APRACA FinPower Programme

Completion Report:
Regional CEO Dialogue Forum on Creating Conducive Rural Finance Policy Environment and Regulatory Framework

Kunming, China April 6-10, 2007

Editor: Benedicto S. Bayaua
Facilitator: Jocelyn Alma Badiola
Documentors: Cristina Lopez and Emmalynn Guinto

With Special Sponsorship of the
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APRACA FinPower Publication 2007/2

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This documentation-report is published during the incumbency of Mr. Thiraphong Tangthirasunan (APRACA Chairman), Dr. Do Tat Ngoc (APRACA Vice Chairman) and Mr. Benedicto S. Bayaua (APRACA Secretary General).

MESSAGE from the
APRAC1A CHAIRMAN and VICE-CHAIRMAN

Greetings! This completion report of the FinPower CEO Regional Dialogue Forum on Creating Conducive Rural Finance Policy Environment and Regulatory Framework, the first in a series of events to be conducted by APRACA in collaboration with the International Fund for Agricultural Development (IFAD), is a testimony of APRACA's strong commitment to pursue the promotion of efficient and effective rural financial systems and broadened access to rural financial services in order to help reduce rural poverty among countries in Asia and the Pacific. APRACA has successfully established among its members, machinery for systematic interchange of information on sustainable rural and agricultural financial services, encouraged inter-country studies and provided training, consultancy, research and publication services on matters of common interest in the field of rural finance.

In all these aspirations, IFAD has played the role of APRACA's strategic partner under the FinPower Program. APRACA and IFAD share that mutual desire to pursue and create conducive rural finance policy environment and regulatory framework in Asian countries, including the development of sustainable financial services in rural areas, pilot testing of innovative approaches, delivery mechanisms and linkage programs, promoting finance reforms aimed at poverty alleviation, and disseminating best rural finance practices to more countries.

May we therefore thank Dr. Thomas Elhaut, IFAD Asia Division Director, and Dr. Ganesh B. Thapa, Regional Economist, for the trust and confidence they have continuously bestowed on APRACA and for their commitment to help alleviate poverty and accelerate rural growth and development among countries in Asia and the Pacific.

We wish to congratulate Mr. Benedicto S. Bayaua, APRACA Secretary General and FinPower Regional Program Manager, for initiating the program and supervising the FinPower activities.

We also convey our thanks to APRACA's research and training arm, the Center for Training and Research in Agricultural Banking (CENTRAB), particularly to Ms. Jovita M. Corpuz, President and Atty. Eduardo Garcia, Managing Director, for their support and commitment to the FinPower Program. We sincerely wish that this book will continuously inspire policymakers, practitioners and other stakeholders in the different countries in Asia and the Pacific to work towards poverty reduction and rural development.

MR. THIRAPHONG TANGTHIRASUNAN
President, Bank for Agriculture and
Agricultural Cooperatives and
Chairman, Asia-Pacific Rural and
Agricultural Credit Association
2007

DR. DO TAT NGOC
Chairman, Vietnam Bank for Agriculture
and Rural Development and
Vice-Chairman, Asia-Pacific Rural
and Agricultural Credit Association
2007

MESSAGE from the President

AGRICULTURAL DEVELOPMENT BANK OF CHINA

It was indeed a great pleasure for me and the officers and staff of the Agricultural Development Bank of China to host in Kunming, China the FinPower CEO Regional Dialogue Forum on Creating Conducive Rural Finance Policy Environment and Regulatory Framework, the first in a series of events to be conducted by the APRACA FinPower Program.

The focus of the dialogue forum is timely and significant as the Asia-Pacific region gears itself to setting the building blocks of a robust rural economic landscape and strengthening of rural financial systems, which are hoped to extend to those that do not have access to formal financial services. I laud the International Fund for Agricultural Development for leading and inspiring rural and agricultural finance key players, particularly those that are within the APRACA family. IFAD continues to play a significant role as APRACA's strategic partner under the IFAD-supported APRACA FinPower Program.

APRACA aims at promoting the creation of conducive rural finance policy environment and regulatory framework in Asian countries, including the development of sustainable financial services in rural areas. It is our wish that the dialogue forum will be a significant contribution to this end.

Thank you very much.

Mr. Zheng Hui
President
Agricultural Development Bank of China

FOREWORD

Through the years, the Asia-Pacific Rural and Agricultural Credit Association or APRACA has aspired to work for rural growth and development, with priority emphasis on the uplift of rural poor. It has pursued the promotion of efficient and effective rural financial systems and broadened access to rural financial services. It has established among its members, a machinery for systematic interchange of information on sustainable rural and agricultural financial services, encouraged inter-country studies, and provided training, consultancy, research and publications services on matters of common interest in the field of rural finance.

In all these aspirations, the International Fund for Agricultural Development or IFAD has played the role of a strategic partner. Between 1996 and 2001, IFAD provided a technical assistance grant to APRACA under the APRACA MICROSERV program to disseminate replicable rural finance models to a wider audience. The dissemination was particularly enhanced through APRACA's vast network, resulting in broader geographic reach, cost-effectiveness, and assured project continuity.

IFAD has again re-engaged APRACA, beginning in year 2007, in their mutual desire to pursue and create conducive rural finance policy environment and regulatory frameworks in Asian countries, including the development of sustainable financial services in rural areas, pilot testing of innovative approaches, delivery mechanisms and linkage programs, promoting finance reforms aimed at poverty alleviation, and disseminating best rural finance practices to more countries. The re-engagement is realized through the IFAD five-year technical and financial assistance grant to APRACA, officially named as the APRACA Regional Program of Accelerating the Financial Empowerment of Poor Rural Communities in Asia and the Pacific through Rural Finance Innovations or dubbed as the IFAD-supported APRACA FinPower Program.

As one of the initial activities of the APRACA FinPower Program, this Regional CEO Policy Dialogue Forum aimed at presenting and discussing the current policy environment and regulatory framework for rural finance (including microfinance, as well as public and private sector financial institutions and operators) of different countries in the Asia-Pacific region.

The forum is also intended as one of the platforms for analyzing the findings and building upon these to pursue a diverse, yet unifying course of action for the whole region. It is a venue for APRACA's continued quest to identify the most appropriate rural finance policies for each APRACA represented country based on its own distinct needs and requirements.

II. VENUE, HOST, COORDINATION AND PARTICIPANTS

The FinPower CEO Regional Dialogue Forum on Creating Conducive Rural Finance Policy Environment and Regulatory Framework, the first in a series of events to be conducted by APRACA, in collaboration with IFAD under the APRACA FinPower Program, was held in Kunming, China on April 6-10, 2007 and hosted by the **Agricultural Development Bank of China**, an APRACA member institution. The APRACA **Center for Training and Research in Agricultural Banking (CENTRAB)** provided facilitation and documentation services to the Program.

A total of 64 participants from APRACA member institutions in 15 countries as well as from IFAD, other partner institutions, and the APRACA Secretariat/Agencies attended the dialogue forum. Countries represented included: **Cambodia, China, India, Indonesia, Iran, Japan, Republic of Korea, Lao PDR, Malaysia, Myanmar, Nepal, Philippines, Sri Lanka, Thailand, and Vietnam.** The **Directory of Participants** is shown in **Annex 1.**

III. DIALOGUE FORUM OBJECTIVES

The CEO dialogue forum was convened to:

- determine the status and assess the development of the current policy environment and regulatory framework for rural finance (including microfinance, as well as public and private sector financial institutions and operators) of different countries in the Asia-Pacific region;
- conduct a dialogue among CEOs on the most likely success factors and critical issues pertaining to rural finance policy environment and regulatory framework; and
- develop a common regional strategy and plan of action to enhance policy environment and regulatory framework for rural finance and to establish continuing participatory dialogue in each country and in the region as a whole.

The forum (see **Annex II for Schedule of Activities**) included country paper presentations, discussions and synthesis of the issues, constraints and recommendations arising from the presentations, and action planning for the FinPower Program. The forum also included a visit to a company in Yunnan Province for a briefing on its contract growing arrangements with farmer-producers in adjacent villages and a tour of its facilities and operations.

It is hoped that the recommendations of this dialogue forum would help in guiding future actions of APRACA and other interested rural finance players to facilitate adoption the creation of a conducive policy environment and a client-friendly regulatory framework in their respective countries.

Benedicto S. Bayaua
APRACA Secretary General and
FinPower Regional Program Manager

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COMPLETION REPORT

I. BACKGROUND

Through the years, the Asia-Pacific Rural and Agricultural Credit Association or APRACA has aspired to work for rural growth and development, with priority emphasis on the uplift of rural poor. It has pursued the promotion of efficient and effective rural financial systems and broadened access to rural financial services. It has established among its members, a machinery for systematic interchange of information on sustainable rural and agricultural financial services, encouraged inter-country studies, and provided training, consultancy, research and publications services on matters of common interest in the field of rural finance.

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IV. OPENING CEREMONY

In his opening remarks, Mr. Zheng Hui, President of the Agricultural Development Bank of China (ADBC), stressed the importance of addressing rural and agricultural finance policy issues particularly among the developing countries. He said that the Chinese Government attaches great importance to this issue, particularly agricultural finance which is dealt with by considering China's inherent conditions and international experiences.

Mr. Zheng likewise presented the role of ADBC in promoting the healthy and steady development of rural and agricultural areas in China and in protecting the interests of the farmers by faithfully implementing the policies of the Chinese Government on rural credit. He emphasized that APRACA member institutions possess a trove of rich rural finance experience and advanced expertise from where ADBC and other institutions can learn. He also invited APRACA members to take advantage of opportunities in the China's market in order to strengthen and expand cooperation among the members according to the principles of "equality, mutual respect, mutual trust, mutual benefit, and win-win cooperation."

Ms. Cheng Yingxuan, Deputy Governor of Yunnan Province, China, also gave her welcome remarks, emphasizing the role of APRACA in facilitating cooperation among its members in promoting rural economic and social development and poverty alleviation. She said that through better cooperation among members, the Asian economy has been experiencing sound and rapid growth, with promising future for agricultural and rural finance.

Ms. Cheng welcomed the delegates to Yunnan Province, which she described as boasting of a beautiful landscape with unparalleled natural resources. She said that Yunnan is also a land of diverse cultures, through its from 26 ethnic groups, and a dynamic hub connecting China with Southeast and South Asia. She added that Yunnan is keen on promoting bilateral and multilateral economic cooperation in the sub-region of Greater Mekong, covering Bangladesh, Cambodia, China, India, Lao PDR, Myanmar, Thailand, and Vietnam.

In his speech, **Mr. Thiraphong Tangthirasunan, President of Bank for Agriculture and Agricultural Cooperatives (BAAC) and APRACA Chairman,** stressed the need for a client-friendly policy environment and a responsive regulatory framework to increase the rural poor's access to needed financial and finance-related services.

Mr. Thiraphong said that the gathering of the region's rural and microfinance experts and practitioners will add depth to the dialogue, clarity to the definition of concepts and critical debate to the issues. He said that the rural poor are now steadily able to access formal financial services, through the establishment of self-help groups and their linkage with the formal sector. He lauded APRACA's role in strengthening rural finance and microfinance institutions since the Asia-Pacific region is expected to lead in the creation of a conducive climate for financial institutions to provide needed rural financial services to the rural areas.

Mr. Budi Rochadi, Bank Indonesia Deputy Governor noted that, as part of the global society, APRACA is committed to help achieve the Millennium Development Goals (MDGs), by reducing half of world poverty at the end of 2015, as launched in the International Year of Microcredit campaign. APRACA as an international organization focusing on rural and agriculture finance should be able to play a significant role in achieving the MDGs. There have been many actions conducted, aiming for the poverty alleviation through various approaches based on unique conditions and characteristics of the members.

Mr. Budi said that since the rural finance is mostly served by the Microfinance Institutions (MFIs), it is necessary to create conducive environment with proper regulations, sound institutions, wide outreach, and quick-simple-secure procedure. From Bank Indonesia's point of view, proper regulation basically refers to the international regulation known as Basel II. However, being able to formulate a proper regulation for Non-Bank Financial Institution (NBFI) is a distinctive challenge. It does not only consider the complexities of the problem but also the various needs of the rural society.

In the case of Indonesia, microfinance has been acknowledged since more than 100 years ago. Microfinance plays the most important factor in the development of micro, small and medium enterprises (MSME) that amounted to more than 40 millions units or 90 percent of all enterprises in Indonesia. Under the New Central Banking Act No. 23 of 1999, amended by the Central Banking Act No. 4 of 2004, Bank Indonesia's role to strengthen and develop the MSME sector is of an indirect policy.

In 2007, Bank Indonesia pursued efforts to expand the coverage of banking services with focus on the MSME sector for more equitable outreach extending to all remote areas as one of leading principles of policy direction and strategy. To put these policies into effect, we will mainly be pursuing the empowerment of the role and function of rural banks. Bank Indonesia have begun encouraging rural banks, which have so far been concentrated in Java and Bali, to expand to other more remote areas that have so far not benefited from proper coverage of banking services. The expectation is for rural banks to spearhead financing for the MSME sector, particularly in agriculture and for the rural population.

Ms. Jovita M. Corpuz, Executive Director, Agricultural Credit Policy Council (ACPC) and APRACA-CENTRAB President, presented in her speech the two-faced Asia-Pacific region, where one can observe the renewed hubs of urban prosperity spurred by the growth of income and the expansion of the ranks of the middle class, on the one hand, and the face of poverty and the poverty-related consequences, on the other hand.

Ms. Corpuz said that rural poverty remains the greatest challenge to contend with in the Asia-Pacific region. APRACA, as a pioneering global rural finance association, with the support of IFAD and the training expertise of CENTRAB, APRACA's training arm, continues to stand at the forefront of the fight against poverty since rural finance is a vital tool for boosting productivity, income and the quality of life of the rural poor in the countryside. She also explained the role of ACPC in ensuring a more efficient and effective credit delivery in the Philippines. She likewise stressed the importance of microfinance institutions in servicing the needs of poor households and microenterprises. She said that she hoped the meeting will forge the partnership and cooperation needed to launch not only the second wave of rural finance reforms but also the renewed campaign for equitable and sustainable progress in the Asia-Pacific region.

Dr. Ganesh B. Thapa, IFAD Asia Division Regional Economist, introduced IFAD rural finance policy and its re-engagement with APRACA in the area of rural finance. He said that one of IFAD's strategic objectives is to provide improved financial and related non-financial services to the poor in the rural areas. He emphasized that over the last two and half decades, IFAD has promoted a number of innovative rural finance approaches in Asia and the Pacific, in collaboration with governments, banks, NGOs and other partners.

Mr. Thapa said that based on the past successful collaboration with APRACA, IFAD welcomes the opportunity to work with APRACA in implementing the FinPower Program, which aims to promote the financial empowerment of the rural poor in countries of Asia and the Pacific through policy dialogue, innovative pilot programs, and knowledge sharing among major actors in the rural finance sector.

Mr. Benedicto S. Bayaua, Secretary General of APRACA gave a brief introduction of the APRACA FinPower Program where he explained that IFAD provided a five–year technical assistance grant to assist APRACA in its role of promoting the financial empowerment of the rural poor in Asia-Pacific countries.

He said that the activities undertaken by the program will further consolidate rural finance knowledge and replicate successful approaches among beneficiaries in the Asia-Pacific region. He said that the APRACA Regional CEO Dialogue Forum on Creating Conducive Rural Finance Policy Environment and Regulatory Framework is the first activity under the Finpower program. He encouraged the active participation of the delegates in the forum for a fruitful and enriching exchange of ideas and experiences.

Ms. Usha Thorat, Deputy Governor of the Reserve Bank of India, in her vote of thanks, emphasized the importance of providing affordable financing services to the poorest of the poor. She said that dealing with the issue of rural poverty is a challenge to the APRACA member countries. She highlighted the significance of the forum as a venue for exchanging ideas and information and adopting suitable policies in order to provide the necessary financial services to those who need it the most at the lowest possible cost.

V. HIGHLIGHTS OF THE CONSULTATION

Ms. Jocelyn Alma R. Badiola, Deputy Executive Director of ACPC and the forum facilitator, presented the forum mechanics. She explained that, in terms of creating conducive and enabling rural finance policy environment and regulatory framework, the basic questions to be answered are:

- How far have we gone?
- What is slowing us down or preventing us from getting there?
- What needs to be done further?

Ms. Badiola said that every country should have an enabling policy environment and regulatory framework that will encourage financial institutions to lend and at the same time sustain lending so that specific sectors will be able to access or continue to have access to credit and other financial services from these institutions. She explained the order of the country paper presentations (see **Annex 3 for the Edited Country Papers**).

The following are the major country rural finance and microfinance highlights as drawn from of the oral and written presentations of delegates from member institutions:

RURAL FINANCE SITUATION

All the participating member institutions recognize that appropriately-designed financial services are an essential component of the enabling environment for rural economic growth and poverty reduction. Access to working capital or investment credit can substantially accelerate the adoption of modern agricultural technologies and production patterns which improve the ability of the rural sector to provide for the subsistence needs of the poor, produce the surplus in primary and intermediary products required for urban consumption and export, and avoid environmental degradation. Suitable credit products can also attract entrepreneurs to avail of financing services and take advantage of investment and/or income-generating opportunities.

The **Cambodian** banking system started in the early 1990s when the government launched the economic reform program from a centrally planned to a free market economy. Reform programs have been introduced and good progress has been achieved in regulating and supervising banks and microfinance institutions.

Most rural financial operators in Cambodia have been transformed from non-government organizations (NGOs) that were involved with humanitarian work amongst refugees in the Thai border. After the Paris Peace Accord in October 1991, the refugees had returned home.

With the passage of time, NGOs have redefined their roles in terms of interventions in the microfinance development process. NGOs have been involved in virtually every sector of the economy including microcredit programs and savings. Microcredit is the most active service due to banking services of commercial banks being limited in urban areas, and rural people are unable to receive such services, especially loans from the banks. Main practical rural financial services are individual loan, group loan and savings from members.

In response to the huge need for microfinance services, many Microfinance Institutions (MFIs) have engaged in providing these kind of services. In 2006, Cambodian microfinance has grown remarkably. This growth makes a significant contribution to economic development and poverty alleviation. With its credit and savings services, MFIs help people, especially the poor to relieve their family burdens and improve their livelihood to some extents. Currently there are 17 licensed microfinance institutions, 26 registered rural credit operators and around 60 NGOs freely operating in the whole country.

The Royal Government of Cambodia has committed to the development of rural finance since it is a key ingredient for sustainable economic development, particularly rural development, and for alleviation of poverty. In addition, the government has announced 2006 as the Year of Microfinance of Cambodia and it always supports the development of this sector through the introduction of policies and creates a favorable environment for further growth.

The government is also considering giving priority to the agricultural sector development in order to improve people's living standard and to reduce poverty. Today, the government is even putting more effort into building up an adequate legal framework, infrastructure, and investment incentives for the agro-industrial sector; farmers training in theory, practice, and technology transfer.

Rural finance and microfinance are still at an embryonic stage in **Lao PDR**. Outreach is still limited, and the poor in particular have little access to formal financial services. Rural finance technology is not yet well developed. For Lao PDR, its financial sector is small and dominated by the state-owned commercial banks. The commercial bank's attention toward rural areas is very limited. The Agricultural Promotion Bank (APB) with its mandate to promote agriculture is the bank most engaged in delivering financial services in the rural areas. There are three main types of microfinance organizational forms present in the Lao PDR. These are: Microfinance Institutions (MFIs), licensed and registered operating under Bank of Lao PDR (BoL) regulations; Savings and Credit Unions (SCUs) operating under BoL regulations; and Village Savings and Credit Groups (VSCGs) and Village Revolving Funds (VRFs), not operating under BoL regulations.

In **Indonesia,** on the other hand, Bank Rakyat Indonesia (through its Unit Desa -BRI Unit) and Rural Banks are the leaders of microfinance that serve the rural areas. Other microfinance interventions that are currently being undertaken by Indonesia include the Permodalan Nasional Madani, a state-owned entity managing microcredit and SME lending programs and microfinance families such as the village credit agency, saving and credit cooperatives, credit unions and rural fund and credit institutions. The success of BRI's Unit Desa systems can be attributed primarily to the fact that the system has adhered to the fundamentals of banking and finance for the rural microentrepreneurs, including the provision of competitive savings services. The BRI, through its microfinance operations, has generally achieved its strategic goals of providing appropriate loan products for microentrepreneurs; diversifying the bank's portfolio to reduce risk; and maximizing the performance of its branch network as well as providing financial services to a broad cross-section of the population.

In **Iran,** as the only specialized bank in the agricultural sector, Bank Keshavarzi has played a key role in the growth of the sector during the past 70 years. It can also be claimed that the extensive operations of the bank has made effective contributions to achieve self-sufficiency in crop production and to develop non-oil exports.

In the **Philippines,** rural finance/microfinance delivery systems can be viewed at two levels: wholesale and retail. The main players at the wholesale level include the Land Bank of the Philippines, the Development Bank of the Philippines, the Rural Credit and Guarantee Corporation, the People's Credit and Finance Corporation, and Small Business Corporation. Those that provide rural finance/microfinance services directly to clients include: rural banks, NGOs and credit cooperatives. The Bangko Sentral ng Pilipinas (the country's central bank) classifies banks engaged in microfinance into two broad categories: (a) microfinance banks and (b) microfinance-oriented banks. Microfinance banks are those whose loan portfolios are 100 percent microfinance loans. On the other hand, microfinance-oriented banks are those banks whose microfinance loans comprise at least 50 percent of their gross loan portfolio. The rural financial market in the Philippines has gone through various stages of development and experience – from a policy environment characterized by credit subsidies, credit allocations and loan targeting in the seventies; a liberalized and deregulated financial markets starting in the eighties; the resurrection of subsidized credit programs in the mid-nineties; and a rebound of financial reforms through the Agriculture and Fisheries Modernization Act starting 1998 up to the present.

In **Nepal,** the microfinance practices of the organized sector that are prevailing in the country can be grouped broadly into seven microfinance models: Grameen Model (Grameen Bank and replication); Small Farmers Co-operative Model (SFCL's of ADB/N); Financial Intermediation by NGO's Model (FINGOs); Priority Sector and Deprived Sector Credit Model (Directed Lending for Commercial Banks); Savings and Credit Co-operative (SACCOS) Model (RSRF's POs and registered SACCOSs); Project-based Microfinancing Model (PFIs); and Wholesale (RSRF, RMDC and SKBB) Model for Microfinance. At present, there are six major donor-funded microcredit programs that are running in the country. They are: Production Credit for Rural Women (PCRW); Microcredit Project for Women (MCPW); Poverty Alleviation Program in Western Terai (PAPWT); Third Livestock Development Project (TLDP); Community Ground Water Irrigation Sector Project (CGISP); and the Rural Microfinance Project. Parallel with government's efforts to establish a network of rural financial service providers in the early 1990's, the private sector also came forward to serve as financial service providers. These providers included formal cooperatives (savings and credit, and multi-purpose cooperatives), NGOs, savings and credit organizations and international non-governmental organizations. An emerging rural financial product is their Remittances and Loans for Migrant Workers.

In **Myanmar,** the financial system is composed of the Myanmar Agricultural Development Bank, other state-owned banks and private banks. However, these banks have yet to engage in microfinance for rural clients because of their perception that providing microfinance to the poor is a risky endeavour. Hence, much of their activities are focused on commercial or business loans.

Sri Lanka's rural finance sector includes savings, credit insurance and payment services delivered by Cooperative Rural Banks, Regional Development Banks, the National Development Trust Fund, the Samurdhi Banking Societies and the SANASA Thrift sociities. However, the sector remains fragmented and the institutions suffer from weak governance, poor repayment rates, high transaction costs, weak supervision and recurring losses. Being a State-owned Bank, the Bank of Ceylon (BoC) recognizes the important role it has to play within the scope of its national commitment and social responsibility. BoC extends full backing and co-operation to the Government's new approach towards accelerated national development. The implementation of novel schemes like the Gamata Naya (credit to villages) and Sookshma (a new microcredit scheme) are producing excellent results.

In **Thailand,** the Bank for Agriculture and Agricultural Cooperatives (BAAC) has successfully developed a loan mechanism that aims to increase access of farmers to financial services. The mechanism includes the following: non-collateral lending through joint liability groups or JLG; peer monitoring through; flexible repayment schedule, such as annual repayment and calculation of interest rate base on the date of repayment; simple and quick procedure for the loan disbursement; and progressive lending based on the repayment performance. The introduction of the JLG mechanism has been primarily responsible for the development of BAAC as an efficient and effective lending institution for small farmers and fishermen. BAAC has utilized JLGs to help in loan screening and peer monitoring on timely repayment. BAAC is able to cover the financing needs of more than 95 percent of all agricultural farm households in the whole country.

In **India,** rural financial institutions (RFIs) including cooperatives have the greatest potential to serve as MFIs for the poor. The National Bank for Agriculture and Rural Development (NABARD) has played a big role in expanding the APRACA linkage banking concept by linking self-help groups (SHGs) to banks and microfinance institutions, with non-governmental organizations providing finance-related and non-financial services to SHGs. Authorities, thus, deem it important to take appropriate steps in strengthening RFIs. India's credit market is characterized by an excellent financial infrastructure with a wide network. However, the government has intervened heavily in the banking sector with policies for bank branching, mandatory quotas, and below-market interest rates.

Poverty alleviation is the lynchpin of India's rural finance policies. Thus, the government has embarked on subsidized credit programs, the most notable of which are the "melas" in which large volumes of funds were imprudently issued as subsidized loans to weaker segments of society with loan waivers offered until 1991. India also implemented the Integrated Rural Development Program. Under the Program, loans were made through the banking system at subsidized interest rates to those belonging to the low income strata of society. In addition to the loans, a cash subsidy was paid to borrowers.

