratio of 1.71 for the World Food Programme's Food-for-Work scheme, and 2.62 for CARE's similar program.

However, this argument of selectively subsidizing MFIs to reach the poorest of the poor does not question the imperative for MFIs to achieve as high a degree of financial self-sufficiency as possible by reducing operational costs and charging market rates of interest. The higher the degree of self-sufficiency, the greater the extent to which an MFI can leverage donor and government funds to expand outreach.

DETERMINANTS OF THE SUSTAINABILITY OF MFIS: LESSONS FROM ASIA AND THE PACIFIC

This section identifies the main determinants of financial sustainability of MFIs in different parts of the world, from which countries in Southeast Asia can learn important lessons.

Institutional Innovations

Institutional innovations have played an important role in enhancing the sustainability and outreach of MFIs in different countries. Some examples include:

BRI Unit desa, Indonesia: The establishment of the BRI Unit was an institutional innovation, with far-reaching consequences on the success of the system. The Unit as the institutional nucleus provided both standardization and flexibility. It was easy to replicate and adapt to the scale of operation in any given area, which provided an ideal institutional basis for expansion and scaling up.

Each Unit was highly decentralized and semi-autonomous and was kept small by limiting the number of staff and focusing its operations. It adopted an accounting system which allowed each Unit's performance to be evaluated as a profit center. A standardized management information system provided timely information on a few key performance indicators to managers and supervisors.

PKSF, Bangladesh: In Bangladesh, the institutional innovation was the establishment of the Palli Karma Sahayak Foundation (PKSF), a public-private apex body that channels funds for microfinance to MFIs. PKSF has played a critical role in the expansion and improved professionalism of microfinance industry in the country (CGAP 2004). Its main functions are (a) to lend resources to eligible MFIs to expand their microfinance operations; (b) build capacity of MFIs and move them towards financial sustainability; and (c) to advocate microfinance issues and help develop an appropriate regulatory framework. PKSF played a critical role in sharply increasing the access of the poor to microfinance in the 1990s by expanding the capital base for MFIs to on-lend to the poor. It also helped in sharpening the focus of many MFIs on financial sustainability and in strengthening the regulatory structure for microfinance.

SHG Federations: Two NGOs (MYRADA and PRADAN) pioneered the concept of SHG federations in India primarily as an exit strategy, that is, to allow organizations that had promoted SHGs to withdraw their support to SHGs while also ensuring their sustainability (Nair 2005). Now,

several other NGOs and government agencies are promoting SHG federations. SHG federations help SHGs gain economies of scale, obtain value-added services, reduce transaction costs, and enhance empowerment, thus contributing to the organizational sustainability of SHGs.

A recent study indicated that both SHGs and SHG federations could be financially viable even when all costs, including those subsidized by the promoter agency, were accounted for (Nair 2005). This study also showed that SHG federations were able to achieve financial sustainability but they had difficulty achieving organizational sustainability. SHG federations' organizational sustainability depends on progress achieved in federation governance, staffing, and organizational processes and systems. SHG federations' accountability to SHGs needs to be strengthened by building SHG capacity to hold federations accountable and creating institutional arrangements that provide incentives for federations to be accountable to SHGs. Major constraints in forming sustainable SHG federations include the inadequate capacity of promoter agencies, limited knowledge base on SHG federations, and the lack of legal frameworks.

Strong Commitment and Political Support for Change

In Indonesia, BRI's top management, along with other members of the Board, has protected the Units from political interference and led the development of a new institutional culture. This change was associated with the shift from subsidized farm credit to commercial micro-banking. Although the BRI Units were part of a government-owned bank, they were able to maintain operational autonomy and to avoid distortionary policies such as credit targeting, interest rate restrictions, provision of cheap funds, as well as to protect themselves from interferences in lending decisions.

Likewise in Bangladesh, the vision and commitment of the leaders of the NGO/MFI movement were instrumental in ensuring the success of the microfinance sector. At the initial stages, leadership skills played a key role in convincing the public that providing credit to the poor was a viable option. These skills were equally important during the scaling-up period to recruit

and motivate staff, decentralize authority, build management information systems, and to establish the learning culture.