In **Malaysia,** microcredit is being provided through government funding. Bank Negara Malaysia, the Malaysian Central Bank, is the institution tasked to ensure a sustainable and commercially driven microfinance industry. Because of the need to address the increasing demand for microfinance services, development financing institutions (DFIs) are being transformed into microfinance institutions. DFIs are under the regulation and supervision of Bank Negara Malaysia. Banks providing microfinance include the following: Amanah Ikhtiar Malaysia; Bank Pertanian Malaysia; Farmers Organization; Yayasan Tabung Ekonomi Kumpulan and the Usaha Niaga Nasional.

In **Vietnam,** microfinancing is provided by formal, semi-formal and informal sectors. The formal sector includes the Vietnam Bank for Social Policies, Vietnam Bank for Agriculture and Rural Development, Vietnam Postal Saving Company and the People's Credit Fund. The semi-formal sector, on the other hand, includes 57 international non-government organizations and 4 government-recognized microfinance organizations. The informal sector consists of the "Ho/Hui" (a popular form of rotating savings and credit associations (ROSCA)), relatives, friends, neighbours and other moneylenders.

POLICY ENVIRONMENT

Cambodia is one of the first countries to embrace full microfinance operations. It has adopted a market-oriented interest rate policy. Policy authorities in Cambodia are guided by the school of thought that since most sources of funds for MFIs are private funds, an interest rate cap could discourage growth because when microfinance operations are not profitable, there will be no further investments in this sector. Since it is market-driven, interest rates will be determined solely by competition in the market.

Interest rates on loans from informal sources in Cambodia are extremely variable, ranging from interest-free on many loans from relatives and friends to 10 percent per month and higher on those from traders and moneylenders. Despite high interest rates, borrowers continue to use informal services for a variety of reasons, including ease of the loans, flexibility in repayments, personal relationship, and lack of alternatives to access formal loans.

Besides policy formulation, Cambodia's attention has also been focused on the establishment and provision of appropriate support services in the rural areas. For instance, national and rural road systems have since been rebuilt in the remote areas. Better roads allow microfinance operators to enter and provide services at low costs which helps bring down interest rates. In addition, the construction of irrigation systems such as canals and ponds also contributes towards the increased capacity of microfinance borrowers to pay back their loans as they are able to increase their production and income. Other critical support services such as training on new farming technology including the correct use of fertilizers as well as proper animal feeding, have been given attention by the government in order to increase the creditworthiness of the poor.

With respect to the role of government, the government in **Cambodia** is not involved in microfinance operations or lending. Microfinance operators make their own credit decisions without influence from the government. However, the government promotes the transformation of NGOs into MFIs and the transformation of MFIs into commercial companies by setting simple conditions for them to comply with. Meanwhile, the Rural Development Bank (RDB), a specialized bank 100 percent owned by the government, has been established with the intention of receiving funds from every source to provide MFIs the capacity to grant micro loans.

In Cambodia, foreign investment is seen as a key requirement to allow the sector to expand quickly enough to meet the needs of the expanding Cambodian economy. Foreign owned MFIs or MFIs with foreign investment either debt or equity must meet the same prudential supervision requirements as domestically owned MFIs. The microfinance sector in Cambodia is at an early stage of development and therefore, deposit taking is very limited, usually only compulsory and staff savings.

The Asian Development Bank (ADB), however, has conducted a survey on micro savings in some potential provinces. The outcomes of the survey have shown that rural people are willing to save. Based on this result, the NBC will carefully prepare a regulation governing deposit taking institutions by setting up a complete set of criteria to evaluate the qualification of MFIs. Finally licenses will be given to those who meet the criteria as Deposit Taking Institution (DTI) .

MFIs transforming from NGOs have continued their tradition of lending to solidarity groups, which are not required to put up collateral. Lending to individuals requires collateral when there is no trustworthy guarantor. For local private MFIs, the majority of loans have been lent to individual clients with the required collateral. There are no restrictions on where MFIs may borrow from, domestic or international sources. Their ability to take deposits from the public is, however, tightly restricted by regulation. The effect is that nearly all the funding for MFIs is sourced from foreign entities. Local banks, generally will not lend to MFIs because they do not have assets that meet the bank collateralization criteria. MFIs are actively encouraged to open branches to both increase the outreach to the poor and to increase competition. Branch growth is only limited by the overall prudential ratio applied by the NBC and the capabilities of the MFIs own management and human resources.

In **Lao PDR**, microfinance entities are also free to set its own interest rates for loans and deposits in order to allow them to cover their costs and have a reasonable profit margin.

The deregulation of interest rates in **India** is a result of their past experience that limiting interest rates did not allow banks, particularly cooperative banks to recover their costs and gain sufficient margins in their lending operations. Thus, State Cooperative Banks (SCBs) and District Central Cooperative Banks (DCCBs) have been given freedom to determine their lending rates.

In **Nepal,** the Central Bank has also adopted the policy of deregulation of interest rates which has led to variations in interest rates charged on microfinance loans. In **Nepal,** there are no clear policies established with regards to the deposit-taking activities of microfinance institutions. For instance, while Section 47 of the Clause of the Banking and Financial Institutions Act (BAFIA) 2006 indicates that microfinance institutions are allowed to accept interest bearing or non-interest bearing deposits within the limit issued by the Nepal Rastra Bank (NRB), Clause-B of the same section of BAFIA provides that, these institutions can mobilize savings among their group members but not among non-group members.

In terms of the area of business operation and branch expansion, microfinance instituions are given autonomy to expand, close or merge their branches within the approved geographical working area. However, the bank should seek prior approval from NRB before expanding. The opening up of a new branch should be based on the Business Plan approved by their respective Board.

Similarly in **Korea,** interest rate is also market-determined. However, to minimize great variations on the level of interest rates, an Interest Rate Coordination Committee is in place to adjust the rates among cooperatives.

In the **Philippines,** the government initiated a set of financial policy reforms in 1981 which deregulated interest rates and gradually removed credit subsidies. The Central Bank rediscounting window, which served as the mechanism for preferential credit allocation was also closed. By the late 1980s, the Central Bank has moved out of development financing, having turned over to the Land Bank of the Philippines the implementation of the World Bank-funded Agriculture Loan Fund (ALF). The use of market-based interest rates was adopted as a policy. In November 1994, the Bangko Sentral ng Pilipinas (BSP), which replaced the CBP, issued a circular lifting the ceiling on lending rates for rediscounted papers covering agricultural production, cottage and small industries and financing of working capital.

In contrast to these countries, the government of **Thailand** still regulates its interest rates on loans to the poor including small farmers and fishermen. The primary reason for such a policy is to give the poor more opportunities to engage in income-generating activities through cheaper credit. The development of the Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand, therefore, has been influenced by national policy interventions which have regulated the lending interest rates, limited target groups of BAAC, provided special privileges, and enforced the implementation of special programs. BAAC also provides small scale loans to farmers without collateral through the joint liability group concept.

In **Sri Lanka,** a microfinance entity is allowed to borrow from both domestic and foreign sources if they fulfill the necessary requirements. For instance, when borrowing from abroad, MFIs should demonstrate a sound financial statement for a period of three years. Collateral-free lending is not yet allowed, so that land, house and in some cases, small machinery are accepted as collateral. Moreover, foreign investment in the sector is not yet allowed by the government. With the implementation of the new Law on Commercial Banks, the situation can rapidly change which could result in more opportunities for foreign capital to come in and invest in the rural finance sector.

In **Myanmar,** however, the Central Bank of Myanmar has the only full authority of borrowing, with the approval of the Government, in any foreign currency on such terms and conditions as it considers appropriate, and also giving security for such loans. The bank, in turn, issues loans to State-owned agricultural organizations, livestock organizations, cooperative societies, private persons, joint ventures in cooperation with farmers, entrepreneurs and labourers for agricultural, livestock and rural socio-economic enterprises.

REGULATORY FRAMEWORK FOR RURAL FINANCE INSTITUTIONS

In order to ensure a sustainable microfinance system, **Cambodia** recognizes the need to further strengthen the National Bank of Cambodia (NBC) to maintain its effectiveness and efficiency in the regulation and supervision of the microfinance sector. At the same time, authorities would like to make sure that all institutions taking deposits are properly guided and oriented and thus, should be subjected to graduated regulatory requirements and supervision based on the size and type of activities. There should also be a common standard for reporting in order to allow for sound financial performance analysis and information dissemination and consequently, help promote the sector's growth.

The NBC has also started to issue and amend regulations in order to help NGOs become registered and licensed MFIs. After receiving license and registration certificates, these institutions are subjected to NBC's regulation and supervision. Since 2002, the NBC has started to issue licenses and registration certificates to qualified NGOs. By the end of 2006, about 17 institutions have become licensed MFIs and 26 registered as rural credit operators. Majority of these institutions were former NGOs and the others, local private companies.

In **Indonesia,** there is no comprehensive legal framework, or a law that regulate the wide type, range and spread of MFIs. In fact, there are many types of MFIs in Indonesia that are operated without any legal basis. Commercial banks, however, have microfinance windows, and the largest by far is the unit-desa system (BRI Units) of BRI, a major State-owned bank (now transformed into a publicly listed company).

In **Lao PDR,** the commercial banking industry has three principal groups: first, the State-owned commercial banks which include the a) Banque pour le Commerce Exterieur Lao (BCEL), b) Lao Development Bank (LDB), c) Agricultural Promotion Bank (APB) and the d) new Nayoby Bank (Policy Bank, which does not accept deposits from general public); second, the joint-venture and private banks such as the Joint Development Bank, Vientiane Commercial Bank, which now has a partnership with ANZ Bank, Lao-Viet Bank and the new 100 percent Lao private bank, Phongsavanh Bank; and third, the foreign commercial banks: six branches of Thai commercial banks, one Malaysian bank and the Standard Chartered Bank representative office. The Bank of Lao PDR (BoL), the regulatory and supervisory body, is regulated by Law No. 5 on the Bank of Lao PDR. Agricultural Promotion Bank (APB), the main provider of rural financial services, is regulated by a new Law on Commercial Banks, adopted by the National Assembly in December 2006. There is also Regulation No. 02/SB for credit cooperatives. Therefore, now, a regulation exists for each type of financial institution.

In **Nepal,** along with the economic liberalization policy, many banking and finance policies, rules and regulations have been worked out and modified in the last two decades. These include the removal of entry barriers to new banks including joint-ventures, (1984), lowering the level of statutory pre-exemption (May, 1986), deregulation of interest rates (August, 1989), authorizing commercial banks to take convertible currencies (July 1985), relaxation of credit ceiling rules (1989) and introduction of prudential norms related to risk-weighted capital adequacy requirement, accounting, income recognition, loan classification and loan provisioning and exposure (1989).

In **Myanmar,** in line with government's efforts to reform the financial system, laws relating to banking were promulgated in 1990 including: The Central Bank of Myanmar Law; The Financial Institutions of Myanmar Law and The Myanmar Agricultural Development Bank Law. These laws provided the: 1) legal framework for the operation of financial institutions, such as commercial banks, development or investment banks and finance companies; and 2) the establishment of financial institutions, whether private, state owned, or jointly owned by the state and private sector, to perform financial activities with the permission of the Central Bank. Moreover, these laws require all existing State-owned commercial banks, along with newly emerged private banks, to engage both in domestic and foreign banking services. These laws likewise specify the functions, duties and powers of financial institutions, and regulatory provisions to be observed by the financial institutions.

Sri Lanka's financial system remains subject to extensive government influence but has been growing rapidly since the government started pursuing privatization and liberalization policies. Regulations are largely consistent with international standards, but supervision and enforcement are insufficient. Foreign investors are free to access domestic capital markets, and the government allows 100 percent foreign ownership of commercial banks, insurance services and stockbroker services. At present the Social Service Department of Sri Lanka is empowered to grant permits for putting up microfinance institutions in the country.

In the **Philippines,** banks are generally supervised and regulated by the Bangko Sentral ng Pilipinas or the Central Bank. The basic law that paved the way for the creation of the favorable environment for banks engaged in microfinance is the General Banking Law of 2000. It recognized the special features and peculiarities of microfinance and mandated the BSP to issue appropriate implementing guidelines. The NGOs are required to register with the Securities and Exchange Commission as non-stock, non-profit organizations. They are not subject to prudential regulations. At present, there is no government agency that exercises supervision over the NGOs. The NGOs do not report to any oversight agency and hence, there is no single institution that has a complete set of relevant information on the financial performance of NGOs. The Cooperative Development Authority (CDA) is tasked to regulate cooperatives under RA 6539. However, the CDA has not been a fully effective regulator because of institutional weaknesses and its pre-occupation with another major objective which is to develop and promote the cooperative sector. Thus, the CDA does not supervise nor examine the books of credit cooperatives. To help build the architecture for the effective regulation and supervision of credit cooperatives, the National Credit Council prepared a standard chart of accounts, an accounting manual and set of performance standards for credit cooperatives called the COOP-PESOS.

The Philippines is actually one of a few countries with a well-defined policy and regulatory architecture for microfinance. The government through the National Credit Council has worked for the creation of a favorable environment. The National Strategy for Microfinance provides the policy framework for microfinance and is anchored on the following principles: greater role of the private sector/MFIs in the provision of financial services; an enabling policy environment that will facilitate the increased participation of the private sector in microfinance; market-oriented financial and credit policies, e.g. market-oriented interest rates on loan and deposits; non-participation of government line agencies in the implementation of credit/guarantee programs. The national microfinance policy framework, therefore, includes the following specific strategies: (1) in providing for a conducive policy environment: a) implementing a market-oriented interest rate policy; b) pursuing financial policy reforms with the end in view of removing existing distortions in the financial market; c) rationalizing all existing government credit and guarantee programs; (2) in establishing a market-oriented financial and credit policy environment which is conducive for the broadening and deepening of microfinance services: a) provision of appropriate supervisory and regulatory framework for MFIs which will enable them to engage in the development of new and innovative product lines and services appropriate to the demand for financial services/products by poor households and microenterprises; b) establishment of standards of performance and business practices to guide the operations of MFIs; c) promotion of broad-based savings mobilization, linkage banking technology and other microfinance technologies; d) provision of information and training on best practices in microfinance to MFIs; (3) in implementing a capacity-building program for MFIs: a) provision of technical assistance to MFIs with particular emphasis on local deposit mobilization; financial and project management; use of information technology; and development and establishment of microfinance technology, innovative product/service lines; b) documentation, packaging and dissemination to MFIs of practitioner-based training and technical services;

c) encouraging research and academic institutions to conduct studies, convene policy level discussions that will promote awareness of microfinance as a sound commercial investment.

The openness of Philippine authorities to a market-based rural financial market also led to the emergence of microfinance and the increased participation of financial institutions including non-government organizations (NGOs) and cooperatives in the provision of microfinance services.

In **India,** the Reserve Bank of India (RBI), the country's Central Bank, the National Bank for Agriculture and Rural Development (NABARD) and State Governments are the appropriate regulatory and supervisory authorities for Cooperative Banks and Rural Financial Institutions. Each State has enacted its own State Cooperative Societies Act which applies to Cooperative Banks. RBI continues to be the regulatory authority in formulating policies on interest rate structures on advances and deposits, as well as prudential norms and exercising powers that have been conferred on them by the Banking Regulation Act 1949 and RBI Act 1934.

Cambodia emphasized the need to provide rules and incentives to support banks and related institutions to do banking business in a safe and efficient manner, through (1) foundations of the financial system especially property rights, contract enforcement and dispute resolution mechanisms, (2) preconditions to effective banking operations and supervision especially a safe and efficient payment system, and (3) effective regulation and supervision of banks and similar institutions such as MFIs, money lenders and money changers. The recent establishment and official recognition of the Cambodian Microfinance Association (CMA) provides an opportunity for improved representation in the sector. CMA, in cooperation with other agencies, develops and disseminates policy options to improve dialogue, advocacy, and research and information exchange. CMA's role may be formalized in future legal and regulatory reviews of the sector.

Further links should be created between MFIs and NGOs dealing with the destitute. This will allow poor people who, through NGO support, become non-destitute and participate in the microfinance sector.

In **Cambodia,** the regulations issued by the NBC include criteria for licensing and registration, minimum capital requirement, solvency ratio, liquidity ratio, uniform chart of accounts, reporting requirements, and interest calculation. These regulations are consistent with the scope of work of the MFIs and support them in expanding their activities under an appropriate requirement. Commercial banks are governed by the Law on Banking and Financial Institutions and can carry out the following business activities: lending to the public with interest and receiving non-earmarked deposits from the public and providing means of payment.

The activities of commercial banks remain concentrated in the city and focused on big commercial and real estate transactions with multinational corporations. Poor people living in rural areas do not have access to loans or savings services from commercial banks. The commercial banks have neither the resources nor the possibility to expand their limited range of rural services because microfinance, especially rural microfinance, is a high cost and hardly profitable operation. Rural people have limited access to rural credit with low interest rates. Most NGOs provide loans to group members of the same occupation or type of business. In these cases there are few opportunities for loan diversification. Loans are usually provided on a six-month cycle basis. Most of the smaller NGO credit operators have compulsory savings requirements where members control group savings and use these savings to lend amongst themselves. Generally, rural credit and savings schemes are not viable due to the lack of savings and good savings services, excessive reliance on external financing in the form of grants or project financing, lack of professional management needed to handle saving and credit schemes, lack of an appropriate legal structure, and lack of external supervision.

In **Malaysia,** financial institutions are governed by the Development and Financial Institutions Act of 2002. Banks are regulated and supervised by Bank Negara Malaysia as well as by the respective ministries such as the Ministry of Finance and the Ministry of Agriculture and Agro-based Industries.

The cycle of rural finance policies across most of the participating countries has been almost identical. A common concern over food security and the strong presence of political interference initially drew governments in theses countries into supporting subsidy-laden programs for agriculture to increase productivity in the sector at whatever cost it may take. Except for Thailand, credit is supply-driven, there is strong government intervention, and credit interest rates are subsidized.

The bad experience with supply-driven credit policy gave rise to reforms in the credit market of these countries. Some of these reforms include: (1) market pricing of interest rates; (2) demand-driven allocation of loans; and (3) promotion of savings mobilization.

While most countries have started to cut down on credit subsidies and allow the market to determine interest rates, much is left to be done to sustain the flow of credit to rural and agricultural development.

Based on the country paper presentations and discussions, the following table shows the varying degrees of the presence of a conducive rural finance policy environment in the 15 countries which participated in the forum:

Countries with early stage of development	Countries with partial market-based policy environment	Countries with full market-based policy environment
Lao PDR	China	Indonesia
Myanmar	India	Philippines
Cambodia	Iran	
	Republic of Korea	
	Nepal	
	Japan	
	Malaysia	
	Sri Lanka	
	Thailand	
	Vietnam	

In terms of the presence of a regulatory framework, the following information can be observed:

With regulatory framework covering banks and all MFIs	With regulatory framework covering banks but not all MFIs
Thailand	Nepal
Lao PDR	Philippines
Cambodia	
Malaysia	
Myanmar	
Indonesia	
India	
China	
Iran	
Republic of Korea	
Sri Lanka	
Vietnam	
Japan	

VI. EMERGING ISSUES

1. Policy issues

In spite of the policy reforms already initiated in the different countries, the effective functioning of the rural financial markets continue to be constrained by such factors as the lack of structural reforms alongside the implementation of policy reforms and the unrelenting political pressures, resulting in the persistent adoption of lower-than-market interest rates in government lending, creation of more directed credit programs and continued adherence to mandatory lending polices for agriculture. With the growing number of rural financial institutions, it is imperative that these institutions should properly be monitored, supervised and coordinated. Accordingly, the NRB in Cambodia is formulating a National Microfinance Policy to address all issues and challenges including the regulatory and supervisory frame work relating to the microfinance sector. It is also creating a national microfinance development fund at the apex level from which MFIs can avail of whole sale loans for on-lending to targeted beneficiaries. There are suggestions to establish a separate institution outside the purview of the NRB which will supervise, monitor and regulate the various microfinance institutions of the country depending upon the size, capital and service areas of such microfinance institutions.

The policy issues identified during the forum include the following:

- **Sustainability of MFIs.** With the growing number of rural financial institutions, it is imperative that these institutions should properly be monitored, supervised and coordinated. The following recommendations were identified to improve the MFIs among the participating countries:
  - strengthening the existing MFIs
  - focusing funds on the right target and at the right time
  - supporting wholesale credit market
  - supporting the establishment of an MFI Association
  - facilitating the distribution of credit information, and
  - encouraging MFIs to use an information management system
- **Interest rate.** The microfinance sector charges higher interest rates than commercial banks, due to: high operation cost; high risk; lack of guarantee and collateral etc.
- **Limited source of fund.** Foreign grant to operators has been reduced and limited savings deposited in banks and other financing institutions have been minimal.

2. Institutional issues

Whilst the roles of the various bodies in supervision and regulation have been recognized, there is still considerable work to do in delineating roles and pursuing effective supervision and regulation. It is necessary to go deeper into the structural issues surrounding the sector, and to sequence the interventions to support the development of a well-functioning microfinance sector. Interventions to develop the Microfinance Sector will be diverse, but interdependent. There are a number of major issues which need to be addressed, and which affect the development of the sector directly.

- **Competition from informal sectors**. Develop a wholesale market for loan financing, operated within the private sector and linking the MFIs with the commercial banking sector. In Cambodia, for example, MFIs have difficulty in accessing credit in riel. A national wholesale payment system and money/interbank market should not only link the microfinance and banking sectors, but should also provide flexibility in the currency in which loans are provided. Additionally, linkages should be extended via measures that provide banks the opportunity to lend to, and work with, MFIs. This requires a lending approach that is based less on collateral and more on cash flow and accounts analysis. Interim guarantee measures that can offer security substitutes for collateral will be explored.

- **Lack of professional manpower and management info systems**. There is a need to improve financial institution operations — through human capital development, education and appropriate regulation and supervision. Many MFIs are already profitable and sustainable, and some progress has been made in this area. The support network for those MFIs, nevertheless, requires development, and their long-term sustainability will need that support. Again, this will be a continuing set of activities, in the future, which will be open-ended, as the sector responds to continuously-changing market realities.

The intensive interventions required to build capacity via training support is still a major priority. The training support is not just required for off-the-job training, but also for the development of capacity building structures within the MFIs and systems of needs identification, skills development and management succession. This will require the identification of a suitable institution which is prepared to expand into this field and to provide such support over the long term.

Updating and upgrading skills is a priority area which must be an ongoing feature of development, with institutional capabilities for training enhanced in line with the deepening of the financial system. As the boundaries of the financial system move outwards, so should skills development, through the development of institutional outreach capabilities in training provision.

Cambodia suggests the establishment of a training facility which can provide off- and on-the-job training for all levels within the microfinance sector. The training facility should establish a governing council for microfinance capacity building that includes the MFIs, both licensed and registered, to ensure that it meets the needs of the sector. It will develop off-the-job training courses and outreach capabilities to support the establishment of training management systems for effective on-the-job training in MFIs. This would include training of trainers; work task analysis; needs assessment; training, planning, budgeting and on-the-job delivery; appraisal methodologies; management succession training; and training recording systems. The training facility would operate as an integral, responsive part of the microfinance sector, funded by sustainable pricing of services.

- **Operational systems and delivery mechanisms** The MFPs have had limited interface with each other and with the dynamic regional and international microfinance industry. Thus, its exposure to international standards of performance in microfinance has been scarce.

- **Limited extension and infrastructure support services** Inadequate infrastructure development in rural areas, the concentration of industry and financial services close to the main ports and the airport, and the poor performance of the agricultural sector have led to an unequal distribution of the benefits of the economic growth.

  Marketing of agricultural produce becomes difficult soon after the peak harvesting period when market gluts bring down prices and deprive farmers of dependable incomes.

  Weak infrastructure (communications, electricity, transportation, etc.) and social services (education, health, etc.), limited client information (no personal identification or credit information), and low integration with complementary markets result in highly fragmented financial markets that involve high costs of overcoming information barriers and limit risk diversification opportunities.

- **Geographical dispersion in the rural areas** Low population density, small average loans, and low household savings increase the transaction costs per monetary unit of financial intermediation. Low population density in many countries means that financial services are spread across long distances. This makes it harder for financial service providers to reach people in a cost-effective manner.

- **Weak market linkages**. There is the need to link bank and microfinance through increased confidence in regulation, supervision and enforcement and developing appropriate financial infrastructure especially in terms of a national wholesale payment system, money/inter-bank markets including short term government securities, and improving financial information quality and transparency. There is a need for government to treat providers of financial services equally to level the playing field, avoid regulatory arbitrage and provide a progressive, developmental system for non-banks conducting banking type activities. It is a priority to support development of links between the commercial banking sector and the microfinance sector. The microfinance sector requires constant injections of liquidity to expand its activities, sustainable, into new areas. As new products are developed, further liquidity will be required to service the markets.

- **Inherent risks** – There is a need to identify and address risks in agricultural lending. Natural disasters, limited market base for local agricultural products, seasonality of agricultural activities and long maturation periods for others all contribute to the unevenness of farming incomes, that makes demand and payment for loans and the whole agric-credit business unpredictable and erratic.

  Risks linked specifically to floods, drought, pests and diseases, price fluctuations, and limited access to suppliers and markets heighten the probability of covariant risks (in prices and yields). These risks can also hit many poor households at the same time, with a potentially devastating impact on the financial service providers. In low-income areas, these risks are even higher.

Lack of usable collateral, ill-defined property and land-use rights, costly or lengthy registration procedures, and poorly functioning judicial systems in poor rural areas mean that reliable collateral is rarely available.

- **Decentralization** There is a need to support other forms of microfinance institutions including those that are community-based and non-registered, etc. to broaden the types of needs being met, and introduce greater variety and flexibility into the system. Again, treating providers of similar financial services equally — will level the playing field, avoid regulatory arbitrage and provide a progressive, developmental system for non-banks conducting banking type activities.
- **Credit Pollution** Emerging credit pollution detected by MFIs themselves particularly on cases of 'over borrowing' by some of their borrowers.
- **Risk-based Supervision** Personal circumstances of the clientele, use of informal financial information, cash-flow based lending and non-traditional loan collection techniques create different types of risks.
- **Need for New Standards** Imposition of new BASEL standards; national government should implement programs that will promote lending to the sector, including implementation of guarantee programs.

VII. FORUM RECOMMENDATIONS

The conducive policy environment and regulatory framework for rural finance are prerequisites for the development of viable, sound financial institutions in cooperative, public and private sectors, that serve the demands of the rural poor. A conducive policy framework includes among others, macroeconomic stability, deregulated interest rates, autonomous financial institutions and regulatory authorities, functioning prudential regulation and due legal process. This also facilitates the identification of areas and strategies for sustaining a competitive economy.

In spite of significant differences, participating countries have taken an almost uniform path to rural finance development.

Through the unifying force of organizations like the APRACA, most of the member-countries have, in varying degrees, liberalized and deregulated financial markets, adopted open branching policies, evolved innovative financing schemes, and — in view of the growing popularity of microfinance — defined regulatory framework and standards for microfinance institutions (MFIs).

Among the proposed plan of actions identified to address the problems hindering the expansion of financial services to poor households are the following:

(1) Study structural risks associated with the MFIs, in terms of governance and ownership and how this will work in the agriculture sector. There is a pressing need to identify and define microfinance markets in each of the participating countries in terms of definitions — geographically, sectorally, in size and in scope to address the issue of sustainability. In line with this, there is also a requirement to define and elaborate on the scope of alternative financing sources at the local levels (moneylenders, family, friends, village banks, cooperatives, etc.). This will serve as the basis for MFIs in their product development and for the government in making the appropriate policies.

(2) Improve the provision of management information systems (MIS) for MFIs. At present, the quality of software and systems varies considerably, with some MFIs unable to access integrated accounting and loan portfolio systems, while others have very expensive and effective systems. Create capabilities to support other forms of microfinance institutions i.e. community-based, non-registered, etc. to broaden the types of needs being met, and introduce greater variety and flexibility into the system.

(3) Establish credit information systems/credit bureaus as well as MFI capacity ratings systems, based on commercial ratings support and credit information exchange. The information exchange should include both positive and negative information.

(4) Develop credit policies based on international best practices. Expansion of microfinance services can only be effective if all parties play a role – with the government initiating an improved legal

framework following international best practices and an improved national microfinance policy that phases out unsustainable microfinance programs. There is a need for the government/policymakers to learn from the best practices of successful rural lenders who have found a way to deal with the factors that constrain the provision of financial services in the rural areas. Hence, the need to document and replicate success stories, innovations and best practices.

(5) Build up an effective organization and management capacity for microfinance institutions. Efficient financial intermediation leads to more efficient resource allocation, increased yield in capital and higher output growth. Conduct of continuous institutional capacity building activities for coops, FIs, and MFIs is necessary.

(6) Conduct dialogue/workshops or financial education or credit counseling on policy regulations focusing on interest rates, transaction costs, savings mobilization, risk management, credit insurance, delivery mechanisms including remittance system of member countries and meeting the needs of modern agriculture-supply chain financing.

(7) Develop a brief for political leaders on the rules and regulations governing microcredit highlighting issues on microfinance. There is a need to strengthen partnership between the national and local governments, and financial institutions for financial inclusion.

(8) Pursue with more vigor the setting up of an APRACA Fund to support fund-deficit member countries.

RURAL FINANCIAL SYSTEM IN CAMBODIA

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OVERVIEW OF THE CAMBODIAN FINANCIAL SYSTEM

- **Brief Background**

The Cambodian financial system started in the early 1990s after the government launched an economic reform program. The most advanced financial sectors are banking and microfinance which have been regulated and supervised properly after the adoption of the Law on Banking and Financial Institutions in November 1999. The purpose of the reform is to issue a new series of prudential regulations to set up criteria for licensing to permanent shareholders identification and strengthening the capital base. As the result, 16 banks stepped out of the system.

The Cambodian banking system consists of the National Bank of Cambodia (NBC), banks and MFIs. At present, there are 20 banks, consisting of 15 commercial banks, 5 specialized banks and 2 foreign banks' representative offices. Among the 15 commercial banks, 10 are locally incorporated, 2 are subsidiaries of foreign banks and 3 are foreign banks branches. Of the 10 locally incorporated banks, 5 are wholly foreign-owned, 4 are wholly domestic-owned, and one is a joint venture. Four out of 5 specialized banks are locally owned and one state-owned.

In addition, there are 17 licensed MFIs, 26 registered credit operators, and around 60 small unregistered NGOs operating in the rural areas.

The Cambodian banking system can be characterized as follows:

- dollarized and cash-based
- insufficient network of financial service providers
- absence of inter-bank/money market
- absence of a national payment system

- **National Bank of Cambodia**

The NBC is the central bank of the country. It is governed by the Law on the Organization and Conduct of the NBC promulgated in 1996. This Law provides NBC an independent autonomy status to carry out its operations. Its main duties and functions are to act as monetary authority, to act as the sole issuer of national currency of the country, to act as supervisory authority of the banking and financial system, to oversee the payment system of the country and to manage the international reserves of the country.

- **Commercial Banks**

Commercial banks are governed by the Law on Banking and Financial Institutions and can carry out the following business activities authorized by law: lending to the public with interest including leasing operations and commitment by signature, receiving non-earmarked deposits from the public and the providing means of payment.

Until 2000, there were 31 commercial banks under the supervision of the NBC. The banking system was concentrated in Phnom Penh, with only six banks having branches outside the city. The banking sector also includes many small banks, which are operating marginally. Most of these banks were not viable.

The activities of commercial banks remain concentrated in the city and focused on big commercial transactions, real estate and multinational corporations. Poor people living in rural areas do not have access to loans or to savings with commercial banks. The commercial banks have neither the resources nor the capacity to expand their limited range of rural services because rural microfinance operation is costly and is hardly profitable. Rural people have limited access to rural credit with low interest rates.

As at June 2006, the total assets of commercial banks was US$ 1.6 billion, of which loans amounted to US$688 million. Credit increased by 25 percent in 2005. Since 2004, the assets quality has increased and the non-performing loans only at 5.68 percent as of June 2006. Such improvement can be attributed to political and macroeconomic stability and the improvement of the soundness of the banking system.

RURAL FINANCIAL SYSTEM

The microfinance sector began in Cambodia in the early nineties. At first, this sector was developed by NGOs after the Paris Peace Accords in 1991. At that time, NGOs and donor communities had an important role to play in providing the poor with rehabilitation and reconstruction work.

The government gave first priority to its social sector development program for reducing rural poverty by using all means and resources to rehabilitate and develop the economy. Thus, the government considered the rural financial sector an important mechanism in reducing poverty and developing the economy, because the rural financial sector increases and expands business and productivity by generating income that upgrades people's living standards.

However, despite the economic success during the last decade, Cambodia remains the poorest country in East Asia, with an estimated annual GDP per capita in 2005 of about US$497. Social indicators are low, while poverty rates are high, particularly in the rural areas. The economy has a small industrial base and depends heavily on subsistence agriculture. About 80 percent of the population live in rural areas, where production contributes about 31 percent of the GDP.

Even though the banking sector has grown quickly, the country will always need to use microfinance. It is the sole means of allowing farmers to have access to credit; otherwise, they would borrow money from the informal credit market, which charges very high interest rates.

Of the 15 commercial banks, one bank (ACLEDA Bank) has transformed from an NGO operating microfinance into a specialized bank, and finally as a commercial bank. ACLEDA Bank has the largest network among commercial banks, with branches both in the cities and in remote areas of the countryside.

- **NGOs as micro operators**

There are about 90 NGOs supplying credit to the rural areas, seven of which play a significant role. International NGOs have established local NGOs in order to create continuity of its programs in Cambodia. Many local NGOs are supported by international entities, which provide management guidance and financial support for institutional building and credit for revolving funds.

Most NGOs provide loans to group members of the same occupation or type of business. Hence, there are very few opportunities for loan diversification. Loans are usually provided on a six-month cycle. Most of the smaller NGO credit operators have compulsory savings requirements, where members control group savings and use these savings to lend among themselves.

NGO credit operations are frequently integrated with other programs such as health, education and community development.

- **Informal sector**

According to the 1996 socio-economic survey in Cambodia, approximately 704,000 rural households took loans with a total value of about US$120 million during the period 1994-1995. About 54,000 of them obtained loans from traders, 114,000 from moneylenders, 400,000 from relatives, and 114,000 from friends and neighbors. Of the remaining loans, 7,000 came from banks and 71,000 from NGOs.

- **Microfinance institutions**

In 2000, the NBC started to issue and revise regulations in order to transform NGOs into registered and licensed MFIs according to their scope of operations. After receiving license and registration certificates, these institutions were regulated and supervised by the NBC. Since 2002, some NGOs have been licensed and some others have been registered. By the end of 2006, there were 17 licensed MFIs and 26 registered rural credit operators. The majority of them were transformed from NGOs, while others were from local private companies.

RURAL FINANCE POLICY AND REGULATORY FRAMEWORK

- **Rural finance policies**

The government has announced 2006 as the Year of Microfinance of Cambodia. Many actors applauded this innovative approach to rural development as relevant government ministries, development partners, and other stakeholders highlight the crucial role of microcredit in contributing to poverty reduction.

Significant progress has been made towards the first Cambodian Millennium Development Goal with a commitment to halve the proportion of people living below the national poverty line between 1993 and 2015.

Based on this aspect, the Royal Government of Cambodia is considering giving priorities to economic development, especially in the agricultural sector in order to improve people's living standard and to reduce poverty.

The government does not limit interest rates, especially the interest rates for microfinance. In the context where most sources of funds for MFIs are from private funds in the country and overseas, an interest rate cap creates an unfavorable environment for growth in this sector because when the microfinance operators are not profitable, they will not invest in this sector.

The government is not involved in microfinance operations or lending. Those operators are fully free in making decisions on their operations.

The government promotes the transformation of NGOs into MFIs and the transformation of MFIs into commercial companies by setting simple conditions for them to comply with.

Meanwhile, the Rural Development Bank (RDB), a specialized bank and fully owned by the government, has been established with the intention of receiving funds from every source to provide MFIs the capacity to grant micro loans.

- **Regulatory Framework: Regulation and Supervision**

The regulations issued by the NBC include criteria for licensing and registration, minimum capital requirements, solvency ratio, liquidity ratio, uniform chart of accounts; reporting requirements and interest calculation. These regulations are consistent with the scope of work of the MFIs and support them in expanding their activities under an appropriate framework.

A summary of these regulations is shown below:

- Criteria for licensing and registration: The identification of permanent shareholding, in particular the influential shareholders holding 20 percent or more of the capital.
- Requirement for being licensed: NGOs having loan outstanding of (Cambodian Riel = KHR) KHR 1,000 million or more or 1,000 borrowers or more.
- Minimum paid-up capital: KHR 250 million
- Liquidity ratio : 100 percent, compared to 50 percent for commercial banks.
- Solvency ratio : 15 percent of net worth
- Capital guarantee : 5 percent, compared to 10 percent for commercial banks.
- Reserve requirement : 5 percent, compared to 8 percent for commercial banks.
- Calculation of interest rate is based on the remaining balance of credit.
- Reporting requirement: monthly for licensed MFIs and quarterly for registered NGOs.
- Reports: Asset and liability statement, profit and loss statement, statement of deposit and loan classified currency and by types, loan classification, and branch network.
- Introduction of uniform chart of accounts of the NBC into the system (MIS).

- Annual license fee: KHR 1 million for each MFI with no fee for branch, with the purpose of promoting the expansion of branch network to reach poor people in remote rural areas.
- No fee for registered NGOs.

- **Deposit taking**

The microfinance sector in Cambodia is at its early stage of development and therefore, deposit taking is very limited, only a restricted amount of deposits, mainly compulsory and staff savings. The outcome of an ADB survey had shown that rural people have the willingness to save. Based on this survey result, the NBC will carefully prepare a regulation governing deposit taking institutions by setting up a complete set of criteria to evaluate the qualification of MFIs. Finally licenses will be given to those who meet the criteria for a Deposit-taking Institution.

MFIs, transforming from NGOs, have continued their culture of lending in the form of solidarity groups where lending does not require collateral. Lending to individuals requires collateral when there is no trusted guarantor. For local private MFIs, the majority of loans have been lent to individual clients with the required collateral.

Since NBC is promoting the growth of MFIs, the requirement for opening a new branch was not set, except for prior notice to the NBC. However, once branches are allowed to collect savings and, even more, on-lend them, then the NBC needs to supervise that these savings are managed securely (requirements on buildings, environment, security, vault, transport, etc.). As with the opening of bank branches, such MFI branches need to be properly licensed.

Since MFIs have developed, a savings mobilization trend has spread; but not yet at the desired level. At the end of 2006, MFIs had total deposits of US$2.6 million, which was equal to 5 percent of loan outstanding. To meet lending requirements, MFIs need to look for other sources of funding other than savings.

- **Borrowings**

There are no restrictions as to where MFIs may borrow, either domestically or internationally. However, their ability to take deposits from the public is tightly restricted by regulation. The effect is that nearly all the funding for MFIs is sourced from foreign entities. Local banks generally will not lend to MFIs because they do not have assets that meet the bank collateralization criteria.

- **Branches**

MFIs are actively encouraged to open branches to both increase their outreach to the poor and to increase competition. Branch growth is only limited by the overall prudential ratio applied by the NBC and the capabilities of the MFIs' own management and human resources.

- **Foreign investment**

Foreign investment is seen as a key requirement to allow the sector to expand quickly enough to meet the needs of the expanding Cambodian economy. Foreign owned MFIs or MFIs with foreign investment, either debt or equity, must meet the same prudential supervision requirements as domestically owned MFIs.

- **Disclosure of audited financial statements**

Moreover, the NBC is strengthening the implementation of the uniform chart of accounts for MFIs and the disclosure requirements in accordance with international accounting standards. The NBC is strengthening the management of the MFIs, as well.

- **Regulation and supervision**

To ensure the implementation of these regulations, the NBC conducts off-site supervision of reports regularly received and on-site supervision. Moreover, field visits are conducted to verify their activities when applying for a license or registration.

In addition to its supervisory activities, the NBC has encouraged MFIs to establish a professional association for microfinance, so that it can communicate with the NBC or other institutions to share views and to protect their interests.

Commercial private investment in MFIs is encouraged, as it can produce better performance. Local banks and the public are also encouraged to invest and deposit in them. But effective oversight of such investors is needed.

To implement law on banking and financial institutions and improve financial services in rural areas, NGO suppliers of financial services need to be licensed as MFIs by NBC. The purpose of the regulation is not to restrict their activities but to promote them. Regulation and licensing are necessary for MFIs that collect savings and deposits from their members, acquire long-term borrowing from foreign and local organizations and employ these funds to provide loans to rural areas.

A MFI must be registered and incorporated as a legal entity: as a company, cooperative or have a legal status according to the law. An MFI must obtain a license from NBC on application by submitting the required documents.

For the first time in 2000, NBC issued regulations on the classification of MFIs into three categories according to the level of their operations, and created criteria for licensing and registration. The obstacle preventing NGOs from transforming into MFIs is ownerships. At the beginning, it is difficult to identify the shareholders because funds used by NGOs to operate microfinance are granted by international donors. To overcome this, staff associations have established themselves as the owners of those funds, opening the way for NGOs to transform into MFIs.

The bigger MFIs must be licensed by NBC. The regulation is very similar to commercial banks, except that the capital requirement is substantially lower. The medium-sized MFIs are only be registered by NBC and are submitted to lighter regulation and in particular, reports sent to NBC are simplified. The smaller MFIs can operate freely with no requirement to be regulated and supervised due to high operating costs.

The banking supervisor should have appropriate powers and systems relating to supervisory approach, supervisory techniques, supervisory reporting, corrective and remedial powers, consolidated supervision, and home-host relationships.

The NBC has been working hard to improve supervision, but much work remains to be done. Key objectives include improvement of on-site and off-site supervision techniques; continued capacity building at NBC and in banks, development of NBC processes and information technology systems and judicial implementation and enforcement.

RURAL FINANCE TECHNOLOGY

The NBC has established procedures for licensing, regulating and monitoring MFIs. The NBC provides detailed guidance on the monitoring framework: compulsory registration and licensing conditions, loan classification and provisioning, liquidity ratio, reserve requirement and detailed reporting requirements for licensed MFIs (with registered MFIs being encouraged to provide data as much as possible).

For licensed MFIs, the requested standard input reports consist of a full set of reports aimed at checking performance and compliance with regulatory requirements. For registered MFIs and NGOs, the requested standard input reports are limited to a number of reports aimed at collecting information on MFIs prior and during their license application period. For licensed MFIs, the reporting requirement is monthly and quarterly for registered MFIs.

This framework enables the NBC to fulfil its monitoring objectives: preserving integrity of financial system and avoiding disruptions, promoting public confidence in the financial system, encouraging savings mobilization, protecting depositors, supporting best management practices and transparency and preventing fraud and illegal activities.

To ensure that the NBC can fulfil its objectives and implement the proposed monitoring framework, MFIs need to provide performance data on a regular basis. To help MFIs to provide the data in a structured and consistent way and to avoid errors and omissions, a data input and transfer system has been installed in the monitored MFIs. This manual assists the users of this input and transfer system.

As discussed above, while there are highly prescriptive requirements for MFIs to report to the NBC, there are no such requirements on the MFIs internally. There is a wide variation of practice between MFIs on how they actually perform their credit analysis and support. One of the results of MFIs having to borrow from international sources to fund their operations has meant that they have been forced to meet international standards of reporting, internal management reporting and transparency that meet the demands of international lenders, not only those of the domestic regulator.

There is no doubt that the MFIs would benefit from further development of information technology and human capital, but they must be at a cost that their businesses can support or have some form of support to assist in further development.

At present, as a result of rapid development, it is necessary to go further into the structural issues surrounding the sector, and to sequence the interventions to support the development of a well-functioning microfinance sector. Interventions to develop the microfinance sector will be diverse, but interdependent. There are a number of major issues which need to be addressed, and which affect the development of the sector directly.

The microfinance sector, itself, has grown since 2001, and has moved forward in many areas. Given the proven dynamism of the sector, the character of required interventions has changed, and there is a need, now, to re-identify, prioritize and re-schedule interventions, to reflect the developing needs of the sector.

Overall, the growth of the sector will be determined as much by internal performance factors as by external interventions. Also, the needs for intervention have changed considerably. Now, the type of intervention is of a more supportive nature to ongoing activities. Expanding the scope, growth and outreach of activities will arise from introducing new skills, new perspectives and new ideas, as well as introducing additional funding.

To optimize the microfinance sector's development and performance, and to provide prudential supervision to protect the more vulnerable in society from being unduly exploited, there is a requirement for imaginative and deliberate interventions which will generate growth and create the architecture to protect the interests of all involved.

It is also essential to identify those for whom the microfinance sector cannot offer services. The destitute, by definition, do not have assets or potential income generating activities. They therefore have no deposits, which they could make, or income by which they can repay any loans granted to them. If loans are provided, it places the destitute in a worse position than if they had not been provided with loans, since they will be placed under pressure to repay and will have debts which they never had before. The destitute can only be assisted via grants or free services and provided skills for livelihood to pull themselves out of their destitution and eventually enter the market for microfinance services.

RURAL CREDIT COOPERATIVES IN INDIA

Dr. Y.S.P. Thorat, Chairman, National Bank For Agriculture And Rural Development

INTRODUCTION

The formation and functioning of cooperative banks are different from those of commercial banks and Regional Rural Banks. Historically, cooperatives are organized on the basis of certain factors like helping people of certain community in villages, region, district, and state. While cooperatives have achieved the objective of serving its people, they are in crisis today because of mismanagement, competition, dual control, etc.

SALIENT FEATURES OF THE COOPERATIVE CREDIT STRUCTURE (CCS) IN INDIA

2.1 The rural Cooperative Credit Structure is organized into two broad streams, viz. the Short-Term Cooperative Credit Structure (STCCS), which traditionally provided short term loans for raising crops, and the Long-Term Cooperative Credit Structure (LTCCS), which catered to the investment credit needs of the farming community. Of late, this exclusivity is narrowing down as both the structures are purveying production and investment loans.

2.2 The STCCS is a federal structure, consisting of 112,309 primary agricultural cooperative societies (PACS) at the grass root level, 367 district central cooperative banks (DCCBs) at the intermediary or district level and 31 state cooperative banks (SCBs) at the provincial level. In North Eastern and smaller States, there are no DCCBs and SCBs purvey credit through its affiliated PACS.

2.3 The LTCCS, consisting of State Cooperative and Agricultural Development Banks (SCARDBs) at the apex level and PCARDBs/branches of SCARDB at the primary level operating in 20 states, provide investment credit to agriculture.

ROLE OF COOPERATIVES IN PROVIDING AGRICULTURAL CREDIT

The major players in the field of agricultural credit in the formal sector include the commercial banks (CBs), the regional rural banks (RRBs) and the rural cooperatives. In terms of number of outlets in the rural and semi-urban areas, cooperatives with a network of 124,355 outlets, have much larger presence than commercial banks and RRBs put together with 47,162 rural outlets. In terms of outreach i.e. number of borrowers financed cooperatives outperform the CBs and RRBs put together. However, CBs and RRBs exceed cooperatives in terms of total outstanding rural credit and also average loan outstanding per borrower. This is explainable as significant share of coop credit goes to small and marginal farmers.

Rural cooperatives, particularly at the primary level, provide, in addition to credit, non-credit services such as supply of agricultural inputs, marketing of agricultural produce, and distribution of essential commodities.

Despite their vast network and outreach, the market share of cooperatives in rural credit has been steadily declining. From nearly two-thirds during seventies, their market share came down to just about 21 percent. As on 31 March 2006, the share of cooperatives (both ST and LT) in ground-level credit to agriculture was at Rs 394 billion or a mere 21 percent.

STRENGTHENING THE CCS

- **Task Force on the Revival of Rural Cooperative Credit Institutions**

Concerned with the need for strengthening the cooperative credit structure in the country, the Government of India constituted a Task Force on the Revival of Rural Cooperative Credit Institutions in August 2004 to formulate a practical and implementable action plan to rejuvenate the rural cooperatives with the following Terms of Reference:

- to recommend an implementable action plan for reviving the rural cooperative banking institutions, taking into consideration, inter alia, the main recommendations made by various committees in this regard;
- to suggest an appropriate framework and the amendments which may be necessary for the purpose in the relevant laws;
- to make an assessment of the financial assistance that the cooperative banking institutions will require for revival, the mode of such assistance, its sharing pattern and phasing; and
- to suggest any other measures required for improving the efficiency and viability of rural cooperative credit institutions.

The Task Force had examined available literature on the subject including the work of the earlier committees and had discussions with 150 cooperators, officials and politicians from all over the country and arrived at the conclusion that, the structure is impaired in governance, managerial and financial fronts.

Impairment in governance

The impairment in governance is deep. The lower tiers are managed by the higher tiers in varying degrees and the function of conducting elections and auditing is vested with the State Government in most of the states. By implication, the cooperatives have lost their right to self-governance and have to look up to the State constantly for several of the functions that fall in the domain of the General Body and the Board of Directors.

The following points highlight impairment in governance:

- No elections have been held in the CCS units across all tiers for a decade or more in three States;
- Boards of nine out of 31 SCBs and 134 out of 367 DCCBs have been superseded;
- Most State Governments combine the roles of Dominant Shareholder, Manager, Regulator and concurrent Supervisor and Auditor;
- The Department headed by the Registrar of Cooperative Societies (RCS) can and does, influence administrative matters. The interference is in the form of supersession of Boards, appointment of administrators and assuming powers to approve staffing patterns, recruitment, emoluments, asset purchase pattern etc.;
- The Department also interferes in financial matters in various forms, like direction on interest rates, interference in loan decisions, announcement of waivers, and direct or indirect pressure on non-recovery of loans;
- The impairment is also because of politicisation of these institutions. The Directors on Boards of Cooperative Banks are involved in active politics;
- There are delays in the audit of primary level societies, which is pending for more than a year in at least 15 percent of the PACS. The quality of audit is also not up to the mark; and
- The audit classification of some banks in some States seems to suggest that the audited results do not depict a true and fair position of the banks concerned.

Impairment in Management

The impairment in the management of rural cooperatives is a direct result of the impairment in governance. The various forms of interference of State Governments include deputation of officials to top positions in many banks, setting up common cadres for senior positions in cooperatives across tiers, determination of staffing pattern, and interference in the operational decisions of the cooperatives.

The impairment in management is also owing to the following additional factors:

- Managers of PACS in several States are drawn from a common staff pool who do not feel accountable to the PACS. Remuneration often is without reference to business level or results;
- A generally ageing staff profile characterized by inadequate professional qualifications and low levels of training;
- Delineation of governance and management functions are unclear and the boards take up issues at operational level, thereby losing sight of long-term strategic issues; and
- Poor housekeeping, weak internal controls and systems.

The cumulative result is that members, who are mostly borrowers, have little or no sense of stake in the cooperatives, or any accountability in ensuring prudent management of funds. On the contrary, government policies (loan and interest waivers, delaying recoveries, the fact that loans carry State guarantees) encourage them to presume that they can with impunity, delay or even fail to meet their repayment obligations. Boards of management and their functionaries are not held accountable for laxity in granting and monitoring loans, poor quality of loan portfolios, high default rates and non performing assets (NPAs) and their adverse effects on the financial health and viability of the Societies.

Financial Impairment

While the large majority of SCBs were reporting profits during this period, more than 21 percent of DCCBs and more than half the PACS were reporting losses. About one in five SCBs and almost 37 percent of the DCCBs have eroded their net worth. Accumulated losses of DCCBs amounted to around Rs 32 billion in 2000-2001 and increased to Rs 48 billion in 2004-2005. As per the latest data available for ACS for the year 2002-2003, their accumulated losses were to the extent of Rs 46 billion.