Learning and Experimentation

In Indonesia, BRI learned from the experience of others before setting up its own system. For example, it studied the experience of Bank Dagang Bali, a private bank set up in 1969, and the Badan Kredit Kecamatan (BKK), a community-based institution. It also learned from informal moneylenders on how they collected information on prospective borrowers from input suppliers and buyers. Furthermore, BRI resorted to experimentation on a regular basis to test-run its services. It tried the Kredit Mini and Kredit Midi products for several years, which allowed it to analyze the viability of informal micro-enterprises. After a demand study, it introduced the first version of SIMPEDES as a pilot project in 1984. This facility was expanded to all units after some modifications and refinements.

In Bangladesh, another important factor for the rapid scaling up of NGO-led microfinance services has been the ability to learn from experiences and adapt programs accordingly. Both the informal feedback by field staff during regular interactions with management, and the formal monitoring and evaluation contribute to this learning process. The adoption of more flexible financial services in recent years was mainly based on client feedback and an analysis of the limitations of a standard microfinance model.

New Products Appropriate for the Poor

An important factor for the success of the Grameen approach was the creation of a loan product that allowed borrowers to repay in small, weekly instalments. This suited poor households who could repay out of their small, regular incomes. Regular repayment schedules have other advantages: they screen out undisciplined borrowers and give early warning to loan officers and peer group members about emerging problems (Morduch 1999). All these factors contribute to the financial sustainability of MFIs.

In Indonesia, Bank Rakyat Indonesia (BRI) turned 3,624 village units (unit desas) into full-service rural banks in 1984, with management and accounting separate from other elements of BRI and with profitability as the primary criterion of success (Donaghue 2004). BRI introduced a new loan product—KUPEDES or general village credit—which, following the government's interest liberalization, was priced to cover costs and generate a surplus. KUPEDES interest rates were fixed at 1.5% per month or an annual effective rate of 33%. The borrowers were required to provide collateral to cover the value of the loan, usually in the form of land titles, but they could also pledge buildings, motorcycles, or other property.

A simple passbook savings product (SIMPEDES or village savings) was introduced in 1986. Savings was an integral part of the Unit banking philosophy and strategy from the beginning (CGAP 2004). As more people in rural areas tended to be savers than borrowers, providing better savings services was seen to be more effective in achieving an equitable distribution of banking services than providing cheap credit. The BRI Unit system as a whole became profitable in 1986, on its third year of operations. SIMPEDES proved to be a great success, with the number of savings accounts increasing from 4.2 million in 1987 to over 30 million in 2003.

Long-Term Banking Relationship

Throughout the Asian financial crisis of 1997-98, BRI's micro-banking system continued to perform well. It experienced an increase in deposits because it benefited from its status as a state-owned bank. More than three million new deposit accounts were opened in 1998 alone, and the volume of deposits in rupiah doubled. In contrast to the massive defaults of large and corporate customers in the Indonesian banking sector, KUPEDES borrowers continued to repay their loans despite economic hardships. A major factor for this was the long-term banking relationship that had developed between the Units and the borrowers. They were particularly keen to maintain access to BRI's credit facilities because such credit availability was seen as a form of insurance for dealing with external shocks.

Procedural Simplification

After the liberalization of interest rates in 1983, BRI introduced drastic changes in the accounting systems and staff incentives for its village-level offices, the Unit desas. They became individual profit centers, with full accountability for their performance and an incentive structure to reward staff achievement. Significant investments in human resource development created a motivated workforce, which contributed to the profitability of the system.

To provide access to commercial credit for the enterprising poor on a large scale, BRI introduced a small-scale KUPEDES product in 2000 with simplified administrative procedures and flexible collateral requirements for loans under one million rupiah (US\$120). However, there are limits to the provision of very small loans in a financially sustainable way. In spite of the simplified administrative requirements, the break-even point for small-scale lending is Rp1.2 million (US\$143) when the full cost of lending is accounted for (Marquez and Seward 2002).