Considering that the upper-tier cooperatives largely depend on the primaries for their business that the structure stands on very weak foundations. Current profits or losses, as reported, could be misleading, especially since some of the institutions that are making current profits have accumulated losses and that all of them may not have made the required provisions against their NPAs.

As on 31 March 2005, 6 out of the 31 SCBs and 136 out of 367 DCCBs were not compliant with Section 11 of the Banking Regulation Act, which means that they have completely eroded their net worth. The amount of deposits eroded (over and above the net worth erosion) at the DCCB and the SCB level in loss-making banks is also significant. The erosion of deposits was at Rs 35 billion at the level of DCCBs and Rs 1.5 billion at the level of SCBs. The data relating to the erosion of deposits in PACS is, however, not available.

The reason for the losses can be traced mainly to the overall business levels and poor recovery position of each of the tiers. The recovery percentages for the system as a whole have been continuously low, making the system unsustainable without external injection of resources.

While the recovery and NPA positions indicate the extent of reported impairment in the upper tiers, the figures at the primary level have to be viewed with caution, as there are no standard practices in respect of financial reporting.

The system is impaired partly because of high transaction costs at 1.45 for SCBs and 1.83 for DCCBs and high risk cost at 0.98 for SCB and 1.05 for DCCBs Transaction Costs and Risk Costs are expressed as percentage of Cost of Management. High transaction costs are because of lack of standardized business model irrespective of business volume, overstaffing in some cases and not linking salaries with business levels in others. High risk costs are because of low recovery levels.

The margins are also under pressure as DCCBs generally offer a higher rate of interest for attracting deposits. Deposit resources of PACS are limited and they depend on DCCBs for their lending. In spite of interest rates having been 'deregulated', lending rates are subject to limits set by the State Government. Lack of scope for cross-subsidisation compounds the problem. At the higher tiers, there has been over-exposure to certain sectors of agriculture, which increases the co-variance risks. Sugar, cotton and tea, for instance, are sectors where the primaries have an exposure at the farm level and the DCCBs and SCBs have an exposure at the processing unit level.

REGULATION AND SUPERVISION

The external regulation and supervision for the structure is not as stringent as it is for the commercial banking structure more particularly in the following aspects:

- Primary agricultural cooperative societies (PACS) are excluded from the scope of the Banking Regulation Act, 1949;

- The minimum capital requirement is only Rs 0.1 million for banks;
- The cash reserve ratio (CRR) requirements are lower than that for commercial banks;
- The Capital-to-Risk Weighted Assets Ratio norms have not been prescribed even for SCBs and DCCBs;
- All CCS units are, however, subject to submission of regular returns on their financial status and operations, the compliance of which is weak;
- The cooperative banks are open to periodic inspection by NABARD. The compliance with the supervision findings and regulations is, however, weak.

The central regulatory authority (the Reserve Bank of India) is naturally concerned at its inability to ensure that financial institutions comply with even the relatively diluted prudential norms applicable to them and to enforce punitive measures against banks that are in poor and deteriorating financial health. This may be attributed to three primary reasons:

- Dual control of cooperative banks by the RBI and the State Governments;
- Ambiguity on the precise jurisdiction of powers between the two; and
- Reluctance of the State Governments to enforce disciplinary sanctions by the RBI.

The provinces and, in some cases, the Union Government have not helped the regulatory authority. On the contrary, their actions (e.g., waiver of loans in 1989 by the Union Government, periodic waivers of interest and principal by the State Governments, delay in payments by the State Governments on promises made, their formal or informal instructions to delay or dilute loan recovery, and their unwillingness to facilitate recoveries under the Revenue Recovery Act) have contributed to an atmosphere that encourages defaults in payment and worse.

REMEDIAL MEASURES AND APPROACH TO REFORM

Recognizing the important role that the cooperative network can play in delivering credit to sections of the rural population, which cannot, or are unlikely, to be reached through commercial and rural banks, the Task Force concluded the cooperative credit structure needs:

- Special financial assistance to wipe out accumulated losses and strengthen its capital base;
- Institutional restructuring to make for democratic, member-driven, autonomous and self-reliant institutions;
- Radical changes in the legal framework to empower the RBI to take action directly in matters and to the extent deemed appropriate for prudent financial management of banks;
- Qualitative improvement in personnel in all tiers and at all levels through capacity building and other interventions, leading to an increase in overall efficiency;
- Recapitalization must cover all the tiers of the cooperative credit structure. Recapitalization and Restructuring of the intermediate and upper tiers without addressing the infirmities of PACS would defeat the objective of reviving and revitalizing the CCS;
- The Revival Package must include assistance for restoring the PACS to acceptable levels of financial health and measures to be initiated to enable PACS to evolve into democratic self governing and financially well managed institutions;
- Recapitalization must cover the aggregate erosion of capital in all the tiers of the CCS. Otherwise, partial recapitalization will place the entire resource support at risk; and
- Recapitalization may be limited to institutions that conform to standards of eligibility prescribed and the remaining non-viable, dormant and defunct credit cooperatives or banks may be closed or their future set up may be decided by way of mergers or amalgamation.

RECOMMENDATIONS

In its report submitted to the Government of India (GoI) in February 2005, the Task Force made the following recommendations:

- Extension of a financial package for cleansing the Balance Sheets of Short-Term Cooperative Credit Structure (STCCS) to bring them to an acceptable level of financial health;

- Introduction of legal and institutional reforms necessary for their democratic, self-reliant and efficient functioning; and
- Taking measures to improve the quality of human resources and operational efficiency through appropriate technical assistance.

The GoI accepted in principle the recommendations of the Task Force. The Task Force recommendations were extensively discussed with State Governments and a consensus was arrived at, based on which GoI approved a Revival Package for Short-Term Cooperative Credit Structure (STCCS). The Package has the following components:

Financial assistance

Covers cleansing of the balance sheets, support for minimum capital requirements, developing uniform accounting system and computerization. Funding of the financial package, estimated at Rs 135.96 billion will be shared by the Central Government, State Governments and the CCS based on origin of loss and existing commitments.

Legal and Institutional Reforms

The Revival Package also seeks to bring down the interference of the State Governments in credit cooperatives and envisages suitable amendments to the respective State Cooperative Societies Acts and Banking Regulation Act. Release of financial assistance under the financial package will be back-ended and linked to achievement of pre-defined benchmarks in respect of legal, institutional and regulatory reforms and will, therefore, be phased over a period of three years.

Technical Assistance

The technical component of the financial package will cover costs of training and capacity building to improve financial management skills of staff and board members; for installation of uniform accounting and monitoring systems; and for computerization.

SALIENT FEATURES AND CONDITIONALITIES OF THE PACKAGE FOR STCCS

Government of India: The GoI will provide its share as grants to cover

- 100 percent of accumulated losses arising out of direct credit business of PACS and agricultural credit business of DCCBs/SCB;
- a portion of losses arising out of non-agricultural credit business of DCCBs/SCBs;
- 50 percent of losses due to Public Distribution System (PDS) and Input Distribution of PACS;
- requirement of resources to raise Capital-to-Risk Weighted Assets Ratio to 7 percent; and
- Full cost of technical assistance for human resources development, common accounting system with computerization and implementation costs.

State Governments: The State Governments are required to bear:

- a portion of losses arising out of non-agricultural business of DCCBS/SCBS;
- 50 percent of the losses on account of PDS and Input Distribution of PACS; and
- 100 percent of unpaid invoked guarantees and other receivables from State Governments.

CCS units: The CCS will bear losses arising out of activities like direct advances taken up on their own and losses due to frauds. The actual magnitude of the share will be determined on the basis of special audits with reference to the financial position as on 31 March 2004.

LEGAL AND INSTITUTIONAL REFORMS

The Package seeks to bring down the interference of the State Governments in the credit cooperatives and suitable amendments to the State Cooperative Societies Act and Banking Regulation Act are proposed, as detailed below. These form part of the important conditionalities to be complied with under the Package.

AMENDMENTS TO STATE COOPERATIVE SOCIETIES ACT

- Ensuring full voting membership rights on all users of financial services including depositors in cooperatives other than cooperative banks;
- Removing state intervention in all financial and internal administrative matters in cooperatives;
- Providing a cap of 25 percent on government equity in cooperatives and limiting participation in the Boards of cooperative banks to only one nominee. Any state government or a cooperative wishing to reduce the state equity further would be free to do so and the cooperative will not be prevented from doing so;
- Allowing transition of cooperatives registered under the CSA to migrate to a parallel Act (wherever enacted);
- Withdrawing restrictive orders on financial matters;
- Permitting cooperatives in all the three tiers freedom to take loans from any financial institution and not necessarily from only the upper tier and similarly placing their deposits with any regulated financial institution of their choice;
- Permitting cooperatives under a parallel Acts (wherever enacted) to be members of upper tiers under the existing cooperative societies Acts and vice versa;
- Limiting powers of State Governments to supersede Boards;
- Ensuring timely elections before the expiry of the term of the existing Boards;
- Facilitating regulatory powers for RBI in case of cooperative banks as mentioned earlier; and
- Prudential norms including CRAR for all financial cooperatives including PACS.

AMENDMENTS TO BANKING REGULATION ACT

- All cooperative banks would be on par with the commercial banks as far as regulatory norms are concerned;
- RBI will prescribe fit and proper criteria for election to Boards of cooperative banks. Such criteria would however not be at variance with the nature of membership of primary cooperatives which constitute the membership of the DCCBs and SCBs;
- However, as financial institutions, these Boards would need professional support at the Board level. Thus, the RBI will prescribe certain criteria for professionals to be on the Boards of cooperative banks. In case members with such professional qualifications or experience do not get elected in the normal electoral process, then the Board will be required to co-opt such professionals in the Board and they would have full voting rights;
- The CEOs of the cooperative banks would be appointed by the respective banks themselves and not by the State. However, as these are banking institutions, RBI will prescribe the minimum qualifications of the CEO to be appointed and the names proposed by the cooperative banks for the position of CEO would have to be approved by RBI; and
- Cooperatives, other than cooperative banks, as approved by the RBI would not accept non-voting member deposits. Such cooperatives would also not use words like “bank”, “banking”, “banker” or any other derivative of the word “bank” in their registered name.

RELEASE OF FINANCIAL ASSISTANCE UNDER THE PACKAGE:

The release of financial assistance under the financial package will be back-ended and linked to achievement of pre-defined benchmarks in respect of legal, institutional and regulatory reforms and will, therefore, be phased over a period.

IMPLEMENTING AGENCY

NABARD has been designated as the Implementing Agency for the Package. Special Audits for determining the exact amount of recapitalization assistance for the units of STCCS are conducted under the supervision of NABARD. GoI grants are released through NABARD for recapitalizing the STCCS and for implementing the technical component (HRD initiatives, common accounting and computerization).

MONITORING

Implementation of the Package is monitored by Implementation and Monitoring Committees constituted by the GoI at the national level and by the State Governments (provincial) at the State (province) and DCCB Levels.

STATUS OF IMPLEMENTATION

- **Acceptance and execution of MoU**

Ten States, viz., Andhra Pradesh, Bihar, Gujarat, Haryana, Madhya Pradesh, Maharashtra, Orissa, Rajasthan, Uttaranchal and Uttar Pradesh have executed MoUs with GoI and NABARD for implementing the Package. Another 5 states viz., Arunachal Pradesh, Goa, Punjab, Sikkim, Tamil Nadu, and the Union Territory of Dadra and Nagar Haveli have accepted the Package in principle. The ten States in which the implementation is underway account for 62 percent of PACS and 70 percent of DCCBs in the country.

- **Special Audits**

NABARD has imparted training to about 600 master trainers in different participating States, who in turn have trained grass-root level auditors in the conduct of special audit for assessing the extent of accumulated losses and financial assistance. Special Audits of PACS have commenced in Andhra Pradesh, Haryana, Maharashtra, Rajasthan, Orissa, Uttaranchal and Uttar Pradesh. Audit has been completed in the State of Rajasthan.

- **Co-operative Reforms**

The State Governments of Andhra Pradesh, Gujarat, Haryana, Madhya Pradesh, Maharashtra, Orissa, Rajasthan, Uttaranchal and Uttar Pradesh have initiated steps for amendment of respective State Cooperative Societies Acts, to give effect to the reform measures under the Package.

- **Uniform Accounting System and Training for PACS**

NABARD is working on developing a Uniform Accounting System for PACS. An internal committee set up by NABARD is preparing training modules, materials and strategy for training of the PACS staff, Board Members, etc.

- **Financial Arrangements**

The GoI has released an amount of Rs 4 billion to NABARD for the Revival Package. ADB and KfW have sanctioned a loan of $1 billion and $150 million respectively to GoI for financing the Package. The GoI is in negotiation with the World Bank for a loan of $600 million. Thus the funding by external agencies is likely to the extent of 50 percent of the estimated assistance under the Package.

SHG-BANK LINKAGE AS A TOOL FOR REFORMS IN COOPERATIVES

The SHG-Bank Linkage Program started in the country as an Action Research Project in 1989. In 1992, the findings led to the setting up of a Pilot Project by NABARD. The pilot project was designed as a partnership model between three agencies, viz., the SHGs, banks and non-governmental organizations (NGOs).

SHGs were to facilitate collective decision-making by the poor and provide ‘doorstep banking’; banks as wholesalers of credit, were to provide the resources; and NGOs were to act as agencies to organize the poor, build their capacities and facilitate the process of empowering them.

The program has come a long way from the pilot stage of financing 500 SHGs across the country. Of the total SHGs formed more than 2.3 million have been linked with 44,362 bank branches of 547 banks in 583 districts across 31 States of the Indian Union. Cumulatively, they have so far accessed credit of Rs 114 billion. About 33 million poor households have gained access to the formal banking system through the program.

COOPERATIVES IN THE SHG-BANK LINKAGE PROGRAM

The cooperative banking network started participating in the SHG-Bank Linkage Program in recent years in a significant manner. The broad strategies followed by NABARD in encouraging the cooperatives in taking advantage of the now proven sustainable approach to banking with the poor and thereby enhancing the business and outreach are as under:

- Encourage state governments to make enabling provisions in State Cooperative Societies Act to facilitate enrollment of SHGs as nominal members of (Primary Agricultural Cooperative Societies (PACS)/District Central Cooperative Banks (DCCBs);
- Facilitating exposure visits of senior executives and elected leaders of cooperatives to best practice areas in other cooperative banks;
- Providing trainers' training to the cooperative banks for SHG financing;
- Organizing direct training for staff of DCCBs/PACS/other field level functionaries;
- Providing technical support to banks to evolve suitable intermediate structures akin to Farmers' clubs to increase the outreach of the branches in promotion and linking SHGs; and
- Encouraging and supporting innovations of cooperatives to take on the role of Self-Help Promoting Institutions.

As on 31 March 2006, 342 cooperative banks were participating in the SHG-Bank Linkage Program by credit linking 0.31 million SHGs with a cumulative disbursement of Rs 10.9 billion Some of the forerunners include States like Karnataka, Maharashtra, and West Bengal. Most of the States have created an enabling environment to facilitate the linkage of SHGs to cooperative institutions either through amendments of Cooperative Societies Act or through issue of notifications.

Going by the feedback from the pioneering DCCBs in linkage program, it can be inferred that the banks have tasted the success under the linkage program from the point of view of (i) expanding the client base through coverage marginal farmers, agricultural labourers, artisans, etc., (ii) tapping the untapped savings business at the PACS level, (iii) generating untapped credit business, (iv) almost 100 percent repayments by SHGs creating pressure on repayments of other earlier NPA loans from the village and (v) supporting a women empowerment process in the rural areas.

Both the lower tiers of the cooperatives, i.e. PACs and DCCBs, have gained significantly in areas where the linkage business has reached critical mass. Apart from the direct business generated, the good-will being created in the villages gets translated into other indirect benefits like repayment of older NPAs from other members, deposit mobilization, etc.

FUTURE OUTLOOK

With the implementation of the Revival Package, the STCCS is expected to emerge stronger with following benefits accruing to the system:

- Better financial position with cleansed balance sheets;
- Reduced control of the State Government;
- Professionalized boards and management;
- Autonomy to take business related decisions;
- Ability to access resources from institutions outside the cooperative fold;
- Autonomy in the matters of personnel policy, staffing, recruitment, posting and compensation to staff;
- Timely elections and conduct of audit;
- Computerized operations with a common accounting system and better internal checks and controls resulting in operational efficiency; and
- Adequate appreciation among cooperative banks about the market potential in microfinance through SHG linkage.

RURAL FINANCIAL SYSTEM IN INDONESIA

Mr. Sulaiman Arif Arianto, Managing Director, Bank Rakyat Indonesia

INTRODUCTION

The Indonesian economy, as in many other developing countries, is dominated by micro, small and medium enterprises (MSME). These enterprises account for more than 90 percent of all enterprises in Indonesia. They also dominate in the output of production that covers more than 60 percent of Indonesia's Gross National Product.

Of Indonesia's total population of 210 million, about 18 percent live below the poverty line, with 66 percent of poverty concentrated in rural areas. As most of MSMEs are located in rural areas that link to the local economy, the fundamental problem is the persistence of a major gap between demand and supply of microfinance services in the rural areas, especially amongst the poor and the limited the outreach of commercial banks into rural areas.

Studies show that there is still an "**un-banked majority**" in all Indonesia's provinces. In other words: despite all efforts at financial deepening over the past three decades, in Indonesia the majority of villagers still do not have access to financial services.

The data also shows that nearly all of the more than 40 millions units of MSMEs do not have any access to formal financial institutions, especially to commercial banks. This is because most of them are not bankable yet. The census data stated that of the total MSMEs, only 60,000 received loans from banks, 113,000 from cooperatives, and 62,000 from non-bank financial institutions.

Since most of MSME do not have any access to the banking sector because of their limited ability to meet formal banking procedures and the absence of commercial bank services, microfinance plays the most important factor in the development of MSMEs. Microfinance does not only provide credit facilities for MSME but also provides savings and remittance facilities. Microfinance then is recognized as one of the most important sectors in Indonesia's national economy. This is reflected in the rapid absorption of increased microloan as they are made available in the Indonesian market. Simple and quick procedures on credit approval and office administration jointly with special attention on socio-cultural aspects of the communities are the aspects that support the success of microfinance.

MICROFINANCE DEVELOPMENT

Microfinance in Indonesia began more than 100 years ago. The basic reasons in the establishment of microfinance was to eradicate very high interest rate from money lenders charged to village peoples and also put hard restriction to lenders.

A Package of Deregulation issued in October 1988 (PAKTO 1988) was a milestone for the massive growth of rural banks in Indonesia. The package eased private domestic investors to establish rural banks, known locally as Bank Perkreditan Rakyat (BPR), by only fulfilling an initial capital requirement amounting to Rp 50 million. Since then, the number of rural banks grew to a very significant number.

The issuance of the Banking Law in 1992 was also a very important milestone for rural banks as BPR were clearly recognized as one of two banking types in Indonesia. Article 5 of the Law defined that there are only two kind of banks in Indonesia: commercial banks or 'Bank Umum' and rural banks or 'Bank Perkreditan Rakyat'. This law also gave opportunity for rural fund and credit institutions (LDKP) to transform into BPR by fulfilling the particular requirements on BPR establishment within the period of 5 years or until October 1997.

Nowadays, microfinance in Indonesia is provided by both the formal sector and the informal sector. The formal sector agents are:

1. Commercial banks with microfinance windows – The largest by far is the **unit-system of BRI**, a major state-owned bank (now a publicly listed company),
2. Rural Banks,
3. State-owned pawnshops (Pegadaian),
4. Permodalan Nasional Madani, a state-owned entity managing microcredit and SME lending programs,
5. Microfinance facilities such village credit agencies, saving and credit cooperatives, credit unions rural fund and credit institutions and
6. Microfinance programs

The vast informal sector include: various non-government organizations, hundreds of thousands of self-help groups, money lenders, local sources of trade and consumer credit, informal savings and loan groups and informal cooperatives and mutual credit, especially Arisan, a type of rotating savings and credit association (ROSCA). The number goes into thousands because of the economic growth in rural areas and the huge number of MSMEs that have increased significantly.

The long list of MFIs demonstrates an interesting microfinance sector in Indonesia. But what is our assessment of the sector, in the context of outreach to promote sustainable MFIs?

OUTREACH

In broad terms, excluding pawnshops, **outreach** appears to be extensive and impressive: there are some 53,000 MFI outlets, with some 17 million loans. Appearances, however, are deceptive. In spite of the apparent extensive outreach, the demand/supply gap at the village and rural level remains and the "un-banked majority" are still un-banked. Lack of outreach remains the systemic problem.

Among the many types of formal microfinance in Indonesia, Bank Rakyat Indonesia Unit Desas (BRI Units) and the rural banks (BPR) are recorded as the leaders of microfinance that serve MSMEs in the rural areas. Their successful achievement is represented in the number of office all over Indonesia and the amount of loan disbursement to MSMEs. BRI Unit specifically is very phenomenal in Indonesia's microfinance history because of their commitment to serving people in rural areas and is generally regarded as the most successful, profitable and largest microfinance system.

As of December 2007, there were 4,229 BRI Unit Desas nearly one in every sub-district of Indonesia. The BRI Units offer deposit services and small-scale credit at commercial interest rates. Collateral is provided, and the demand for follow-up loans is a big incentive to repayment. As of December 2007, there were 33 million deposit accounts with deposits of Rp 42.3 trillion (US$4.2 billion), and 3.4 million borrowers, with loans outstanding of Rp 27.9 trillion ($2.1 billion).

The success of BRI's Unit Desa systems can be attributed primarily to the fact that the system has adhered to the fundamentals of banking and finance for the rural microentrepreneurs, including the provision of competitive savings services. BRI's microfinance business may not compete with the most spectacular returns, but it does achieve these strategic goals: consistently performing products for microentrepreneurs; diversification of the bank's portfolio to diversify its risk; the performance of its branch network maximized; and provision of financial services to a broad cross-section of the population.

BRI's achievements demonstrate that financial services to microentrepreneurs can generate a commercially competitive rate of return and fulfill an important strategic goal for commercial banks.

Apart from its general policy success, from operational point of view, the main principles that underline the success of BRI Units could be seen as follows:

The lending side:

- Eliminating subsidized interest rate, so the interest rate given is the rate that would cover all overhead costs, cost of fund and bad loan and gives profit to the BRI Unit;
- Maintaining good borrowers and the performance of the borrowers is the main reason for subsequent borrowings;
- Not giving over-loan disbursement to the borrowers, so the loan is based on the needs and the repayment capacity of the borrowers;
- Simple and professional in providing services to customers; and
- Close supervision on the loan performance by assigning special supervisors.

The saving side:

- Strong networking that gives more value for the depositors;
- Developed savings product such as by giving lottery prizes;
- Competitive interest rate based on the market; and
- Good information system that gives more trust to the depositors.

BRI UNIT OPERATION

- Efficient in organization structure that limits the number of staff. This could cut down the overhead cost;
- Interest rate in the credit and savings product determined by the head office to eliminate the possibility of fraud;
- Simple administrative procedures;
- Incentives for the employee including regular training program for the BRI Unit staff; and
- Keep the BRI Unit small means to transfer the bigger part of the BRI Unit to the branches or split the BRI Unit that has become bigger.

POLICY CHALLENGES AND ISSUES

It has to be recognized that Indonesia has a complex but at the same time rather limited legal framework for microfinance. So far, there is no comprehensive legal framework or an MFI law that regulates the widespread and long lists of MFIs. The existing legal framework for 'formal' financial institution are: **the 1992 Banking Act,** which allows only banks to take deposits from the public, and **the 1992 Cooperative Act**, which allows registered cooperatives to take deposits but only from their respective members.

On the other hand, many others regional MFIs have no 'formal' Act and still operate under the 'old fashioned' Act. Village Credit Agencies operate under the pre-colonial Government Regulation of 1929, and the credit institutions operate under enabling provincial regulations. These subsidiary regulations conflict with the Banking and Cooperative Acts, which enables only banks or cooperative-MFIs to take deposits. The present regulatory "windows" do not provide an appropriate regulatory basis for the operations of thousands of existing non-bank and non-cooperative MFIs; therefore, they are un-licensed or not properly regulated and supervised. Most existing MFIs deal with the public and this conflicts with the Banking Act. Likewise, large numbers of cooperatives are dealing with non-members.

There are many types of MFIs in Indonesia that operate without any legal basis. Many more non-bank and non-cooperative MFIs operate in a grey area. They are Village Credit Agencies (Badan Kredit Desa/BKD), LDKP that do not have status as BPR yet and any other microfinance institutions that collect fund from the public. In a nutshell, a growing number of microfinance institutions are seeking to become part of the regulated formal financial sector in order to increase the scale of their operations. The spirit of the legal framework for microfinance is to give a legal basis for the existing MFIs, to enable the establishment of new MFIs, to protect small depositors and to give the basis for building MFI capacity and infrastructure for the development of MFI industry. The absence of an MFI law has been claimed to limit the development of MFI in Indonesia. Lessons learned from other countries that already issue their respective MFI laws, present a very positive impact in the development of microfinance. The fact will then raise a question as to whether microfinance shall be regulated under a formal act that is distinct and separate from an existing banking act.

SOME IMPLICATIONS

Some implications of the massive growth MFIs with their legal status will include supervisory and governance issues. With this growth and the taking of deposits from public, the question arises as to who will supervise them and how will funds flow be monitored, particularly with the existing limited human resources capabilities of supervisory authorities.

Another concern is consumer protection: to protect thousands of small savers of existing unregulated or improperly regulated non-bank MFIs. Therefore, to establish public confidence and limit systemic risks, the new proposed law on microfinance should be equipped with an insurance scheme for microcredit and to protect small depositors in MFIs. This is to secure both sides of the lender and the depositors. Banks will feel secure to extend loan to MSMEs as some of the credit covered by insurance scheme, or to channel its fund to MFIs. Of course this is not free, and the banks should pay some amount of premium to the insurance institution. Also to be considered are how to minimize the possibility of moral hazard, which sometimes accompanies this protection measure.