Enabling Macroeconomic Environment

A stable macroeconomic environment particularly with respect to interest rates and inflation is a prerequisite for the growth of microfinance. Regulations and policies adopted by the government play an important part in creating a favorable environment for the sector. Financial liberalization normally supports the development of effective microfinance institutions. Flexibility to determine interests is an important factor for sustainable microfinance.

Reforming a Government Bank to Reach the Poor

The BRI experience has provided valuable lessons for policymakers and microfinance practitioners all over the world. A major lesson is that a state-owned bank can be reformed and existing infrastructure and human resources can be utilized to implement a sustainable approach of large-scale microfinance within a short period of time (CGAP 2004). It also demonstrated that the commercial provision of credit and saving services

could have a positive impact on the poor, based on locally mobilized savings without subsidies and funds from government or donors. However, this required a change of culture, which treated the poor not as beneficiaries but as customers who can save, who are able and willing to pay market prices for goods and services, and who honor their obligations and repay their loans despite economic hardships.

GOVERNANCE

The term “governance” has assumed prominence in the discussion of economic and social development issues since the early 1990s. Although first used with reference to governments and companies, this term is now also applied to microfinance. In microfinance literature, the term was first used by CGAP in 1997 when governance was defined as, “a system of checks and balances whereby a board is established to manage the managers. Governance is sometimes conceived as a virtuous circle that links the shareholder to the board, to the management, to the staff, to the customer, and to the community at large”.

As a microfinance institution reaches a larger number of clients, manages increasing volume of financial resources, borrows substantial amounts from financial markets, and starts to earn profit, governance becomes an important requirement. What makes governance of MFIs different and more challenging than that of other types of institutions are four unique attributes, namely: the dual mission of microfinance—achieving profitability and maintaining a social objective; the ownership of MFIs; the fiduciary responsibility of the board; and risk assessment in MFIs (Rock et al. 1998).

Most MFIs are promoted by NGOs with donor support and start with the social objective of reaching out to the poor. As they evolve and expand outreach, they start to focus on achieving financial self-sufficiency, as donor money and subsidies decline. As a result, most MFIs attract private capital, including deposits, to expand their operations. Although the dual objectives of MFIs appear contradictory, several MFIs have shown that the social mission and the desire to earn profits are not mutually exclusive. For example, BRI in Indonesia and ASA in Bangladesh have achieved both objectives.

Different stakeholders may have different objectives for an MFI. For example, donors, non-profit organizations, and technical assistance providers may emphasize the MFI’s social mission, while private investors and employees may be more interested in financial sustainability. However, there are cases where diverse interests have been preserved by making sure each stakeholder has representation on the board of directors. Acknowledging the multiplicity of stakeholders can help in maintaining an institution’s initial strategic orientations (Box 3).

BOX 3. Credit Rural de Guinée (CRG): A shared management model

The ownership structure of CRG is the fruit of an extensive consensus-building process among the actors involved, and aims to exemplify the philosophy of “shared management” that is unique to this network. Two shareholder groups representing the main stakeholders at the institution’s base constitute the “pillars” of the governance structure and consult on the main strategic directives that guide the network. Joint training sessions with the two groups have proved especially useful for helping achieve consensus. The community banks group, representing the borrower-members, holds 40% of the capital and nominates five candidates to the board of directors. According to the statutes, the President of the network’s apex structure, CRG, S.A., is elected by this group of directors. The other group is composed of employees, who hold 35% of the capital and nominate four candidates to the board of directors. These two groups work together to create a shared strategic vision. To facilitate compromise among stakeholders with, at times, contradictory interests, there exists a third minority group of external partners who provide technical and financial expertise and play the role of mediator. The group consists of the former project implementer (IRAM), a socially responsible investor (SIDI), and the Government of Guinea, which carries the commitments of future private national investors, commercial banks or professional organizations that may be interested in developing the services of the network (producers federations, cooperatives, etc.).