Bank Indonesia as the central bank has continuously put strategic policy to develop microfinance. The program is in line with the new government policy to develop rural areas, especially in the agricultural sector. The main objective is to generate prosperity for majority of Indonesians that live and work in the rural areas. This strategic policy includes regulation and promotion of microfinance with the final objective of how to provide more financial services to MSME.

However, reaching poor households and microenterprises with sustainable financial services is a difficult and time-consuming task that requires a long-term, multi-pronged strategy. The proposed legal framework is only one strategy to improve regulation and expand the outreach of sustainable microfinance. Expansion can only be effective if all parties play a role, with the government initiating an improved legal framework following international best practices and an improved national microfinance policy that phases out unsustainable microfinance programs.

It can also be effective with rural banks expanding outreach through opening large numbers of new branches, with commercial banks bringing microfinance into their mainstream operations, with provincial governments replicating the LDKP model, with the dormant BKD sector being revived, with expanding bank linkages with groups, and finally, with sound donor initiatives that take a financial-systems approach to expand microfinance, especially in the poorer provinces.

BANK KESHAVARZI: CHALLENGES AND OPPORTUNITIES

Mr. Mohammadtaghi Pakzad, Member of the Board, Bank Keshavarzi

Bank Keshavarzi (BK), with 73 years of experience in servicing the agriculture sector, has been reforming its procedures and upgrading its performance by adopting new approaches. Bank Keshavarzi, like other rural financial intermediaries in developing countries, are facing challenges which hamper its efficient performance:

Barriers to financial intermediation: Barriers such as improper macro-economics policies, distorted financial policies, financial inflexibility, inadequate information, as well as legal and regulatory constraints, etc.

Urban-oriented policies: Policies such as over-appreciated foreign exchange rates, lower controlled and seasonal prices of agricultural products, under-developed legal and regulatory requirements of mortgage and collateral for rural assets (land, products, agricultural tools) as compared with urban assets (machinery, durable goods, home appliances) and excessive tax levied on agricultural exports.

Specific features of rural areas: Features such as poverty, high population congestion, dispersed markets, high climatic risk, seasonal production, lack of adequate collateral, high income fluctuation and limited opportunities for diversification of risks.

Inefficient Government Intervention: Issues such as allocation of subsidized credit, imposing preferred rates and allocation of the banks' resources to managed facilities.

All these factors hinder the presence of formal sections of financial markets in rural economies and, apart from specialized agricultural banks which are operating under patronage of the government, other authorized financial entities, due to high operational costs, are not that much active in rural areas.

The agriculture sector, by its nature and especially due to longer production period, demands more credit facilities. In the early 1980s, these types of institutions gradually encountered some problems regarding their activities. Ignoring the mobilization of deposits made these institutions, in return, severely dependent on government for adequate resources and the governments faced many problems in financing these institutions and offering subsidized credits. In fact, the main reason of these problems is believed to be lack of financial self-reliance. Thus, attempts were made all over the world to increase the self-reliance of such institutions.

BANK KESHAVARZI'S BEGINNINGS

Easy and quick accessibility to financial resources is one of the necessities and prerequisites of developing the activities in agricultural sector. On the one hand, many of the farmers and those involved in agriculture sector are not able to make investment due to low income and high production costs, and on the other hand, the private sector is not inclined enough to invest in the agriculture sector. Hence, the limitation of financial resources is one of the major constraints of the sector.

In order to meet the needs of the agriculture sector, the Industrial and Agricultural Bank of Iran, as one of the first institutions, aimed at financing the agriculture sector in Iran, was established in 1933. The bank experienced various changes and eventually through merging of Agricultural Cooperatives Bank and Agricultural Development Bank of Iran, Bank Keshavarzi (Agricultural Bank) was established in 1979, aimed at providing credit facilities, improving living standards, promoting income level of rural residents as well as increasing the agricultural production, establishing and developing small and traditional industries located in rural areas and partnership in related activities.

Bank Keshavarzi, at the outset, was established as a State-owned financial entity to support the agriculture sector. Thus, its financial resources, mostly in the form of capital, were supplied out of the government resources during the years. As a result, before 1980s, the bank was less concerned about its financial resources, as its main function was to distribute the resources, financed by government. In other words, it would operate as a fund financing the agriculture sector.

In the 1980s, the bank's operations underwent some changes and the bank's required resources used to be supplied out of the surplus resources of the commercial banks or out of borrowing from the Central Bank. The end of imposed war on Iran and the start of reconstruction activities caused the commercial banks to expand their credit activities and as a result they were less inclined to operate actively in the agriculture sector.

In addition, the Central Bank of the Islamic Republic of Iran had come to the point that providing Bank Keshavarzi with resources could lead to strengthening of monetary base and consequently increase in inflation. Therefore, the possibility of absorbing resources through the government and commercial banks diminished.

A STUDY OF BANK KESHAVARZI'S PERFORMANCE IN 1984-1991 INDICATED THE FOLLOWING:

- During 1984 to 1991, only 20 to 22 percent of Bank Keshavarzi's granted facilities were supplied out of attracted deposits. The bank was dependent on other resources, such as government contribution and resources and facilities received from other banks;
- During the period, over 50 percent of the bank's resources were dependent on facilities received from other banks. Such a situation became more crucial by the end of the period and the ratio of the bank's dependence on received facilities soared to 70.6 percent in 1991;
- During the period, the ratio of the bank's deposits balance to total debts and equity was less than 20 percent; and
- Bank Keshavarzi's share of deposits in deposit market of the country was nearly 1 percent. Such a low percentage indicates that the performance of Bank Keshavarzi as a specialized bank had not been proper enough rather, it had been functioning as a credit fund.

ADOPTION OF NEW APPROACH

During the first Economic and Social Development Plan of the country (1989-1993), the necessity of making changes in the bank's approach seemed obvious and respectively some steps were taken. The approach adopted by Bank Keshavarzi can be divided into two shorter periods, based on the type of activities and the results obtained. The first phase is the Transition Period (1992-1997) and the second phase, known as the New Era, is regarded as the period of development and booming of Bank Keshavarzi's performance.

FIRST PHASE (1992-1997)

The first phase commenced in the late 1991 and early 1992. The most important measures taken in this phase were as follows:

- Expansion of the bank's branches in rural areas and an attempt to attract public and rural residents' deposits;
- Simplification of procedures;
- Improving the appearance and the interior of branches;
- Offering banking public services and an attempt to offer new services; and
- Research and study on the bank's affairs.

In general, although expansion of rural branches and the measures taken could promote the bank's status during this period, it was still facing problems in mobilizing required resources. Hence, in order to overcome the problems, the bank entered a new phase of reforms in late 1997.

SECOND PHASE (1998-2003)

In this phase, the required structure for establishment of a learning organization was taken into consideration and in order to liberate the capabilities of the bank's human resources, an empowering program for the staff was put on agenda. Promotion of shareholder-oriented culture and customer-oriented attitude as well as the importance of efficiency, profitability and productivity were included in the mission statement of the bank and were regarded as a common organizational covenant.

In this period, structural reforms in various aspects of the bank's activities, based on studies and scientific rationality in conformity with the time, were conducted.

The adopted strategies and the bank's plans for different fields were as follows:

MARKETING AND RESOURCE MOBILIZATION STRATEGIES

- Expanding the network of urban branches, especially in Tehran and other provincial capitals which include over two-thirds of the country's liquidity;
- Deciding over arrears and unaccomplished projects;
- Planning for debt collection through non-governmental procedures;
- Transferring governmental companies' and organizations' accounts in agriculture and aquaculture sectors to the bank;
- Promoting resource mobilization concerning agricultural enterprises and producers;
- Establishing customers' data base in order to focus on target customers;
- Designing and organizing appropriate mechanism to attract profit-making customers through analyzing target customers' files;
- Conducting promotional programs to introduce new and other common banking services and to change the society's attitude and mentality regarding full-fledged activities of the bank;
- Introducing and offering modern products and services all over the country at a pace enough to succeed in the market;
- Planning to increase the bank's share in total banking deposit market;
- Playing an active role in other fields such as agricultural products insurance, stock exchange market, and agricultural commodity exchange aimed at expansion of the bank's services, diversification of income resources and risk mitigation;
- Proper use of inter-bank resources and facilities to finance profit-making activities;
- Proper use of new financial instruments (participation bonds, certificate of deposit, etc.) to mobilize more resources and to attract new customers; and
- Focusing on various un-bankable groups of people, such as children and the youth, teenagers, women in-charge of households, to whom the banking system had paid less attention and planning for their effective presence in banking activities and the country's economy.

CREDITS AND INVESTMENT STRATEGIES

- Removing the limitation of financial resources and increasing the bank's facilities portfolio;
- Establishing the credit customers data bank;
- Organizing procedures to make a proper use of credit resources and foreign participation;
- Expanding the functions of Investment Guarantee Fund to further support the entrepreneurs;
- Divestment of units and companies, affiliated to the bank, to private sector in order to reduce the bank's sovereignty and to release the bank's resources aimed at providing further support for entrepreneurs and those involved in the agriculture sector;
- Re-engineering and simplifying credit granting procedures to reduce public problems as well as increasing staff productivity;
- Constant and effective supervision on fulfillment of commitment made by projects executers in order to assure the project implementation and repayment of liabilities to the bank;
- Proper use of inter-bank resources and facilities in order to finance profit-making activities; and
- Diversification of credit disbursement fields and credit granting procedures for various agricultural and industrial activities as well as related services, rural housing, agricultural products exports and other sectors through specific mechanism of resource mobilization for each field.

FINANCIAL STRATEGIES

- Value-creation for share-holders through increasing the bank's profitability and productivity;
- Diversification of the bank's income resources;
- Management of resources and allocation as well as reduction of provincial directorates' accounts balance;

- Deciding on reforming, merging or liquidating the loss-incurring branches;
- Self-management and financial reliance of provincial directorates and branches;
- Reducing the deposits costs through absorbing checking and Qard-al-hassanah accounts and increasing the share of cheap and economical resources in the bank's portfolio in order to reduce the actual cost and to increase the competition capabilities;
- Reforms in financial structure through capital gain and escalating the capital adequacy ratio in compliance with approved international standards;
- Designing and implementing a financial mechanism in order to expedite conducting financial affairs, to increase accuracy and to prevent contingency of financial violations; and
- Reducing reliance on borrowed resources from other banks and the Central Bank of the country.

CHALLENGES AND PROSPECTIVE PLANS OF BANK KESHAVARZI

Due to the establishment of private banks followed by the extension of non-government credit and financial institutions, the dominant environment over the banking system of Iran is evolving to be competitive. Moreover, special attention of the government toward employment and endeavour to bring about economic development on the one hand and public awareness about the evolutions and development of the banking system at the global level on the other, have remarkably increased public expectations as well.

THE PLANS INCLUDE THE FOLLOWING:

- Establishing a conglomerate organization to expand banking operations and services, strengthening resource mobilization, and reducing the operational risk;
- Establishing an agricultural investment bank within the extension of the activities of Bank Keshavarzi to direct investment and encourage entrepreneurs to create jobs in the sector;
- Vast cooperation in establishing a stock exchange for agricultural commodity and in strengthening its role to adjust the financial and agricultural products marketplace;
- Strengthening and diversifying the operations of the livestock and agricultural products insurance fund;
- Self-independence and strengthening the Agricultural Investment Guarantee Fund in order to support those involved in the sector and entrepreneurs who encounter problems in terms of collateral and guarantee to extend their activities in the agriculture sector;
- Providing a rural housing fund to promote investment and employment within rural areas and agricultural production centers;
- Promoting youth and children bank (Kids' Bank) to make them socially bankable and institutionalize the process of selecting prospective customers;
- Establishing the Women Savings Fund in order to promote the role of 50 percent of the national population in financial, banking and economic activities;
- Reforming branch network with emphasis on virtual branches;
- Promoting e-banking and enhancing optimal culture of utilization of the facilities among the staff and customers;
- Reforming the financial structure, mobilizing the resources, and emphasizing on financial self-reliance;
- Turning the bank into a learning organization for the sake of institutionalization, learning, innovation, and continuous improvement of service quality; and
- Moving toward comprehensive and universal banking.

Bank Keshavarzi, in addition to encountering the above mentioned challenges and phenomena and due to the bottleneck and serious circumstances of the agriculture sector of the country, carries a very heavy mission. It has to compete with State-owned and private credit institutions and banks, and absorb further resources, on the one hand, and on the other, it should deliver the accumulated resources to those involved in the agricultures sector.

As the only specialized bank in the agricultural sector, Bank Keshavarzi has played a key role in the growth and flourishing of the sector during the past 70 years. It can assuredly be claimed that the extensive operations of the bank, in addition to the decisive role it has in increasing agricultural products and creating new capacities of production in the sector, has made effective contributions to achieve self-sufficiency crop production and to develop non-oil exports.

Adopting a new approach in financing agricultural sector could have a highly favorable impact on the bank's performance so that in the process, despite the extensive growth of the portfolio of the credit (about 7 times), the self-sufficiency percentage of the bank, through mobilized public resources, has climbed from less than 20 percent in the early 1990s to more than 72 percent in 2005. Thus, while the bank has been able to increase its credit disbursement in the agricultural sector six times, it has fulfilled further portion of the sector in the last decade thus, substantiating its major mission (from about 50 percent to over 70 percent). Meanwhile, the bank's share in the deposit banking market has also increased from one percent in the early 1990s to 7.45 percent in the second half of September 2006.

Due to the private banks' operations and the availability of foreign banks across the country, the expansion and deepening of operations in capital market, and the more serious competition among banks, Bank Keshavarzi strives to adopt new strategies focusing on the value creation for shareholders and clients for the sake of sustainable development and growth in the second three-year strategic plan of the bank.

RURAL AND AGRICULTURAL FINANCIAL SYSTEM IN JAPAN

Mr. Yasuo Murata, Senior Executive,
Agriculture, Forestry and Fisheries Finance Corporation

AGRICULTURAL POLICY IN JAPAN

With the internationalization of the economy, liberalization of farm product is being promoted and Japan has now become the world's largest importer of farm products.

Although a plentiful food life has been realized, as a result, the food self-sufficiency rate has declined significantly. In Japan, the farming labor force has declined steadily and abandonment of farm land, underutilized and unused land has increased and the domestic food supply capacity is on a declining trend. In addition, in the rural areas, aging of the population and depopulation are proceeding and in some regions, the population drain is creating impediments to maintenance of community life.

Under such conditions, expectation has been placed on our country's farming and rural areas to achieve sustainable development in agriculture as well as to keep natural environment in good condition.

Toward this end, the Basic Law of Food, Agricultural and Rural Area, was enacted in July 1999 and it was set to promote comprehensively the measures relating to securing stable supply of food, sustainable development of agriculture and promotion of rural areas. Agricultural finance, in steadily promoting the various measures based on the new Basic Law of Food, Agriculture and Rural Area, will play a vital role as a tool to provide comprehensive support for the innovative measures through the facilitation of financing and reducing the interest payment burden for farmers with weak management foundations.

The Japanese economy continued to expand its GDP after the 1960s. It also continued to accumulate trade surplus amount. Therefore, the pressure from overseas to open the Japanese domestic market, especially for agriculture products, has been increasing. The Japanese Government gradually decreased the import control items of agriculture products and cut down on import tariffs. The liberalization of agriculture products in mid of 1960s centered upon products which were less important farm products for Japan. However, in the 1970s the liberalization spread to major products in the Japanese Agriculture. Beef, oranges and dairy products were liberalized by 1990.

The number of products under import control items declined from 103 items in 1962 to only 5 items in 1993, at the time of the conclusion of the Uruguay Round the Negotiations.

Rice, staple food of Japan, was placed on a minimum access category in the process of WTO negotiations. This became a serious issue in Japan at that time. Japan was forced to pledge to import equal volume quota of 7 percent (724 thousand tons, minimum quota) in the rice consumption in 1997. In the long run, it was liberalized in April 1999.

Through these processes, agriculture products were completely liberalized and Japan has become more open than USA and EC Nations. Agriculture products can now be imported at low rates of tariff.

The domestic agriculture production index in Japan stands today at 117 in 2004 with 100 in standard year 1960 while agriculture products import quantity index climbed to 1,280 during the same period, which increased over 12 times for 40 years.

EFFORTS TO INCREASE FOOD SELF-SUFFICIENCY RATE

The food self-sufficiency rate on a calorie basis, peaked at 73 percent in 1965, and has been declining ever since then. It has been falling down to 40 percent in 2004. Japan's food self-sufficiency rate is the lowest in all leading industrialized nations.

On the other hand, among leading industrial nations, the food self-sufficiency rate is 61 percent for UK, 122 percent for USA, 265 percent for Australia in 2001, respectively.

In view of the world food supply and demand in the future, world population is forecast to continue relatively high growth, while the increase in food production, appears to reach its limitation. And we have little prospects for expansion of land for cultivation. It shows that the food supply in the 21st century in the world would come under severe pressure.

Needless to say, food is essential for humankind. Japanese people want to live without food shortage, because of memories of severe starvation shortly after the end of Second World War.

The Japanese people have shown strong interest in maintaining and increasing domestic food-supply in order to protect national welfare and security.

To cope with this problem. Japanese Government has taken various steps to increase and maintain core farmers with high productivity and strong competitiveness.

Reflecting the background of the initiation of WTO structure and the acceleration of deregulation of trade in agricultural products, the new government policy started to support the sustainable development of agriculture in 1999.

The government formulated the action plan with four basic principles in 2000. These principles are to guarantee a stable food-supply, to manifest sufficiently the multi-functional roles of agriculture, to develop sustainable agriculture and to revitalize rural areas. Since then, the government has carried out various measures to realize the goals of new policies with review and revision of the action plan every five years.

FOSTERING CORE FARMERS WITH HIGH PRODUCTIVITY AND STRONG COMPETITIVENESS

One of the objectives in Japanese Government policies is to increase and maintain core farmers with high productivity and strong competitiveness. Many of the farmers are reaching the age of retirement and rapid decrease of farmers is forecast in the near future. Reforms are required to meet this urgent issue.

Consequently, considering current agricultural issues, the Japanese Government has formulated the New Basic Policy of Food, Agriculture and Rural Areas in 1999. The main idea of the policy is to foster and increase core farmers who should shoulder most of farming productions in the future. To be more specific, the government has announced a basic policy to increase the current 200,000 farm management entities to 400,000 by 2015. AFC has a vital mission of providing support toward the achievement of doubling the farming entities using the tool of policy financing. AFC is expected to make its efforts toward the achievement of this target by performing its roles and functions.

ROLE OF AGRICULTURAL FINANCING SYSTEM

Food self-sufficiency rate, on a calorie basis, has been falling down to 40 percent during High Economic Growth and it is at an abnormal level in comparison with the major advanced countries, but taking into account the future trends in food supply and demand, including future world population increase, it is necessary to maintain and expand domestic agricultural production.

Toward this end, it is necessary to expand the farm-management size to improve its productivity by means of fostering farming entities and core farmers with superior management sense. Therefore, financial supports for these farming entities and core farmers is critical to achieve the goal.

CURRENT STATUS OF THE AGRICULTURE FINANCING SYSTEM

Financing agriculture in Japan can be broken down into financing provided by agricultural cooperatives or JA banks, private banks and financing from policy finance institution, the Agriculture, Forestry and Fisheries Finance Corporation (AFC).

With respect to loans to farming and rural areas, the share of loans by financial institutions (as of end March 2006) is dominated by JA banks which accounts for 88.6 percent of outstanding loans while policy-based financial institutions including AFC follows with an 8.0 percent share, combined accounting for 96.6 percent.

Of all agricultural loans, government programmed loans are composed of fiscal funds from central and local governments to pursue policy objectives. AFC loans and government's interest subsidies granted to loans extended by JA banks and private banks.

JA banks are composed of three levels of agricultural cooperatives (JA), prefectural federations and national federation. The lowest level organization of JA is again divided into general JA and specialized JA for each sector. The general JA provides credit services (savings and lending operations) as well as sales, mutual aid and various services including providing agricultural guidance.

JA banks provide loans to member farmers by using the savings deposits from member farmers as the funding source and plays an important role in agricultural finance.

AFC was established as a policy finance institutions in 1953 and as a wholly funded government institution with the objective of providing loans to those engaged in farming, forestry and fishery with long term and low-interest funds necessary for the maintenance and promotion of productive capacity in the field of farming, forestry and fishery.

The lending system of AFC has been reorganized, reconstituted and enhanced in line with its objectives responding to the developments of agriculture, forestry and fishery administration since its founding. Currently, it operates through 22 branches across the country and through 352 agent financial institutions including JA banks, under operating contracts. The loan outstanding for the entire agriculture, forestry and fishery sector is Yen 3,100 billion (as of end March 2006).

AFC's responsibilities include providing support for clients' farm management in development using policy financing as a tool, making contributions to the vitalization of the community and playing a role in ensuring stable and safe food-supply to the people in response to the policy requests.

GOVERNMENT PROGRAM LOANS

JA banks (agricultural cooperatives) play a central role in rural financing. However, in the financing investments in productive infrastructure, productivity improvements, investments in improvements in the rural environment, it is usually supplemented by Government program loans in the form of loans through AFC or through government's interest subsidies granted to private loans extended by private banks including JA banks. The proportion of financing provided by private banks is small. Loans for agriculture, forestry and fisheries face special difficulties for private banks, due to fluctuations in productivity and prices of products caused by natural conditions, inherent low profitability of the fragmented scale of the business, limited credit reliability, long period of gestation required and a low level of return on the investments. Therefore, Government programs loans are extended for those projects to meet government policy objectives and such financing are considered to be very important tools in carrying out government policies.

There are three major Government program loans for agriculture:

AFC Loans: AFC funds its loans mainly through the FILP. AFC extends long-term and low-interest loans for projects that meet government policies and which require systematic promotion by the government.

Agriculture Modernization Loan: These are extended mainly by private financial institutions (mainly JA banks with interest subsidies from prefectures. They are medium-term loans with 5-15 year repayment periods to finance equipment and facilities for individual use and joint use.

Agriculture Improvement Loans: These are interest-free loans extended by prefectures, using their fiscal funds and those borrowed from the central government. Their purpose is to support development of new crops and new technologies. The maximum amount of these loans is smaller and the repayment period is shorter than for other Government program loans.

POLICY ENVIRONMENT AND REGULATORY FRAMEWORK

There was a vital decision on Policy Finance Reform on December 2005. The Japanese Government has been conducting Policy Finance Reforms since then. The idea of this Reform was to make Policy Finance more efficient and more helpful to the Japanese people.

As a result, AFC will be merged into a new policy financing institution together with the National Life Finance Corporation, the Japan Finance Corporation for Small and Medium Enterprises and the Japan Bank for International Cooperation (international finance and the like) effective October 2008.

Consequently, on June 27, 2006, the "System Design Relating to Reforms in Policy Financing" was decided at the Policy Financing Reform Promotion Headquarters and the Administration Reform Promotion Headquarters.

- The new policy financing institution will be a joint stock company to be established under a law based on the Company Law;
- The new policy financing institution will have an internal organization responding to the needs of the general public, small and medium enterprises and those involved in agriculture, forestry and fisheries;
- For agriculture, forestry and fisheries, the branch network will be strengthened (in principle, Financial Service will be offered in all prefectures all over Japan in order to maintain and improve clients' convenience);
- Measures will be taken to avoid unjustified intrusion into the interest of current borrower-clients and bond holders.

STATUS OF RURAL FINANCE IN LAO PDR

Mr. Phanthaboun Sayaphet, Deputy Managing Director,
Agricultural Promotion Bank

THE FINANCIAL SECTOR OF LAO PDR

The Lao PDR financial sector is small and dominated by the State-owned commercial banks (SOCBs). The supply of rural financial services can be broken down into the formal, semi-formal, and informal sub-sectors. The formal sub-sector consists of commercial banks, including Agriculture Promotion Bank (APB); the semi-formal sub-sector composed of project-based interventions and various types of microfinance organizational forms; and the informal sub-sector consisting of loans between friends and family members, informal money-lending, and lending through the traditional Lao *houay*.

The commercial banking industry in the Lao PDR has three principal groups:

- SoCBs: Banque pour le Commerce Exterieur Lao (BCEL), Lao Development Bank (LDB), Agriculture Promotion Bank (APB) and the new Nayoby Bank (Policy Bank, which don't accept deposits from the general public);
- Joint-venture and private banks: the Joint Development Bank, Vientiane Commercial Bank, which now has a partnership with ANZ Bank, Lao-Viet Bank and the new 100 percent Lao private bank, Phongsavanh Bank; and
- Foreign commercial banks: Six branches of Thai commercial banks, one Malaysian bank and the Standard Chartered Bank representative office.

The commercial banks' attention toward rural areas is very limited. APB, with its mandate to promote agriculture, is the most engaged in the rural areas.

The semi-formal sector in the Lao PDR is composed of project-based interventions and various forms of microfinance. Multilateral, bilateral, and INGO projects are typically implemented through local partners. The Lao Women's Union (LWU) is the most frequent local partner, followed by the Ministry of Agriculture and Forestry (MAF). One of the sustainable oriented initiatives, established originally with UNDP support, works with the Ministry of Finance (MoF).

Three main types of microfinance organizational forms are present in the Lao PDR. These are:

- Microfinance Institutions (MFIs) licensed and registered operating under BoL regulations;
- Savings and Credit Unions (SCUs) operating under BoL regulations;
- Village Savings and Credit Groups (VSCGs) and Village Revolving Funds (VRFs) not operating under BoL regulations.

The informal sector in Lao PDR is still important and is estimated at a volume of 660 billion Lao kip with over 353,000 borrowers.

Recently, the Asian Development Bank (ADB) "Rural Finance Sector Development Program" (RFSDP), a loan package of USD 10 million, has been approved and signed by the Government and ADB. Its implementation commenced on March 2007 and has a duration of four years. It will play a important role in fostering demand-driven, sustainable rural financial services.