Source: IFAD 2006.

The mission of an institution and its preferences as to institutional type and ownership structure are closely related and influence each other. Different types of MFIs show structural weaknesses related to ownership, which can have an adverse effect on the effectiveness of microfinance. NGOs do not have real owners, as the capital for non-profit NGOs is provided by donors, foundations and individuals. MFIs' ownership has not expanded significantly beyond NGOs and public sector organizations. The focus of commercial banks on profit maximization and the lack of representation of microfinance in their board is a structural weakness. In the case of credit unions, the divergent priorities of borrowers and savers can create conflicts in the board.

Generally speaking, the fiduciary responsibility of the board of any financial intermediary like an MFI is greater than for other non-financial entities. The lack of deposit insurance in many developing countries even increases the board's obligation in this area. Although the MFI board has a fiduciary responsibility when a non-profit MFI secures funds from donors, the responsibility is greater when the MFI intermediates funds by borrowing from a bank, by mobilizing deposits, or by floating an instrument in the securities exchange.

Guarding against risks is the responsibility of the management of an MFI. Establishing mechanisms to manage risks is directly related to how governance works. MFIs should be aware that microfinance is subject to a variety of risks. These include operational risks (e.g., loan default), information-related risks (e.g., unreliable management information system), organizational risks (e.g., risks related to internal control procedures), strategic risks (e.g., competitive environment), and environmental risks (e.g., climate or political risks).

One important risk that MFIs face is that of mission drift, which appears when a MFI transforms from a project with strong social objectives to a formal institution with a strong pressure to mobilize financial resources and achieve sustainability quickly. In order to achieve financial sustainability, MFIs have to reduce costs and increase revenues. This usually involves higher loan amounts, lending to sectors with strong economic potential, diversifying products, and increasing staff productivity. These measures may lead to redirecting services towards a different type of clientele or changes in the client-

MFI relationship, for example, less proximity with clients or less in-depth knowledge of clients (IFAD et al. 2006). Some NGOs have been able to manage the transformation to a regulated MFI and avoid the mission drift. Box 4 describes the experience of an NGO from the Philippines.

Although good governance has been recognized as being critical for the success of MFIs, very few studies have focused on governance issues (e.g., Hartarska 2004; McGuire 1999). There are several reasons for the lack of interest among researchers to determine the effect of MFI governance on performance. First, data on performance are difficult to obtain since they are normally considered proprietary. The Microbanking Bulletin publishes performance data on a regular basis but they are aggregated by region. Second, a diverse set of organizations (NGOs, banks, cooperatives, and non-bank financial institutions) provides microfinance services, which makes it difficult to choose an appropriate conceptual framework for analysis. The unique characteristics of MFIs also complicate the analysis of governance issues. Some MFIs (e.g., NGOs) emphasize outreach and poverty focus and are similar to non-profit firms, whereas others are like banks since they collect deposits and are supervised by a regulatory body.

The main mechanisms of an effective governance framework are ownership (including institutional and managerial ownership), board and board structure (size and composition), CEO (manager) and director (board member) remuneration, auditing, information, and the market for corporate control (Keasey et al. 1997). A recent empirical study in Central and Eastern Europe, which analyzes the impact of each governance mechanism on both sustainability and outreach of MFIs, provides valuable lessons for South East Asia and other regions (Hartarska 2004).

In the study of Hartarska (2004), it is shown that among the external governance mechanisms, auditing has a positive effect on outreach, whereas supervision by a regulatory authority and rating by an independent agency are not effective mechanisms of control. Among the internal governance mechanisms, the board plays an important role. MFIs with local boards achieve better sustainability. The study also shows that in microfinance, larger boards and boards with higher proportion of insiders have worse financial

**BOX 4. Managing the transformation to a regulated MFI:
The experience of Taytay sa Kauswagan, Inc. (TKSI), Philippines**

In Taytay sa Kauswagan, Inc. (TKSI), as we went through the process of transformation to a regulated MFI, we deemed it necessary that majority of the board of directors of the bank, 5 of them, are members of the board of trustees of the NGO. We, however, took in 2 bankers as independent directors and possibly another 2 seats for minority investors. This was a deliberate move on our part to see to it that the social mission for which TKSI was established would be preserved as it transformed itself into a regulated MFI. Presently, the board chair of the bank is concurrently the board chair of the NGO. This practice is not an isolated case of our organization. It has similarities with two other leading MFIs in the Philippines that transformed into regulated institutions.

One is the Center of Agriculture and Rural Development (CARD), which is the first NGO that established and operated a bank and at present owns 10 rural banks in the Philippines. The president and CEO of the NGO is concurrently the president and CEO of the bank and majority of board members of the NGO are the board of directors of the bank. The other microfinance institution that went into banking is the Negros Women for Tomorrow Foundation (NWTF), where the structure is very much similar to that of CARD. Both institutions, like us, started as non-profit MFIs and eventually became regulated formal financial institutions in the form of banks. In fact, what we are now is partly due to our studies about what they have done. This means control of the bank by the MFI and to some extent having the CEO of the NFI as concurrently that of the bank would assure the continuity and preservation of the social mission even as NGO operates as a regulated institution.

The challenge that the board of trustees of the NGO has to face is their ability to respond to the demands of assuming new legal responsibilities as a banker. We realize the fact that enhancing their skills to enable them to govern a regulated financial institution does not come easy and in most cases are difficult tasks required of them. This is indeed a challenge but not impossible to overcome; a price they have to pay for the transition and most of all allowing them to protect the social mission with which the organization was established.

Transforming to a regulated financial institution does not necessarily mean giving up our operation as an NGO and, to say the least, its existence. A level of reciprocity is required between the NGO and the regulated MFI (bank). This relationship is clearly illustrated in a "hatchery concept", wherein the NGO implements microfinance operations, and given a timeframe of nurturing the clients, transfers them to the bank. The NGO is paid by the bank for its efforts and at its option invests the payment back in the bank. This engagement may extend to the staffing needs of the bank where the NGO supplies competent staffing to the bank. The whole setup is geared towards expanding the social mission of both the NGO and the bank. The NGO is able to expand its work for the poor, the bank finances the expansion.

Source: Angel L. de Leon (n.d.).

results—a finding consistent with other studies. The inclusion of women on the board is found to improve both the depth and breadth of outreach as well as sustainability. The study shows that donor representatives improve the depth of outreach but worsen the breadth and sustainability. In contrast, financiers promote sustainability, which is an expected result.

In discussing governance in microfinance, it is important to broaden the scope of study to include all stakeholders involved (employees, managers, elected officials, clients, donors, bank partners, shareholders, the government, etc.) as well as any

organizational form with a governing role that may have been set up at the establishment of the institution (IFAD et al. 2006).

CONCLUDING REMARKS

Like in other regions of the world, microfinance in Southeast Asia is passing through a critical phase. Although it has demonstrated the ability, through a variety of approaches, of providing financial services to the rural poor excluded from the traditional banking sector, most microfinance institutions face the challenge of institutionalization

and achieving sustainability, while at the same time reaching the poorer segments of the society. Even in countries like Thailand and Indonesia, where formal financial institutions have expanded their outreach significantly and achieved a high degree of financial sustainability, reaching the poorer segments of society remains a challenge. In transition economies of the region, the further liberalization of the financial sector, the strengthening of the legal and regulatory framework for microfinance, and the capacity building of MFIs are needed to expand outreach and achieve sustainability.

The sustainability of an MFI requires not only financial viability but also a clear strategic vision and an organization that is transparent, efficient, and accepted by all the stakeholders. There is a need to continuously innovate new institutional models of MFIs which can reach the rural poor in a sustainable manner.