Characteristics of rural households' demographic structure and income-generating activities are important determinants of financial decisions such as borrowing, savings, lending and risk management.

For over 90 percent of rural households, the primary income source is from self-employment (including farming their own land) or ownership of a business. Only 5.5 percent of rural households have salaried work, while wage labor provides for only 4 percent of rural households. Rice production is the most common primary activity (65.56 percent of rural households), followed by livestock raising (10.24 percent), and trade (6.96 percent). Production of other crops is the primary activity for only 3.34 percent of households. However, there is a high degree of multi-functionality among rural households: 90 percent of rural households are engaged in multiple income-generating activities. While rural finance policies have traditionally focused on directed lending programs for agricultural activities, the high frequency of multi-functionality suggests a need for financial services that serve a broad range of economic activities by rural households.

RURAL FINANCE POLICY ENVIRONMENT AND REGULATORY FRAMEWORK

The Bank of Lao PDR (BoL), the regulatory and supervisory body, operates under the Law No. 05 on the Bank of the Lao PDR as of 14 October 1995 and amended on 14 October 1999. Accordingly, the BoL is the regulatory and supervisory authority for all banking institutions, financial institutions (including domestically incorporated banks and branches of foreign commercial banks) and microfinance entities. APB, the main provider of rural financial services, is regulated under a new Law on Commercial Banks, which was recently adopted by the National Assembly Session on 26 December 2006. The above-mentioned Law has replaced the Commercial Bank Decree.

The Regulation No. 02-SB on Credit Cooperatives is quite elementary and requires revision, particularly in regard to financial reporting and prudential norms. It could be merge with the regulation on pilot SCUs.

There are currently three types of microfinance entities under BoL regulations: credit co-operatives, pilot savings and credit unions (SCUs) and microfinance institutions (MFIs). a regulation exists for each of these three types of institutions.

Every issue in each regulation such a minimum capital requirements, capital adequacy ratios, interest rate policy both on loans and deposits are quite reasonable to attract new entrants into rural finance and microfinance, and therefore ensure the creation of a sound financial intermediation system.

Minimum start-up capital for pilot savings and credit unions is 30 millions kip (USD 3,000 equivalent) and 1,000,000,000 kip (USD 100,000 equivalent) for microfinance institutions.

Minimum share per member in SCU is 100,000 kip (USD 10 equivalent). To have a seat in the MFI's Board, one should have over 10 percent of the start-up capital.

About ***Interest rates Policy***, the regulation leaves free for microfinance entities to set their own rates for loans and deposits in order to cover their costs and have a reasonable profit margin.

For ***Deposit-taking***, SCUs are allowed to accept deposits among members. In the meantime, deposit-taking MFIs can accept deposits from general public, but is subject to maintain a reserve requirements with BoL of at least 10 percent of the starting capital.

Collateral-free lending is not yet allowed, so that the traditional collateral are usually land, house and in some cases, small machinery.

The microfinance entity can borrow both from domestic and from foreign sources, if they fulfill the conditions. For ***borrowings*** from outside the country, it is more difficult because one conditionality for a MFI is it should demonstrate a sound financial statement for a period of three years before submitting a request for loan.

According to the rules, MFIs are allowed to open new ***branches*** nationwide. The issues here are the market and the operation cost. Therefore, these limit their expansion.

Foreign investment in the sector is not yet approved by the GoL. Concurrently with the implementation of the new Law on Commercial Banks, the situation can rapidly change and can offer opportunities to capital flow coming from outside the country to invest in the rural finance sector.

Currently, the infrastructure in place to regulate and supervise the rural and microfinance institutions and providers is under the authority of BoL, specifically under the oversight of the Banking Supervision Department. The new Microfinance Division within the above-mentioned Department, created last year, will be responsible for MFI supervision. Due to lack of skills and experience, this body will continue to strengthen their capacities by receiving external assistance. Actually, FIRST Initiative is present to help to revise the regulations, and it will be possible that the regulation No. 10 can be split in two regulations, the first one for deposit-taking MFIs, and the second one is for non-deposit-taking MFIs.

INNOVATIVE RURAL FINANCIAL PRODUCTS AND SERVICES

Rural finance and microfinance are at an embryonic stage in Lao PDR. Outreach is extremely limited, and the poor in particular have little access to formal financial services.

APB has the largest network, and offers basic savings products and other deposits products in Lao kip (the national currency, 1 USD is currently equivalent to about Lao kip 9,600), Thai baht and US dollar. The proportion of these foreign currencies in APB does not exceed 5 percent of the total deposits. According to the regulations in force, MFIs and other types of microfinance institutions are only offering saving products and other form of deposits in Lao kip. But their rates are higher than the commercial banks (including APB) by about two to five percent per year.

For instance, APB has proposed a savings rate of 4 percent per year, while the Eak Phatthana MFI (EMI) has offered 8 percent per year. In addition, some institutions have compulsory savings. For other types of term deposits, MFI has proposed an interest rate higher than usual commercial banks by two to three percent per year. On loan products, APB is also delivering mostly in Lao kip, with interest rate ranging from 13 to 20 percent per year. MFIs are able to provide loan with interest rate of four to five percent per month in order to cover their high operational costs and get reasonable margin profit from their activities. APB is quite familiar with domestic money transfer to and from the areas where its service units are located.

DELIVERY METHODOLOGY AND OUTREACH

For the formal banking sector, the population in the main cities and the urban areas has the greatest access to loan and deposits services, as well the largest number of services providers. In term of credit delivery to rural areas, the formation of lending group is the common way for microfinance actors. Now, with the introduction of MFIs lending methodology, the trend has changed and it is usual to provide loans on an individual basis, with adequate collateral requirements.

Despite the high and varied demand, the financial sector in the Lao PDR has a low level of outreach in rural areas. APB is the only formal financial institution with significant outreach and service history in rural areas. It has a branch in each of the country's 16 provinces, and service units in 40 of the country's 141 districts. In terms of villages, APB's activities extend to about 6,000 villages (of a total out of 12,000 villages). Per its records, APB provides credit and savings to about 125,000 (or 15 percent) of the country's estimated 900,000 households.

MANAGEMENT, GOVERNANCE AND INSTITUTIONAL REFORMS

Consequently, it is needed that APB and other MFIs in Lao PDR should adhere to the best principles of good governance:

- essential principles on the rights of shareholders and protection of those rights;
- the framework required of equitable treatment of shareholders;
- the rights of stakeholders as established by law and the importance of encouraging active cooperation between stakeholders;
- the need for timely and accurate disclosure and its coverage; and
- the responsibilities of the Board and the segregation of duties with the Management.

For microfinance activities to flourish, it is necessary to clearly define the separate roles of owners and managers. Management autonomy needs to be granted within agreed limits.

Shareholders will appoint the Board, audit committee, external auditors, and ultimately determine the direction of the business. In turn, the board will be responsible for appointing management and internal auditors. The executive managers in turn will be responsible for the recruitment, appointment, supervision and evaluation of staff and the development of the staff.

CRITICAL ELEMENTS OF SUCCESS

Market reforms in APB are necessary and are critical for its future success, transforming it into a sustainable, viable, and market-oriented rural finance institution. Principally, they should be able to (i) separate the roles of owners and managers; (ii) have management autonomy needs to be granted within agreed limits; (iii) define clear mission, corporate objectives and strategies; and (iv) put supervisory and regulatory procedures in place.

APB has committed to having good governance by adopting a new vision, corporate objectives and corporate values in December 2002. The APB's corporate vision states that "APB will be the premier provider of financial services in the rural areas of Lao PDR. It will operate in a market-oriented, financially self-sustainable way in order to make a long-term contribution to poverty reduction and the economic growth and prosperity. In the market context, APB will endeavour to extend the outreach of financial services to rural people and their enterprises, both directly and by fostering linkages with other financial institutions".

APB will:

- Maintain financial services to agriculture and agribusiness as a major component of its business;
- Adopt international best practices in all matters of corporate governance;
- Invest in people, developing the capabilities of its employees, promoting excellence;
- Conduct financial transactions with prudence;
- Orient itself to customer's needs; and
- Progressively diversify its portfolio and introduce new products and services to reduce and spread risk.

The first APB's restructuring plan was prepared and adopted in 2002. Its implementation began in March 2003 and was completed in June 2004. The restructuring activities were:

- Planning for financial restructuring, including
  - putting in place a 3-year rolling corporate planning process;
  - preparing business plans and a financial modeling system;
  - developing and implementing a systematic workout plan for NPLs;
  - preparing a plan to phase out policy lending and project-based credit lines;
  - formulating a plan for compliance with prudential regulations and recapitalization;
  - defining a market-based pricing policy, and
  - simplifying the loan product line.

- Planning for organizational restructuring and human resources best practices, including
  - revising the functions and responsibilities of APB's Board;
  - preparing a plan to strengthen APB's organization;
  - carrying out job analyses and preparing written job descriptions, and
  - conducting a training program to support restructuring.

- Initiating basic risk management practices, including
  - putting in place prudent loan classification and provisioning systems, and
  - defining new basic risk management and credit policies and procedures.

The second phase of restructuring will continue under the RFSDP Loan and will include key policy reforms such as the (i) adoption and implementation of a governance agreement for APB (expect to be signed between Ministry of Finance , Bank of Lao PDR and APB in March 2007), (ii) phasing out of policy lending and interest rate subsidies from APB, (iii) progressive recapitalization of APB based on performance, and (iv) strengthening of APB's new organization through the appointment of qualified department heads.

The governance agreement will be the basis for the time-bound implementation of the approved APB restructuring plan, which includes best-practice provisions to

- bring APB under the prudential regulatory and supervisory regime for SOCBs;
- require APB to operate on a solely commercial basis;
- strengthen APB's institutional autonomy;
- write off loss-graded loans;
- implement a policy lending phase out plan;
- report and grade performance;
- recapitalize APB based on performance;
- carry out sanctions for non-performance;
- carry out internal and external audit;
- strengthen APB's Board and management and clarify their roles;
- adopt new organizational unit mandates and job descriptions;
- upgrade APB's ICT systems; and
- build capacity in APB including human resources and human resource management development, risk management development, and improvement in accounting and MIS.

The Ministry of Finance will inject additional capital into APB in accordance with the governance agreement and performance targets defined therein. The ADB loan will finance the engagement of an international banking advisor and two domestic administrator/banking assistants to assist APB to complete the restructuring program in accordance with the APB Governance Agreement. APB will also receive specialized assistance to review its accounting policies and procedures.

Constraints and Issues

An overall analysis of the sector shows that there are some constraints and issues to be addressed.

The lack of qualified human resources in the banking sector in general as well in the whole rural and microfinance sector limit the scope of the sector development. In the early stage, the sector should intensify the training aspect for all stakeholders. In-training country outreach and also study tours in neighbouring countries are required.

Capital resources remain a serious constraint and only a strong promotion of savings can help to have a great outreach. Most of the surveys have demonstrated that the demand and supply of rural areas are not only for credit, but also for a huge demand for savings services. In other terms, the poor can also save money, and it is crucial for rural financial services to be delivered close to their households.

The policy and regulatory framework of the sector has made significant progress during the last few years, but needs more development and assistance to really attract new entrants. The BoL MFI supervision capacity is under reinforcement, and it appears that some regulations must be revised in order to fit with the new context, especially with regards to the New Law on Commercial Banks. The main provisions of the law are based on the lessons learned from the previous Commercial Banks Decree.

Poor coordination among stakeholders may impede the development of the sector. In the future, BoL can play gradually the active role of supervisor, coordinator and catalyst of the sector. The establishment of the Microfinance Fund within BoL granted by JFPR will help to disseminate microfinance best practices to MFIs and local officials. Through these activities, BoL will initiate periodic consultations with microfinance industry in the country.

Finally, low density population and poor infrastructure on transport and communications constitute a lot of disadvantages.

PROSPECTS FOR THE FUTURE

The Government has reiterated its commitment on several occasions and in several key policy and strategy documents in the past three years, the Policy Statement on Development of a Sustainable Rural and Microfinance Sector (endorsed by the Prime Minister's office in November 2003), the National Poverty Eradication Program (endorsed by the National Assembly in October 2003) and the ongoing consideration of the draft Strategy and Action Plan to develop sustainable rural and microfinance.

The key objective in the future is how to maintain the momentum built up since late year 2000 through the ADB TA cluster on Rural Finance Development of USD 2 million. The GoL will continue to engage its commitment. Recently the Rural Finance Sector Development Program (RFSDP) has been approved and signed on 29 November 2006.

The RFSDP consists of a program loan, ADB Loan No. 2252 of USD 7.7 million, a project loan, ADB Loan No. 2253 of USD 2.3 million and a TA Grant amounting to around USD 3.3 million.

The total amount of TA Grant consists of:

- ***Building BoL supervison capacity on MFIs (FIRST Initiative).*** (USD 0.28 million, 12 months)
- ***Institutional Strengthening for Rural Finance (piggy-backed TA).* (USD 700,000, 48 months, 2007-2010).** The TA will (i) assist the GoL to coordinate and implement its policy reforms to integrate rural and microfinance into the broader financial sector.
- ***Catalyzing Microfinance for the Poor (JFPR TA)* (USD 1.98 million, 36 months, 2007-2009)**. This JFPR TA will support the development of young and new microfinance institutions by building capacity and providing start-up grant funds for eligible MFIs through a Microfinance Fund (MFF). The MFF will support initiatives by MFIs in the Lao PDR that will (i) contribute directly or indirectly to improved incomes, livelihoods, and opportunities for poor people; (ii) involve a product, service, system or procedure that is innovative and would unlikely be addressed without the support of the MFF; (iii) result (directly or indirectly) in increased access to financial services by the poor; (iv) be sustainable, or result in sustainable impact, after an MFF grant has been utilized; (v) share resource costs required implementation between the MFF and the MFI; (vi) be implemented within 3 years, other than in exceptional circumstances; and (vii) not create unfair competition or otherwise distort markets.
- ***Upgrading of ICT and MIS at APB (JFICT TA)* (USD 0.47 million, 24 months, 2007-2008).** The JFICT TA provides a complementary assistance to implement the Project Loan LAO-2253 by assisting APB (i) execute the bidding process to procure ICT hard and software financed under the Project Loan; (ii) strengthen its ICT staff capacity to manage the ICT systems upgrade; and implement the rollout of ICT to the whole APB branch network.

The goal of this program is to assist the GoL to reduce poverty and promote sustainable economic growth in rural areas. The RFSDP will contribute to this goal by promoting a sustainable and market-oriented rural and microfinance sector.

The program loan has four components, as follows:

- Creating an enabling policy framework for public and private provision of rural and microfinance;
- Creating a sound prudential regulatory and supervisory environment for public and private rural and microfinance institutions;
- Transforming APB into a financially self-sustainable, market-oriented rural finance institution; and
- Creating a supportive non-prudential regulatory environment for rural and microfinance.

The project loan has two components: capacity building under APB's restructuring plan and upgrading APB's ICT systems.

The implementation of the whole program will commence on the first quarter of year 2007 and will run until 2010. The RFSDP is expected to have a positive social impact by strengthening the rural finance sector and promoting sustainable delivery of financial services in rural areas. The Microfinance Fund under the Grant

TA, which will pilot and promote best practice MFIs serving a diverse population, will give preference to supporting sustainable microfinance initiatives that benefit women and ethnic groups. The RFSDP is in line with the NPEP, which identifies access to rural finance as critical to reducing poverty and promoting economic growth.

Restructuring APB into a financially self-sustainable, market-oriented rural finance institution will have both direct and indirect social benefits. Directly, APB's transformation will enable it to increase outreach and consequently contribute to economic growth and poverty reduction in the Lao PDR. Indirectly, phasing out directed lending and interest rate subsidies from APB will free scarce resources of the State and thus contributing to macroeconomic stability.

RURAL FINANCE IN MYANMAR

Lt. Colonel Tin Lwan, Managing Director, Myanma Agricultural Development Bank

The following laws relating to banking were promulgated in 1990:

1. The Central Bank of Myanmar Law
2. The Financial Institutions of Myanmar Law and
3. The Myanma Agricultural Development Bank Law

FINANCIAL INSTITUTION OF MYAMAR LAW

The law provides the legal framework for the operation of financial institutions, such as commercial banks, development or investment banks and finance companies. It provides the establishment of financial institutions, whether State-owned, jointly owned by the State and private entities or purely private, to perform financial activities with the permission of the Central Bank.

A financial institution's licence to operate may be granted by the Central Bank after scrutiny and feasibility study. Moreover, the law provides all the existing State-owned commercial banks, along with newly emerged private banks, to engage both in domestic and foreign banking services. It also specifies the functions, duties and powers of financial institutions, and regulatory provisions to be observed by the financial institutions.

DESCRIPTION OF THE AGRICULTURAL AND RURAL ECONOMY

Myanmar is an agricultural country, and agriculture sector is the backbone of its economy. Agriculture sector contributes 43 percent of GDP, 14 percent of total export earnings, and employs 63 percent of the labor force. The State has laid down 12 political, economic and social objectives in its endeavour to establish a peaceful, modern and developed nation. One of the major economic objectives is the development of agriculture as the base and all-round development of other sectors of the economy as well. The objectives of the agriculture sector are to fulfill the needs for local consumption, export more surplus of agricultural products to increase foreign exchange earnings and to assist in rural development through agricultural development.

RURAL FINANCE POLICY ENVIRONMENT AND REGULATORY FRAMEWORK

The Myanma Agricultural Development Bank (MADB) is a specialized bank for agricultural and rural financing. Originally, the bank was established in 1953 under the name of State Agricultural Bank and later, in 1970 under the socialist economic system, amalgamated with other State-owned financial institution, into one bank called Peoples' Bank of the Union of Burma becoming a division of that Bank and later again became Myanma Agricultural and Rural Development Bank under the MARDB law, 1990. In 1996, the bank was transferred under the Ministry of Agriculture and Irrigation from the Ministry of Finance and Revenue and the name changed to Myanma Agricultural Development Bank (MADB) under the State law and Order Restoration Council Law 3/1997. Capital requirement for loans was 50 billion kyats.

MADB directly disburses to farmer's groups of 5-10 members at the bank's branch counter, using the guarantee in group liability, and taking into consideration the repayment capacity and the needs and demands of clients.

The Myanma Companies Act does not apply to MADB. MADB is exempted from registration and from payment of stamp duty under the existing law. Debts owed to the bank shall be given priority in overall debts and taxes, except those payable to the State and Central Bank. It is also exempted from taxes on income or dues and levies related to banking operations.

Microfinance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers and insurance products to poor and low-income households, for their microenterprises and small businesses to enable them to raise their income levels and improve their living standards.

We live in the age of unprecedented prosperity. But this prosperity is not shared by all. While some nations enjoy highest standards of living, the majority remain in poverty. These countries either because of resource constraints, lack of capital and technology or because of conflicts cannot hope to attain development without international cooperation. Because of their innate weakness and unfavorable international economic environment, they will remain forever in poverty. Poverty breeds discontent and despair-ingredients that could lead to a vicious circle of conflicts and violence. We also are striving to eradicate poverty. In our nation-building process, we place special importance on poverty eradication particularly in rural and far-flung areas. In the border area, where most of our ethnic nationalities reside, we are implementing a program of an all-around development in Myanmar. We have established (24) development areas, towards this end.

The Microfinance Project is one of the eleven projects under the UNDP multi-sectoral Human Development Initiative program in Myanmar. It aims at providing rural poor families with an access to microcredit and savings facilities in townships, Ywangan, Pindaya, Kalaw, Nyaungshwe and Pinlaung in the Shan State; Chaung U, Kyaukpadaung and Magway in the Dry Zone; as well as Mawlamyine Gyun, Bogalay and Laputta in the Delta. The Microfinance Project targets especially those who would not normally qualify for credit such as landless labourers through the formal banking system.

THE ROLE OF THE BANKING SECTOR IN MYANMAR

There are four State-owned banks in the country: Myanma Foreign Trade Bank (MFTB), Myanma Investment and Commercial Bank (MICB), Myanma Economic Bank (MEB) and Myanma Agricultural Development Bank (MADB).

The Myanma Foreign Trade Bank has a long history and experience in foreign banking business having a lot of customers of government, cooperation and individuals, diplomatic and non-governmental organizations. The Bank is acting as the Government's bank for foreign exchange affairs of the State.

The Myanma Investment and Commercial Bank, although the name itself reveals the fact that the bank is both commercial and investment-oriented, has become stronger in the commercial banking area both domestically and internationally. MFTB is currently in the position of monopolizing the State Sector customers. But, on the other hand, it has been, in a way, competing with MICB in providing banking services to the private sector, having no other competitor as all the private banks are, at present, not allowed to do foreign business.

MADB is a specialized bank for agricultural financing and it is stronger in extending agricultural credits more in the form of seasonal loans of short-term nature. The Bank still needs to expand on the development financing activities of agricultural sector of Myanmar. The development of private banking in Myanmar appears more impressive if we take into consideration the negative real interest rates, credit restrictions, and lack of banking habits among the people in the country. Semi-government banks have become more and more successful as their reputation and strong government banking could induce people's confidence year after year.

INTEREST RATES POLICY

The CBM Prime rate was 11 to 12.5 percent before 1996 and then raised to 15 percent in 1996, and then again lowered to 10 percent in 2000. When the CBM rate was 15 percent, the minimum deposit rate was 12 percent and the maximum lending rate was 18 percent thus making a spread of 6 percent. At the current 12 percent CBM rate, banks are paying 12 percent for deposits and charging 17 percent for loans within the range of 5 percent spread. Deposit rate of 10 percent in the past and current 12 percent are still lower than the rate of inflation and it makes the negative real interest rate. This also reveals the CBM's position of inability in effectively utilizing the power of "bank rate policy" in controlling the money supply of the country.

CRITICAL ELEMENTS OF SUCCESS IN OUR INSTITUTION

The provision of various crop loans for different cultivation seasons i.e, pre-monsoon, monsoon and winter season are made by the MADB. Similarly, medium- and long-term loans for agricultural development programs are also available. In 2006-2007, total amount of loans to farmers by MADB was 48,000 million kyats. According to area, expansion of paddy and various kinds of crops loan per acre may be increased by MADB. MADB will totally provide 58,000 million kyats in 2007-2008.

RECOMMENDATIONS

- Microfinance Program by itself is not sufficient for poverty alleviation.
- Uniformity of interest rates charged by 3 INGOs is needed.
- The institutionalization of the emerging MFI is needed.
- Determining the cost-benefit ratio of the methodologies used to provide the credit is necessary.
- Development of microenterprises.

Some key factors of success for microfinance promotions are supportive policy environment, performance standards of MFI, borrowers education and enhancing financing capacity of private bansk vis-a-vis microenterprises.

Constraints include inflation, interest rates restrictions, lack of clear legislation or regulations for MFIs and lack of experience and training.

DEPOSIT-TAKING AND COLLATERAL REQUIREMENT

The bank may issue loans to State-owned agricultural organizations, livestock organizations, cooperative societies, private persons, joint ventures in cooperation there among, farmers, entrepreneurs and labourers for agricultural, livestock and rural socio-economic enterprises.

The Board of Directors shall determine the type and amount of loan and the terms and conditions to be complied with in the disbursement of loans by the Bank. The Bank may provide loans and make disbursements in the form of loans, advances or overdrafts.

The Bank may demand as securities crops grown, livestock raised or commodities produced locally. Cooperative societies operating agricultural, livestock and rural socio-economic enterprise may tender immovable property owned by them or by their borrowing members, which are free from any charge as securities for short-term and long-term loans.

THE SYSTEM OF BORROWING

The Central Bank of Myanmar has the only full authority of borrowing, with the approval of the Government, in any foreign currency on such terms and conditions as it considers appropriate, and also giving security for such loans.

OTHERS

In the Myanmar financial System, apart from MADB, other state-owned banks and private banks don't emphasize microfinance activities for rural clients but focus on commercial or business loans, avoiding risky loan performances and repayment.

Although international and national non-government organizations provide microfinance to the rural poor and MADB grants agricultural loan to rural farmers, there are still poor rural households who have no access to credit and who are badly in need of capital.

Only when above the factors are fulfilled, will microfinance in Myanmar be strong that would lead to poverty alleviation and rural development.

PROSPECTS FOR THE FUTURE

According to the researches from some ASEAN countries, it is pointed out that there is a need for ensuring macroeconomic stability where domestic financial resources are mobilized. Macroeconomic stability includes stable monetary and financial policies for controlling inflation, an appropriate exchange rate regime, a trade regime, and tax and investment policies. Another note worthy point is that although financial reforms and liberalization are necessary to be in line with market economy, liberalization should be undertaken gradually in order to minimize chances of error.

As for MADB, financial sustainability of the MADB stands on its own feet and microcredit activities are expected to help reduce poverty in Myanmar.

MICROFINANCE POLICY ENVIRONMENT AND REGULATORY FRAMEWORK IN NEPAL

Mr. Sushil R. Mathema, Executive Director, Nepal Rastra Bank

NEPAL'S FINANCIAL SYSTEM

The Nepalese financial system, until the mid-1980, was composed of less than a dozen banks and financial institutions including the Nepal Rastra Bank (Central Bank). As in other developing countries, financial repression in Nepal existed in the form of interest rate control, ceiling on bank credit, high reserve requirement and entry barrier for new banks and financial institutions. As a result, the banking and financial service was not available to a wider section of the country's population. On this background, the financial liberalization policy was introduced in 1984 with the objective of financial widening (increasing use of money in exchanging goods and services) and financial deepening (greater financial resource mobilization in the form of financial sector).

Along with the economic liberalization policy, many rules and regulations related to the banking (financial) sector had also been changed and modified. Many policy measures such as removal of the entry barrier to open banks including joint-venture ones (1984), reduction of level of statutory pre-exemption (May, 1986), deregulation of interest rates (August, 1989), authorization to commercial banks to take convertible currencies (July 1985), relaxation of imposing credit ceilings (1989) and introduction of prudential norms related to risk-weighted capital adequacy requirement, accounting, income recognition, loan classification and loan provisioning and exposure (1989) had been implemented in the last two decades.