As microfinance institutions in South East Asia expand their outreach, increase their assets, and become regulated entities that can mobilize savings deposits, they need a clear articulation of how different stakeholders will ensure effective governance. It is also important to avoid political interference, as the outreach of microfinance expands and becomes more visible.

AUTHOR'S NOTE

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ANNEX 1. Microfinance coverage in Southeast Asia, 2005.

Institution	Poorest clients as of 31 Dec 2005	Total active clients as of 31 Dec 2005	% of poorest clients that are women
Thailand			
Association of Asian Confederation of Credit Unions (ACCU)	5,069,184	5,069,184	66
Sub-total	5,069,184	5,069,184	
Indonesia			
National Family Planning Coordination Board (BKKBN)	1,777,358	2,334,387	100
Bank Rakyat Indonesia (BRI)	557,297	3,313,532	50
Mitra Usha Foundation	11,704	13,004	100
Ganesha Microfinance Foundation	11,101	12,335	100
Sub-total	2,357,460	5,673,258	
Vietnam			
Vietnam Bank for Social Policies (Vietnam Bank for the Poor)	1,200,000	4,125,000	43
Central People's Credit Fund (CCF)	585,000	1,210,000	36
Vietnam Women's Union, TYM Fund (Tao Yeu May Fund)	21,303	21,303	100
Action Aid, Vietnam	19,561	21,734	99
Capital Aid Fund to Employment of the Poor (CED)	18,559	59,869	73
Quy Khuyen Khich Tu Lap	5,000	7,000	90
Sub-total	1,849,423	5,444,906	
Cambodia			
National Bank of Cambodia	377,505	377,505	77
Asso. Of Cambodian Local Economic Dev Agencies (ACLEDA)	33,389	140,920	64
Angkor Mikroheranhvatho (Kampuchea) Co. Ltd.	32,563	36,221	86
Thaneakea Phum Cambodia	32,397	43,196	93
Vision Fund Cambodia Ltd.	21,998	25,347	79
Sub-total	497,852	623,189	
Philippines			
TSPI Development Organization	125,086	125,298	100
Center for Agri and Rural Dev	108,477	108,477	100
Kabalikat Para Sa Maunlad Na Buhay, Inc.	88,812	88,812	100
WOCCU/CUES Philippines	39,862	39,862	100
Negros Women for Tomorrow Foundation, Inc.	30,602	65,112	99
Alaylay Sa Kaunlaran Sa Gitnang Luzon, Inc.	29,545	31,099	81
Enterprise Bank, Inc.	21,432	21,432	100
Producers Rural Banking Corporation	20,538	27,384	91
ABS-CBN Foundation	16,929	30,653	95
Community Economic Ventures	16,606	16,606	87
Kazama Grameen Inc.	15,709	15,709	100
First Agro-Industrial Rural Bank	11,945	13,272	85
Talete King Pangyulung Kapampangan	11,575	12,492	95
Progressive Bank, Inc.	10,477	10,477	86
Ad Jesum Development Foundation	9,587	9,587	95
Kasagana KA Development Center	8,500	8,500	98
People's Bank of Karaga, Inc.	8,364	20,181	94
Ahon Sa Hirap	7,500	15,841	100
Cooperative Bank of Tarlac	7,460	7460	95
Lipa Public Bank	6,644	9,491	100
Rural Bank of President M.A. Roxas (ZN) Inc.	3,652	3,844	98

G7 Bank (Rural Bank of Nabua, Inc.	3,000	3,507	3
Mallig Plains Rural Bank (Isabela) Inc.	2,300	13,560	100
Sub-total	604,602	698,656	
Myanmar			
PACT Myanmar	81,260	81,260	99
Microfinance Delta Project	66,500	66,500	100
Dawn Microfinance Program	4,200	9,656	100
Sub-total	151,960	157,416	
Malaysia			
Amanah Ikhtiar Malaysia	36,180	120,602	100
Sub-total	36,180	120,602	
Total South East Asia	10, 566,661	17,787,211	

Source: State of the Microcredit Summit Campaign Report 2006.