With the adoption of liberal policy in the financial sector, NRB Act (amended) came into existence in 2002.

Consequently, there has been a tremendous growth in the financial institutions in Nepal. During 1980's, there were only two commercial banks, NBL (Nepal Bank Limited) and RBB (Rastriya Banijya Bank), and two development banks namely ADB/N (Agricultural Development Bank) and NIDC (Nepal industrial Development Corporation). After 1990, the financial sector witnessed a substantial growth of financial institutions following the financial liberalization policy.

OVERVIEW OF THE MICROFINANCE SECTOR:

The 2002 Financial Sector Study by the World Bank revealed that the formal microfinance sector has had limited impact to date in providing financial services to the rural poor. Nevertheless, microfinance is recognized as a powerful instrument for poverty reduction/alleviation in Nepal. Of the estimated 20 million rural inhabitants, 31 percent of whom are classified as poor, only about 700,000 are serviced by formal microfinance institutions. The overwhelming majority of the poor, therefore, have to look to the traditional informal sector viz; moneylenders, family members, friends, traders, landlords, rotating savings and credit associations for these services. Additionally, over the last decade about 20,000 indigenous savings and credit organizations have sprung up. Normally, these are small (less than 25 members) self-managed, unregistered and have limited resources. They have, however, spread to all regions of the country although they are mainly found in the most accessible areas.

The development of the formal microfinance sector dates back to 1974, when the NRB directed that NBL and RBB lend at least 5 percent of their deposits under a "Priority Sector Credit" Scheme. The target sectors under the scheme included agriculture, cottage industries and services. This requirement then was extended to all commercial banks and the guide line was raised to 12 percent of total deposits mobilized. The success of this approach, however, was less than anticipated and the loan portfolio actually extended to small farmers was quite limited.

Presently, Nepal is implementing the World Bank-funded Financial Sector Reform Program (FSRP). As a part of the FSRP starting from the fiscal year 2002/03 to the next five years, the NRB has declared a phasing-out policy of the three decade-old Priority Sector credit program (12 percent requirement) of the commercial banks. According to this phasing-out policy, commercial banks' credit to the priority sector will not be mandatory by the end of FY 2006/07.

Partially, as a result of the limited outreach achieved, the government in 1992 established a series of Grameen Bikas banks to supplement the ongoing activities of the formal sector. These government-supported programs are estimated to serve about 400,000 clients.

In parallel with government's efforts to establish a network of rural financial service providers in the early 1990's, the private sector also came forward to serve as financial service providers. These included formal cooperatives (savings and credit, and multi-purpose cooperatives), NGOs, savings and credit organizations and international non-governmental organizations. The World Bank estimates that they service about 300,000 clients with the largest providers being the registered cooperatives (150,000) and Center for Self-Help Development (36,000). Other large providers are Nirdhan (32,000), the Support Activities for Poor Production of Nepal (SAPPROS) (13,000) and the Development Project Service Center (DEPROSC) (14,000).

HOW MICROFINANCE IS UNDERSTOOD IN NEPAL

Microfinance is the provision of a broad range of financial services to poor and low-income households such as micro-savings, loans, payments/or money transfers and micro-insurance. Microfinance products in the country are microcredit, medium and small enterprise credit, group savings, project loan and micro-insurance. Although the conventional definition of microfinance is to providing banking services to lower income people, targeting the poor and the very poor, the institutional definition of microcredit in Nepal is as the following:

- Central Bank (NRB) in its regulation defines the loan up to Rs 40,000 by Microfinance Development Bank (MFDB) as microcredit.
- Rural Self-Reliance Fund (RSRF) recognizes loan up to Rs 50,000 per borrower given to the deprived sector as microcredit and a group loan up to Rs 100,000 given to the members on joint liability for project loans.

THE 10TH PLAN PROVISIONS ON POVERTY REDUCTION AND MICROFINANCE

Poverty reduction has been receiving high priority in the periodic development plans of Nepal. While the current Tenth Plan has enunciated policies and strategies on cooperatives and rural/microfinance, the Poverty Reduction Strategy Paper (2002-2007) provides the most pertinent enabling framework for them. The "four pillars" of the Strategy as elaborated in the Plan have been (i) broad-based high and sustainable economic growth; (ii) social sector development; (iii) targeted programs for the poor, deprived and excluded sections; and (iv) good governance.

These strategies were designed to reduce poverty level from the then estimated 38 percent to 30 percent by 2007, except that the Plan target of poverty reduction has been pre-empted by the findings of the NLSS regarding remittance–induced poverty reduction. It may be recalled that the findings of NLSS II that the poverty reduction during the above period is mainly attributed to the exodus of labor and increase in remittances and can hardly be attributed to the country's success in development performance. The plan has earmarked a total allocation of 100.75 billion rupees for "rural and agricultural credit" during the plan period, and it includes a sum of 11.90 billion to be financed by MFIs.

The strategies for achieving this objective include: (i) improvement in the institutional mechanism to expand credit flow through MFIs in rural areas, and (ii) gradually hand over of the ownership of rural development banks to the private sector (NPC, 2002). Along this line, the government has also established a Poverty Alleviation Fund, which extends credit through the local NGO/CBO intermediaries in the rural areas. It should, however, be noted that while the first PRSP strategy of "broad-based, high and sustainable economic growth" has generally eluded the country during last fifty years of planned development effort, the recent successes of the various microfinance initiatives have generated an optimism that the "targeted programs for the poor' that should encompass microfinance initiatives, if properly implemented, could go a long way in significantly contributing to the poverty reduction goals enshrined in the plan.

INTEREST RATE STRUCTURE IN MICROFINANCE

As the Central Bank has already adopted the policy of deregulation of interest rates, it is observed that the interest rates charged on microfinance loans vary considerably. The moneylenders in the informal market charge interest rates of 3-5 percent per month. The high interest rates charged is justified on the basis of easy availability and minimum procedural delays. The savings and credit cooperatives charge between 0.75-1.5 percent per month which is around 24 to 48 percent per year and pay six to eight percent per annum on savings account. These interest rates levels are based on the need to cover their high operating costs, including monitoring and supervision costs as well as their cost of funds, if such funds are sourced from wholesale lenders such as ADB/N, RMDC and so on.

ADB/N charges between 12 to 16 percent per year on the reducing balances, and pays interest of 6 percent per annum on savings accounts. The commercial banks' prime lending rates vary between 11-12 percent per annum for working capital loans and 3 percent per annum on loans to entities qualifying as deprived sector loans under the Priority Sector Credit Scheme. The current interest rate paid on savings accounts with the commercial banks is about 3.3 percent per annum.

MICROFINANCE NEXUS IN POVERTY REDUCTION

To date, Nepal has passed through the experiences of about three decades in microfinance and has been exclusively recognized as a poverty-reduction program focused towards raising the income level and social standard of the people living below poverty line, particularly the women. In due consideration of the success of the microfinance program in bringing positive impact towards poverty reduction, the current 10th Plan (2002-2007) has incorporated microfinance as major financial tool to achieve the objective target of poverty reduction. The Tenth Plan, as explained earlier, therefore, has set a target of Rs 101 billion of rural credit to be disbursed during the plan period of which, 50 percent will be disbursed by the microfinance institutions. In this regard, it would be plausible here to discuss in brief about the different kinds of microfinance practices prevailed in the country. The microfinance practices of the organized sector that are prevailing in the country can be grouped broadly into seven microfinance models:

1. Grameen Model (Grameen banks and replication)
2. Small Farmers Co-operative Model (SFCLs of ADB/N)
3. Financial Intermediation by NGO's Model (FINGOs)
4. Priority Sector and Deprived Sector Credit Model (Directive Lending for Commercial Banks)
5. Savings and Credit Co-operative (SACCOS) Model (RSRF's POs and registered SACCOSs)
6. Project-based Microfinancing Model (PFIs)
7. Wholesale (RSRF, RMDC and SKBB) Model for Microfinance

All the above financial institutions (FIs) operating under different models come under the purview of Nepal Rastra Bank's permit for business operation and are functioning as legal entities. However, some partner organizations (POs) of Rural Self-reliance Fund (RSRF) operating in the rural and remote areas are registered with the Department of Co-operatives. Apart from the formal sector, a number of NGOs involved in financial intermediation in the informal sector, village banks and self-help groups are also engaged in providing microfinance services to the rural people. Depending upon the quality of the activities, some of these institutions have been promoted, developed and supported by INGOs, projects and also by the local people.

- **Grameen Model**

A concept of Grameen Bank was evolved in 1992 when the Nepal Government felt the need for establishment of a separate institution which would take sole responsibility after financing the rural poor and supplement to some extent, the rural microfinance activities of the previously established institutions. The aim of the Grameen Bikas Banks (GBBs) thus established as regional development banks in five development regions between 1992 and 1996, operating similar to the Grameen system of Bangladesh, is to provide the targeted rural poor with the appropriate credit delivery mechanism and on group liability basis. These banks are the largest MF operators in Nepal. Training as an entry point of banking has been introduced, as a new specialized banking system by Grameen Bikas Bank. Nepal Rastra Bank has the major share of about 70 percent in 4 GBBs while in one only 10 percent as the later one recently went on privatization process. Besides, the Government-owned five GBBs, four MFIs based on the Grameen model and established as development banks are operating in the private sector.

All the Microfinance Development Banks (MFDBs) are regulated and supervised by Nepal Rastra Bank. In this Grameen bank model, interest rate charge ranges between 10 to 25 percent per annum and four MFDBs' interest rate charge ranges between 10 to 25 percent per annum. The repayment system of all MFDBs including Grameen banks is weekly, fortnightly and monthly basis, both for group loans as well as for project loans.

- **Small Farmers Co-operative Model (SFCLs of ADB/N)**

The Agricultural Development Bank of Nepal (ADB/N) initiated a newly developed financing concept on co-operatives known by the name of Small Farmers Co-operative Limited (SFCL) which is, in fact, a convergent form of the three-decade old Small Farmers Development Project (1976) of the bank, which is considered as the first poverty-focused credit program of the country. To meet the wholesale requirement of SFCL for on-lending to small farmers, ADB/N, has established the Small Farmers Development Bank (SFDB, 2002) under the BFI Ordinance 2005. The main objective of transformation of SFDP into SFCL is to ensure the viability and sustainability of microfinance institutions, which would be managed and administered by the members themselves. Many international organizations including IFAD, ADB/M, CGAP had lent their support to this program in one way or the other and GTZ has been continuously providing technical support to help upgrade these institutions.

As of mid-July 2006, a total of 117,094 members (18,365 small farmers groups) are associated with 200 numbers of SFCL in the country. During the same period, however, only 141 SFCLs have taken wholesale loan from SFDB for on-lending to the small farmers with the credit disbursement amounting to Rs 1347 million. In this model, SFDB provides the wholesale loan to SFCL at 9.5 percent interest rate per annum. Whereas SFCLs disburse loan to their clients at the interest rate ranging between 12 to 16 percent per annum and the loan is repaid within 2 to 5 years from the date of disbursement.

- **FINGOs Model**

This is the latest form of development in microfinance in terms of the financial intermediation process. It is believed that more than 10,000 unregistered NGOs are operating in the country either in the field of microfinance or in social and community-based development activities. However, only 47 NGOs (mid-July 2006) have been permitted license for doing limited banking operation from NRB. Till, mid-July 2006, 51 NGOs are associated with the Rural Self-reliance Fund (RSRF, 1991). After the promulgation of Financial Intermediary Act of 1998 (1st amendment in 2002), a wider scope had been created for the NGOs to function as financial intermediary for mobilizing savings and promote credit activities within the group. In this model the NGOs disburses loan for the microfinance on group basis. The interest rate ranges between 18 to 25 percent per annum and the repayment system of NGOs in MF is in very short term periodic basis i.e. weekly, fortnightly and monthly.

- **Priority Sector and Deprived Sector Credit Model:**

Priority sector lending model was introduced in early 1974 through the mandatory credit requirement as put by the NRB in agriculture, cottage industry and services sector. This mandatory requirement is presently called Priority Sector Credit Program (PSCP) and Deprived Sector Credit Program (DSCP). The Priority Sector Credit Program was renamed later as Intensive Banking Program in 1981 while Deprived Sector Credit Program was introduced in 1991 by the NRB.

Both the programs have provisions for direct and indirect financing. Under the direct financing mechanism, commercial banks provide loans to the beneficiary directly as retail lending while under indirect financing, commercial banks act as wholesale microfinancer and the loan-able funds are channeled through MFIs, co-operatives, FINGOs and MFDBs for on-lending to the beneficiaries. Notwithstanding the fact that Nepal is currently passing through a World Bank-led Financial Sector Reform Program (FSRP), NRB has opted a phasing-out policy of this priority sector credit program within five years starting from 2002/03. It may be recalled that the mandatory requirement to flow fund in priority sector credit program was 12 percent of the total credit outstanding while for DSCP, commercial banks are required to finance microfinance sector at least to the tune of 3 percent of their total credit outstanding. Thus, DSCP is also a major source of fund for on-lending purposes to MFIs. In the Priority Sector Credit Program, the commercial bank charges 4 to 12.75 percent interest rate per annum whereas in DSCP the interest rate ranges between 4 to 11 percent per annum.

- **Savings and Credit Co-operatives (SACCOS) Model**

As stated earlier, co-operative model of financing has emerged in Nepal as early as in the 1950s. This is a member-based organization, registered with the objective of self-help development among the members. As of mid-April 2006, around 8,045 co-operatives have been registered with the Department of Co-operatives of which 2,692 are savings and credit co-operatives (SACCOSs) and 447 or 5.55 percent of them are women SACCOSs. Such SACCOSs provide microfinance services to their members for running income-generating activities. Out of 2,692 SACCOSs, only 19 savings and credit co-operatives have got license from NRB for limited banking transaction. A separate legal framework called Co-operative Act-1998 governs co-operative societies.

- **Wholesale Microfinancing Model**

Wholesale microfinancing in Nepal was introduced in the 1990s and relatively is a new concept which was introduced with the establishment of Rural Self-reliance Fund (RSRF) in 1991. Later another institution called RMDC (Rural Microcredit Development Center) under RMP came into existence in 2000 to cater to the wholesale credit needs of MFIs for on-lending purposes as well as for institutional capacity building of MFIs and capacity building of clients of partner organizations (POs). Concurrently, in the year 2002, another wholesaling microfinance institution called Sana Kisan Bikas Bank (SKBB) was established to provide wholesale credit to Small Farmers Co-operative Limited (SFCL). Likewise, a wholesale institution called National Co-operative Development Board (NCDB) was established in 2003.

DEPOSIT INSURANCE AND CREDIT GUARANTEE CORPORATION (DICGC)

DICGC was established in 1974 with the joint investment of the NRB, Rastriya Banijya Bank (RBB) and Nepal Bank Limited (NBL) with the major share being that of the NRB. The corporation charges one percent premium per annum on the outstanding amount of priority sector loan. It provides guaranteed compensation up to 75 percent of the defaulted rural loans. It has also started to give guarantee against loans for buffalo/cattle since 1987/88. Even after the phasing of Priority Sector Loan, the corporation's continued compensation for the default of the rural lending of commercial banks will encourage the commercial banks to expand the rural branch network and wholesale lending to MFIs for on-lending to targeted poor people.

PRUDENTIAL REGULATION IN MICROFINANCE

Microfinance practices in Nepal started as early as in 1974. However, efforts in creating legislative and regulatory environment for this sector was made possible only after the introduction of Development Bank Act of 1995 and Financial Intermediary Act of 1998. Nepal Rastra Bank introduced with effect from mid-April 2003, prudential regulation for microfinance development Bank (MFDB). This regulation with effect from the fiscal year 2005/06 has made further amendment in some areas. Presently, there are nine MFDBs in operation out of which are five Grameen Bikas Banks (GBBs) in the government sector and remaining four in the private sector. There are two separate legal frameworks for microfinance operation. BFI Ordinance 2005 among others, also permits MFDB to do microfinance business, whereas Financial Intermediary Act of 1998 (1st Amendment 2002) facilitates FINGOs for doing limited financial intermediation like small savings, group savings, microcredit and agent banking. With the introduction of BFI Act (now BAFIO-2005), all microfinance development banks falls under category 'D' financial institution. Details of NRB's prudential regulation for MFDBs are presented below.

CAPITAL REQUIREMENT

A minimum of paid-up capital of NRs. 100 million is required to open an MFDB at national level. Similarly, MFDB which is to be operated within 4 to 10 districts excluding Kathmandu valley requires NRs. 20 million as its minimum paid-up capital. The lowest capital requirement for MFDB is NRs. 10 million and such MFDB can operate with the coverage of three districts only excluding Kathmandu valley.

LIMIT FOR PROMOTERS' STAKE

A minimum of 15 promoters are required to promote an MFDB. The promoters of MFDB can hold a maximum stake of 70 percent. At least 30 percent shares should be allotted to the general public, which should be issued within two years of the operation of the bank. The promoter can off-load their stake with the permission of the NRB after meeting the following two conditions: (a) public issue has been done; and (b) listing of shares at the Stock Exchange has already been done for the last 3 years.

PROVISION FOR FOREIGN STAKE HOLDING

Foreign institutional investors can hold a minimum of 20 percent to maximum of 85 percent stake at the MFDB. However, such stake should not affect the public allocation i.e. 30 percent if the foreign investment is less than 50 percent. If foreign investment is equal or greater than 50 percent of the total paid-up capital, there should be provision of 20 percent for public allocation. But foreign individuals are restricted to have equity in MFDB.

INDIVIDUAL SHARE HOLDING LIMIT

Any individual, firm, family, group, houses, company falling in the same group cannot hold more than 15 percent share of MFDB. Such limit is also applied to the promoters.

LICENSING PROCEDURES

If the proposal for establishing MFDB is found technically and financially viable, NRB will issue banking license to such MFDB within four months of the application submitted with cash deposit to NRB by the promoters. An amount equivalent to 20 percent of the promoter's shares should compulsorily be deposited with the NRB's account at the time of application. Another 30 percent of such amount should be deposited at the time of receiving 'letter of intent' from the NRB. The remaining 50 percent of the promoters' commitment should be deposited at the time of getting business license from the NRB. The NRB does not provide any interest on such deposits. On the other hand, if the proposal is found non-viable, and the promoters could not submit the required documents and fail to deposit cash amount within the timeframe given, the NRB will reject such proposal and notify to the applicants within the timeframe as mentioned above.

GRADUATION OF MFDB

An MFDB (that presently falls under grade D) can be graduated if it fulfills all requirement for upgrading from grade 'D' to 'C' and so on to grade 'A'.

PRIORITY FOR LICENSE

A MFDB, to be operated in the rural areas, is given top priority for business license by the NRB.

OTHER PRUDENTIAL REGULATIONS

NRB has introduced, with effect from mid-April 2003, prudential regulation for MFDB operating in the country with an objective of making microfinance business more viable and sustainable as well as competent and effective in delivering services. The prudential regulation of the NRB has been designed in line with the Basel's prescription for commercial banks. However, some relaxation has been made in this regulation intended for microfinance activities. These regulations, with effect from fiscal year 2005/06, have been incorporated into single regulatory framework designed for all types of financial institutions, including category 'D'. The highlights of such regulations are presented below:

- **Capital Adequacy Ratio**

Based on weighted risk assets (WRA), MFDB is required to keep its capital adequacy at the ratios presented in the table below.

Fiscal year	In Percentage of WRA	
	Primary Capital Ratio (Tier-I)	Total Capital Adequacy Ratio
2003/04	2	4
2004/05	3	6
2005/06	4	8

Primary capital includes paid-up capital, general reserves, retained earnings, irredeemable preference, capital redemption reserves, other reserves and premium on shares while secondary capital (Tier-II) includes other reserves that are not reflected in primary capital.

- **Cap on Mobilizing Financial Resources**

Initially, MFDB can mobilize financial resources up to the maximum limit of 20 times of the core capital (Tier-I capital). This cap has been somewhat relaxed and with effect from fiscal year 2005/06, the maximum limit has been raised to 30 times of the primary capital. Such financial resources include deposits (group-based), special savings deposit and borrowings. For the calculation of capital adequacy, MFDBs are monitored bi-annually (mid-July and mid-Jan).

- **Liquidity Requirement**

MFDB are required to maintain a minimum liquidity balance at 2.5 percent of their savings deposits as a liquidity ratio, of which 0.5 percent should be kept as cash reserve requirement. 'Liquidity' includes cash in vault, investment in government securities, investment on NRB-bonds and balance held at category 'A' financial institutions (commercial banks). For monitoring purpose, such liquidity ratio is calculated in each month based on daily averages. Failure of MFDBs to keep the minimum liquidity requirement makes them subject to pay heavy penalty to the central bank as stated in NRB Act-2002 (generally the highest bank rate is applied as penalty for such shortfalls).

- **Loan Classification and Provisioning for Loan Losses**

Based on the aging of overdue loans of MFDBs, loans have been classified into 4 groups and according to loan classification, necessary provisioning is required to maintain annually as in the following ratios:

Loan Classification	Basis of Classification (Aging of Overdue)	Provision Required P.C. of the Loan
Pass	No overdue and overdue by 3 months	1
Sub-standard	Above 3 months – 9 months overdue	25
Doubtful	Above 9 months – 1 yr. overdue	50
Loss	Overdue by above 1 yr.	100

- **Business Operation Area and Branch Expansion**

MFDBs are given autonomy for the expansion, closure and merger of their branches within the approved geographical working area. However, the bank should seek prior approval from NRB while expanding their existing geographical working area. The opening up of a new branch should be based on a Business Plan approved by their respective Boards.

- **Single Borrower/Member Limit**

Initially MFDB can extend loan to the amount of Rs 30,000 per member of the group as microcredit for income generating activities which has now been raised to Rs 40,000. However, the bank can extend loan up to Rs 100,000 to graduated members for running micro and small enterprises. Such loans are collateral-based. An MFDB can invest in such microenterprises up to 25 percent of its total credit and investment.

- **Good Governance**

To establish a good corporate governance culture in the MFDBs, various norms and standards are set, some of which are mentioned below:

- Minimum qualification requirement for promoters, member of the Board of Directors and Chief Executive Officer
- Restriction on family related borrowings
- Disciplines for Board Members, CEO and staff
- Restriction to staff for affiliating own-self to any political parties and their sister-organizations
- Segregation of internal and external audit
- Declaration of property by bank's officials for transparency purpose

OTHER REGULATORY ARRANGEMENTS

- **Deposit-taking**

In general, provision of deposit-taking activities for microfinance institutions has not been established in Nepal. As per the Section 47(4) Clause of the Banking and Financial Institutions Act (BAFIA) 2006, these institutions are allowed to accept interest-bearing or non-interest-bearing deposits within the limit issued by the Nepal Rastra Bank (NRB). While, the Clause-B of the same section of BAFIA, these institutions can mobilize the savings among their group members while it is prohibited for non-group members.

- **Borrowings**

According to the Section 47(4) Clause-C of BAFIA, in order to effectively use microcredit disbursement, licensed microfinance institutions are allowed to collect loans and grants from domestic and foreign institutions. However, they are required to take NRB's approval for accepting loans and grants from foreign institutions.

CRITICAL ELEMENTS OF SUCCESS IN NEPAL'S MICROFINANCING

The historical record thus reveals that rural credit program has been considered as one of the strong components of poverty reduction program and policy of the government. A better output has come out with the extension of microfinance program through semi-government, non-governmental organizations (NGOs), Grameen Bikas Bank replications and INGOs.

The success of such program is attributed to the following features:

- The program is generally based on group dynamism and solidarity;
- Group is formed only after intensive training is imparted;
- A strong inter-linkage is established among the groups with the formation of a kind of Coordination Committee;
- Decision making process is guided by the participation of the member farmers/entrepreneurs themselves;
- The field staff or field officer/coordinator is very much devoted towards encouraging and motivating the participating targeted clients;
- A system exists for imparting training on new technology and creating awareness basically through inter-group exchange visits among the beneficiaries;
- Savings mobilization scheme is inherent as an integral part of the program;
- Group responsibility is imminent in case a member of a group defaults in loan repayment and therefore is the obligation of the rest of the members to repay the loan default out of their own deposit amount;
- There is built-in monitoring and supervision system; and
- Supplement programs to create awareness and development of skills run parallel to credit provision programs.

EXISTING CONSTRAINTS AND ISSUES

In the history of rural financial system, NRB has played an important role in building up the institutional mechanism to avail microfinance easily and smoothly to assist the income activities of the rural people. As a result, many MFIs have come into the rural scenario and have participated in the microfinancing as the effective financial tools for poverty reduction. With the adoption of a liberal financial system by the NRB in 1991, this led to the growth of financial institutions such as Grameen Bikas Banks. The financial position of some of these banks is not at a satisfactory level. So a major challenge faced these days in microfinance is how to make this industry viable, sustainable and profitable. Reaching out to the majority of the poor people with micro and rural finance and making the financing institutions viable, sustainable and profitable are two different aspects of microfinance. Both aspects are equally important in making rural financing accessible to the rural people on a sustainable basis.

Realizing the latter part of the above two aspects, NRB in October 2001, initiated an important policy correction step known as the 5-year restructuring program for the GBBs. The ongoing restructuring program for GBBs is managed internally by Nepal Government and the NRB. After the restructuring, one out of four ailing GBBs came into profit, one got privatized and another is in the pipeline for privatization process. The GBBs restructuring 2001 has a 15-point reform package, which is directed towards making microfinance business viable, sustainable and accessible to the deprived sector of the society. This has in a way led the NRB to come up with the prudential policy 2003 for MFDBs.

Likewise, the phasing out of Priority Sector Loan program will deprive microfinance institutions of the important source of fund coming from commercial banks while the Deposit Insurance and Credit Guarantee Corporation needs to be strengthened for small credit and deposit insurance and providing support in both livestock and cash crop insurance. There is a need to promulgate some sort of affordable policy to address these issues. But in the microfinance world, there are so many actors involved such as cooperatives, FINGOs and others apart from banks that are actively involved in assisting to raise the income and social standards of the weaker sections of the society. To put all of them into regulation under one umbrella might be a debatable issue.

At present, the regulated microfinance sector is made up of five regional rural development banks (RRDBs), 4 microfinance development banks (MFDBs), 47 Financial Intermediation by NGO's Model (FINGOs) and 19 finance co-operatives which is regulated by the Nepal Rastra Bank and supervised by the Supervision Department. Under the principles of regulation, the institutions that collect deposits from the public should be regulated. But it may be uneconomical to regulate large number of very small institutions. Besides, it is inappropriate to regulate if the central bank/supervisor cannot ensure the prudential behavior of the regulated institutions to justify public confidence in them. The present manpower capacity of the Supervision Department of the NRB and the network of microfinancing institutions involved in the country limit the supervising capacity. Putting under regulation too many MFIs with a few hundred clients will cost a lot while with too many MFI types it will be difficult for public or clients to determine which type is the best.

In the present scenario of microfinancing in the country, there are thousands of co-operatives which are not registered with the NRB but with the Co-operative Department and supervised by it. So it seems that there is a less need for regulation as they are member-based institutions but since its activities do influence the financial sector, one has to look for an alternative way to put them into financial discipline.

FINGOs are at present left out of the regulatory framework as they lack an ownership structure which has adverse implications for governance and reach relatively small numbers of clients. So, it may be advised that the largest MFIs, cooperatives and FINGOs be encouraged to register as the development banks initially at the district level and GBBs could be merged with MFDBs once they go for privatization and attain better financial discipline.

With the growing number of rural financial institutions, it is imperative that these institutions should properly be monitored, supervised and coordinated. Accordingly, the NRB is formulating a National Microfinance Policy to address all issues challenges including the regulatory and supervisory frame work relating to the microfinance sector and also assuming to create a national microfinance development fund at the apex level so that whole sale loans can be availed from this fund to MFIs for on-lending to targeted beneficiaries. Perhaps it is also wise to establish a separate institution outside the purview of the NRB which will do the regulatory and supervisory work to monitor and regulate the various microfinance institutions of the country depending upon the size, capital and area of outreach of the services of such microfinance institutions.

FUTURE PROSPECTS AND STRATEGIES:

The weaknesses observed in the formal credit sector and the liberalization policy adopted by the government opened the scope for the entry of informal sector in the development of microenterprises. This informal sector came into the form of many of domestic intermediaries as well as international NGOs, which led to the growth of microenterprise development program widely in the country. But the participation of semi-government, non-governmental agencies both domestic and international donor agencies in addition to government agencies has generated problem in designing effective models of the microfinance program.

Despite the expansion of such programs at an alarming rate, they are without appropriate institutional building. It has been observed that there is absence of linking the objective with the mode of the program for poverty alleviation, which has unnecessarily generated non-targeting and mis-targeting at the implementation level. Moreover, even with such number of involvement, it has been felt that the demand for rural financial services has been estimated to meet not exceeding five percent of total potential demand and, inadequate prioritization of such programs without having any strong authority to monitor its impact on rural poor has misguided the essence of achieving goal of poverty reduction in most of the related projects, including the donor-funded.

Recent experiences revealed that different participating agencies are experimenting with different modules in the name of sustained and microfinance development programs with credit access as the main component, which may obviously lead to off-tracking of the real objective of the program.

A growing concern is also the total dependence of some poverty alleviation programs on foreign fund. These programs are unlikely to sustain, once the aid is phased out. The microfinancing program has been suffering from various issues such as incidence of overlapping of program location areas, high operating costs, high interest bearing loan and mushrooming of different microfinance development modules at an alarming rate. It is found that they charge as high as 25 percent to poor beneficiaries as against the commercial bank's interest rate of around 14 percent. Surprisingly, most of the microfinance programs running in the country incur high operating cost, in some cases reporting as high as 27 percent. This has brought in a question on the sustainability of microfinance program itself, which may bring higher social cost to the nation if not handled properly in time.

This calls for building up an effective organization and management capacity to bring various microfinance organizations under one umbrella to follow a definite accord and handle all aspects of financial intermediation and credit access.

Microfinance programs have gained popularity in recent times as both national financial institutions as well as bilateral and multilateral agencies have started to link microfinance programs with the development programs of the nation to alleviate/reduce the poverty. Since the operational as well as the social cost of such programs are high, especially after the termination of the project, a device and mechanism for managing loanable funds within the banking system has to be developed. Thus, there seems to be a need for a national policy for setting up a national microfinance development fund so that the fund can be utilized as wholesale financing to many of the MFIs for on-lending to the poor beneficiaries.

The essence of microfinancing should be preserved by bringing microfinancing programs of multi-dimensional institutions under one umbrella for which the activities of wholesale microfinance institutions should be broadened from wholesale microfinancing to developing various norms in specifying the scope of different activities of institutions involved in rural microfinancing as well as the prudential regulation and supervision wherever needed.

A national consensus is therefore needed to come up with an appropriate broad-based microfinance program module, which is adequately designed in accordance with the local need, people's genuine participation, their absorption capacity to income generating activities, loan utilization capacity and the self-regulated and supervisory environment.

CREATING CONDUCIVE RURAL FINANCE POLICY ENVIRONMENT AND REGULATORY FRAMEWORK: THE PHILIPPINE CASE

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INTRODUCTION

The rural financial market in the Philippines has gone through various stages of development and experience – from a policy environment characterized by credit subsidies, credit allocations and loan targeting in the seventies; a liberalized and deregulated financial markets starting in the eighties; the resurrection of subsidized credit programs in the mid-nineties; and a rebound of financial reforms through the Agriculture and Fisheries Modernization Act starting 1998 up to the present.

EVOLUTION OF RURAL FINANCE/MICROFINANCE POLICIES

- **Policies of the 1970s**

Credit allocation, loan targeting, credit subsidies and directed loans to certain sectors were the hallmark of the supply-led finance approach in the 1970s and 1980s. Funding was sourced from government budgetary appropriations and foreign loans.

Implementation of commodity-specific credit programs. These programs were intended to meet the government's objective of attaining self-sufficiency in food requirements, particularly rice and corn. The loans were channeled through the Philippine National Bank (PNB) and the Central Bank of the Philippines (CBP) to rural banks which were given cheap funds for on-lending to small farmers at highly subsidized rates.

Imposition of mandated credit quotas. Presidential Decree 717 or the Agri-Agra Law, issued in 1975, mandated banks to set aside 25 percent of their loan portfolios for agricultural lending, 15 percent of which should be allocated to general agricultural lending and 10 percent to agrarian reform beneficiaries.

Use of subsidized interest rates. To lessen the cost of credit to the agriculture sector, the Central Bank of the Philippines opened a rediscounting window offering cheap funds for loans going to the agriculture sector. Rural banks were the chief beneficiaries of loans at highly subsidized interest rates from the Central Bank of the Philippines.

- **Policies of the 1980s and 1990s**

At the beginning of the 1980s, the government embarked on the liberalization of the financial markets and the deregulation of interest rates. Market-oriented financial and credit policy started to replace the financial repression policies of the earlier decades. Salient policies included the following:

- Deregulation of interest rates.
- Promotion of savings mobilization as source of loan funds.
- Consolidation of directed credit programs in the agriculture sector.
- Implementation of Rural Bank Rehabilitation Program.

Market-oriented financial and credit policies. The Agriculture and Fisheries Modernization Act (AFMA) was enacted in December 1997 mandating the adoption of market-based interest rates in the implementation of government credit programs in the agriculture sector. The AFMA also provided for the phase out of all directed (that is, subsidized) credit programs (DCP) implemented by government non-financial agencies in the agriculture sector over a four-year period. The proceeds from the phased-out DCPs in the sector will be consolidated into the Agro-Industry Modernization Credit and Financing Program (AMCFP), which will then serve the credit demand of the agriculture sector at market-based interest rates. In sum, the market-based policy principles of the AFMA, as follows:

- Provision of a conducive policy environment, critical support and capability-building services that would facilitate increased participation of the private sector in the delivery of credit;
- Greater role of the private sector including rural banks, cooperative rural banks, cooperatives and NGOs in the provision of financial services;
- Adoption of market-oriented interest rates;
- Active participation of government financial institutions in the delivery of credit services and non-involvement of government non-financial institutions in credit decision making.

The Agro-Industry Modernization Credit and Financing Program (AMCFP). As provided for in the law (AFMA of 1997), all directed credit programs are to be terminated and replaced by the AMCFP as the umbrella credit program of the Department of Agriculture. The Agricultural Credit Policy Council (ACPC) took the lead in developing a system whereby government credit resources are administered more efficiently through the AMCFP. The following features make the AMCFP different from the past credit programs of the government: (i) it is demand-driven and not supply-led; (ii) it is not commodity-specific but covers a whole gamut of income-generating projects which farm households may choose to undertake; (iii) the government is not involved in any credit decision-making as the program is implemented as a two step loan program with government financial institutions as wholesalers and qualified private banks as retailers; and (iv) it adopts market-determined rates as opposed to the subsidized rates of the past.

Phase out of DCPs in other sectors. To complement the credit policy provisions of the AFMA, that is, on the phase out of credit programs in the agriculture sector, the government issued Executive Order No. 138 for a similar phase out of all directed credit programs (DCP) in other sectors and the termination of the participation of government non-financial agencies in the implementation of credit programs. Executive Order No. 138 also mandates the adoption of market-based financial and credit policies and the use of government financial institutions as vehicles for the delivery of wholesale credit to private financial institutions that will take care of on-lending at the retail level. The underlying policy frame of AFMA and Executive Order No. 138 is the use of the market mechanisms in the allocation of financial resources and the reliance on domestic savings mobilization to fund credit programs.

Other Policy Reforms. Other reforms include the enactment of the General Banking Act on May 2000 which consists of provisions mandating the Bangko Sentral ng Pilipinas to recognize the unique nature of microfinance as it formulates banking policies and procedures. As such, the moratorium on branching was lifted specifically for microfinance banks; BSP Circular 272 was issued on January 2001 implementing the microfinance guidelines of the General Banking Act (see Annex A); and the supervision and examination process was reviewed to reflect the special nature of microfinance, i.e. non-collateralized loans. Another policy reform was the enactment of the Barangay Microenterprise Business Act which directs the adoption of market-based credit policies in the provision of financial services to barangay or village-based microenterprises. Under this Act, government wholesale financial institutions are directed to create special credit windows adopting market-based interest rates for private financial institutions intending to provide credit to barangay microenterprise business.

EMERGENCE OF MICROFINANCE

The failure of the formal banking system and the DCPs to provide small-scale borrowers such as small farmers, microentrepreneurs access to loans led to the development and evolution of various microfinancing techniques among private microfinance institutions. Bangko Sentral ng Pilipinas defines microfinance loans as *small loans granted to the basic sectors, as defined in the Social Reform and Poverty Alleviation Act of 1997 (Republic Act 8425), and other loans granted to the poor and low-income households for their microenterprises and small businesses so as to enable them to raise their income levels and improve their living standards. These loans are granted on the basis of the borrowers' cash flow and are typically unsecured.* Bangko Sentral ng Pilipinas issued ***Circular No. 272 (January 2001)*** with four important guidelines on microfinance:

- Microfinance loans may be amortized on a daily, weekly, bi-monthly or monthly basis, depending on the cash flow conditions of the borrowers;
- Interest rates shall not be lower than the prevailing market rates to enable the lending institution to recover the financial and operational costs incidental to this type of microfinance lending;

- A bank may not require from its credit applicants a statement of assets and liabilities, and of their income and expenditures and such information as may be prescribed by law or by rules and regulations of the Monetary Board; and
- Lending to small borrowers shall not be on the basis of collateral but on the basis of cash flows.

Bangko Sentral ng Pilipinas' Circular No. 272 exempts microfinance loan borrowers from submitting the usual documentary requirements for credit evaluation and approval, e.g., audited financial statements or statements of income and expense.

Bangko Sentral ng Pilipinas' ***Circular No. 282 (April 2001)*** provides the guidelines for a rediscounting facility to provide liquidity support to microfinance-oriented banks. The facility is open to banks with:

- At least 500 borrowers;
- A past due ratio of 5 percent or less for the microfinance portfolio; and
- A collection ratio of at least 95 percent.

The banks will be charged an interest rate equivalent to the 91-day Treasury bill rate. The interest rate of the rediscounting facility is in line with the government policy stated in Executive Order No. 138 to have market-oriented interest rates for microfinance.

Microfinance institutions comprised of credit-granting NGOs and some rural banks, thus, provide micro/small loans without collateral at market rates of interest to small-scale clientele, mostly non-farm enterprises and microenterprises. Loan repayment is adjusted to the cash flow of the borrower, hence the term "cash flow-based lending" applied to microfinance loan operations. Documentation and lending procedures are simplified and loan repayments are made on time. A common denominator of successful MFIs' operations is their zero tolerance for loan defaults. This ensures borrower discipline and the sustainability of the MFI. The microfinance institutions use a variety of lending mechanisms such as group lending, individual lending; and market-based incentives to motivate good financial discipline among clients and loan officers. Other mechanisms such as the use of collateral substitutes like peer pressure and joint liability and focus on lending to women clients are key factors in the success of MFIs.

Credit-granting non-governmental organizations, credit cooperatives and, to some extent, a few rural banks have discovered the usefulness of microfinance as a sustainable approach to provide basic financial services to small-scale borrowers. These private lending institutions found out that it is possible to attain high levels of sustainability even without government credit subsidies.

The availability of microfinance services has allowed farm households to diversify and increase their income as well as improve their quality of life. In fact, in the recent Small Farmer Credit Survey done by the ACPC, the incidence of borrowing from formal sources among small farmers has increased significantly mainly because of the increased accessibility of microfinance services in the rural areas.

NATIONAL STRATEGY FOR MICROFINANCE

The Philippines is actually one of a few countries with a well-defined policy and regulatory architecture for microfinance. The government through the National Credit Council (with ACPC as head of the sub-group on agricultural credit) and the Credit Policy Improvement Program (CPIP) has worked for the creation of a favorable environment. The National Strategy for Microfinance provides the policy framework for microfinance and is anchored on the following principles:

- greater role of the private sector/MFIs in the provision of financial services;
- an enabling policy environment that will facilitate the increased participation of the private sector in microfinance;
- market-oriented financial and credit policies, e.g. market-oriented interest rates on loan and deposits; and
- non-participation of government line agencies in the implementation of credit/guarantee programs.

The national microfinance policy framework, therefore, includes the following specific strategies:

- In providing for a conducive policy environment: a) implementing a market-oriented interest rate policy; b) pursuing financial policy reforms with the end in view of removing existing distortions in the financial market; c) rationalizing all existing government credit and guarantee programs;
- In establishing a market-oriented financial and credit policy environment which is conducive for the broadening and deepening of microfinancial services: a) provision of appropriate supervisory and regulatory framework for MFIs which will enable them to engage in the development of new and innovative product lines and services appropriate to the demand for financial services/products by poor households and microenterprises; b) establishment of standards of performance and business practices to guide the operations of MFIs; c) promotion of broad-based savings mobilization, linkage banking technology and other microfinance technologies; d) provision of information and training on best practices in microfinance to MFIs; and
- In implementing a capacity-building program for MFIs: a) provision of technical assistance to MFIs with particular emphasis on local deposit mobilization; financial and project management; use of information technology; and development and establishment of microfinance technology, innovative product/service lines; b) documentation, packaging and dissemination to MFIs of practitioner-based training and technical services; c) encouraging research and academic institutions to conduct studies, convene policy level discussions that will promote awareness of microfinance as a sound commercial investment.

INSTITUTIONAL OVERVIEW OF RURAL FINANCE/MICROFINANCE

The Philippines has three basic types of banks: a) commercial and universal banks, b) thrift banks and c) rural banks (including cooperative rural banks). Other institutions in the rural financial market include cooperatives and non-government organizations.

With respect to rural finance/microfinance delivery, the institutions involved are at two levels: wholesale and retail. The main players at the wholesale level include the Land Bank of the Philippines, People's Credit and Finance Corporation (PCFC), Development Bank of the Philippines and Small Business Corporation. Those that provide rural finance/microfinance services directly to clients include: rural banks, NGOs and credit cooperatives. In addition, there are two thrift banks with main focus on the provision of microfinance services. Some cooperative rural banks, that is, rural banks owned by primary cooperatives are also engaged in microfinance. The Bangko Sentral ng Pilipinas (BSP) classifies banks engaged in microfinance into two broad categories: (a) microfinance banks and (b) microfinance-oriented banks. Microfinance banks are those whose loan portfolios are 100 percent microfinance loans. On the other hand, microfinance-oriented banks are those banks whose microfinance loans comprise at least 50 percent of their gross loan portfolio. As of July 2006, BSP reports 142 banks engaged in microfinance of which 135 are microfinance-oriented rural banks and 7 are microfinance banks.

MAIN PLAYERS: WHOLESALE LEVEL

- **Land Bank of the Philippines**

By far, the largest single source of credit to small farmers and fisherfolk is the *LandBank*, which was established in 1963 to purchase landholdings and finance their distribution to tenants under the Agricultural Land Reform Code of that year. It is fully owned by the government with a capitalization of P1.8 billion. In 1973, it was given a license to operate as a universal bank and it has steadily stepped up its support of agrarian reform operations as their scope has widened through the series of land reform acts over the years.

Under the Comprehensive Agrarian Reform Law (CARL) of 1987, LandBank has primary responsibility for land valuation and payment of compensation to land owners under the Comprehensive Agrarian Reform Program (CARP), and for collection of land amortization payments from Agrarian Reform Beneficaries (ARBs). To further expand its outreach of ARBs/small farmers, it adopted the strategy of wholesaling funds through cooperatives or through private rural financial institutions such as rural banks through the LandBank's rediscounting program.

LandBank is also tasked to implement the AFMA-mandated Agri-Fisheries Modernization Credit and Financing Program or the AMCFP as one of the program's wholesalers. As provided for in the Agriculture and Fisheries Modernization Act (AFMA) or RA 8435 of 1997, the AMCFP is meant to replace the different credit programs under the Department of Agriculture in order to make credit delivery to small farmers and fisherfolk efficient, responsive and sustainable.

In 1995, the LandBank fully capitalized the *People's Credit and Finance Corporation (PCFC)* as its principal arm in lending to the poor. PCFC became fully operational in June 1996. The objective is to use PCFC for poverty alleviation lending programs.

More recently, the LandBank has also decided to play an active role in microfinance. It has recently launched a nationwide microfinance program. It expects to have a complementary role with PCFC in providing wholesale loans to various MFIs. Before this happened, LandBank's involvement in microfinance has been mainly to guarantee the loans obtained from ADB-IFAD and the World Bank for the funding needs of PCFC. Before the pilot test of 12 microfinance accounts, LandBank has not lent directly to microfinance institutions at the retail level although some bank officers believe they have actually been doing microfinance through rural banks and cooperatives under their other programs.

LandBank's Rural Finance/Microfinance Programs. The LandBank also implements various program approaches to provide a more holistic assistance to the clients. These programs include:

TODO UNLAD Program. TODO UNLAD stands for Total Development Options Unified Lending Approach for Development. Through its various lending programs and support services, TODO UNLAD links cooperatives, local government units, private corporations, small and medium enterprises and non-government organizations in specific areas.

ACCESS Program. ACCESS stands for Accelerating Change in the Countryside thru Equity Sharing Strategy. ACCESS is an initiative of LandBank aimed at inviting key players in rural development (farmers and fisherfolk cooperatives and their federations, private entities, non-government organizations, LGUs and other interested investors) to become partners of the Bank in undertaking equity investments in agri-related or off-farm economic projects.

Innovative Financing Scheme (IFS). The IFS is a joint program between the ACPC and LandBank. It is an alternative (non-traditional) way of financing the credit needs of small farmers and fisherfolk who are not eligible to access credit from formal lending institutions.

SME Unified Lending Opportunities for National Growth (SULONG). SULONG is a program jointly implemented by different government financial institutions (GFIs), composed of LandBank, Development Bank of the Philippines (DBP), National Livelihood Support Fund (NLSF), Philippine Export-Import Credit Agency (PHILEXIM), Quedan and Rural Credit Guarantee Corporation (Quedancor), Social Security System (SSS) and Small Business Guarantee and Finance Corporation (SBGFC) in support of the government's National Small and Medium Enterprise Development Plan.

LBP Microfinance Program for Microfinance Institutions. The Microfinance Program of LandBank aims at supporting the government's thrusts of poverty alleviation and jobs generation. Under the Program, the Bank provides credit assistance to small farmers and fisherfolk and microentrepreneurs to finance their livelihood projects through various microfinance institutions retailers and wholesalers.

LandBank Development* Advocacy *(DevAd) Program. The DevAd Program aims to generate a different perspective in lending to the mandated and priority sectors of the Bank. In lending to small farmers and fisherfolk and MSMEs, the DevAd Program will consider the core fundamentals of credit, but appreciate the same in the light of the peculiarities of the mandated/priority sectors.

Countryside Financial Institutions Enhancement Program (CFIEP). This is a joint program of the Bangko Sentral ng Pilipinas (Central Bank), LandBank and Philippine Deposit Insurance Corporation meant to strengthen the capital base of the RFIs. The program consists of three (3) modules, namely:

Module 1	Purchase of Countryside Financial Institution (CFI) Arrearages with the CB.
Module 2	LandBank's equity investment program
Module 3	Merger, Consolidation and Acquisition Incentives.

Capacity Building and Enterprise Development Programs. As major development partner in the countryside, development assistance has been extended to support cooperatives. This is essentially aimed at improving the absorptive capacity of these cooperatives.

Integrated Rural Financing Program (IRF). The IRF is a comprehensive financing program for small farmers and fisherfolk cooperatives. In partnership with the ACPC and the DA, cooperative development technicians (referred to as "Institution-building Specialists or IBS) provide on-site, hands-on technical support – business/ enterprise project identification, planning, and packaging, marketing assistance, technology transfer, project monitoring and documentation, operations management training and the like.

LandBank-Local Government Unit (LGU) Cooperative Strengthening Partnership Program. This Program is envisioned to enhance the partnership with the LGUs in cooperative strengthening thru identification, planning, and implementation of needed interventions and projects to hasten cooperative development under the 'resource-sharing arrangement.'

- **The People's Credit and Finance Corporation**

The leading Philippine government agency on microfinance is the People's Credit and Finance Corporation (PCFC). It was established in June 1996 as a subsidiary of Land Bank of the Philippines. The objective is for PCFC to focus on poverty alleviation lending programs while LandBank concentrates on its mandate to be the financing arm of agrarian reform and to service the agriculture sector's growing demand for financial services.

The PCFC provides credit to accredited NGOs, financial institutions and people's organizations, collectively called "program partners", that implement credit assistance programs for the poor. It also provides credit for institution and capability building activities related to the lending program.

PCFC encourages the formation of self-help groups basically because it lends to NGOs who utilize the Grameen Bank technology and its variants. The Corporation views the SHGs as essential in instilling credit discipline and in enforcing repayment. The NGOs are basically the ones in charge of group formation.

With respect to number of program partners, PCFC provides wholesale funds to around 200 microfinance institutions (MFIs) including 78 rural banks, 26 cooperative rural banks, 2 thrift banks, 63 cooperatives and 30 non-government organizations as of March 31, 2006.

- **Small Business (SB) Corporation**

The SB Corporation is the result of a merger between the Small Business Guarantee and Finance Corporation (SBGFC) and the Guarantee Fund for Small and Medium Enterprises (GFSME). SBGFC was created under a law passed by Congress in 1991 and amended in 1998. The law is known as the Magna Carta for Small and Medium Enterprises. SB Corporation is under the direct supervision of the Department of Trade and Industry. The accounts of SB Corporation are examined by the Bangko Sentral ng Pilipinas (BSP) and the Commission on Audit. The mandate of SB Corporation to undertake microfinance operations is included in the BMBE Act of 2002.

- **Development Bank of the Philippines (DBP)**

DBP was established by an act of Congress in 1949. It had its origins in the defunct Rehabilitation and Finance Corporation (RFC) which was established after the Second World War to help finance the reconstruction and rehabilitation efforts designed to revive the war-ravaged economy. RFC was renamed DBP in the late 1950s'. DBP is a development bank catering mainly to small and medium enterprises (SMEs). The bank is under the administrative supervision of the Department of Finance and also under the regulatory supervision of the BSP. It is likewise audited by the Commission on Audit. Its mandate to undertake microfinance operations is spelled out under the BMBE Act of 2002.

- **Quedan and Rural Credit Guarantee Corporation (Quedancor)**

The Quedan and Rural Credit Guarantee Corporation (Quedancor) was created by an act of Congress, namely, RA 7393. Its primary purpose is to accelerate the flow of investments into the countryside in order to increase productivity, livelihood and income opportunities. Under RA 8435 known as the Agriculture and Fisheries Modernization Act (AFMA), Quedancor is one of the wholesalers of the AFMA-mandated Agro-Industry Modernization Credit and Financing Program (AMCFP).

- **Bangko Sentral ng Pilipinas (BSP)**

Bangko Sentral ng Pilipinas opened a rediscounting window for microfinance in support of the provisions of RA 8791 or the General Banking Law of 2000 (RA 8791). Specific provisions in the law indicate the need for the Monetary Board to consider the "peculiar characteristics of microfinancing" (Section 40, RA 8791) and for the Monetary Board to "regulate the interest imposed on microfinance borrowers by lending investors and similar lenders" (Section 43, 8791). Bangko Sentral's major objective in opening said rediscounting facility is to support those banks that have achieved efficiency in their microfinance activities while adhering to BSP standards.

The BSP rediscounting facility for MFIs targets those that are able to meet the following eligibility requirements: (1) a one-year track record in microfinance; (2) those with at least 200 borrowers; and (3) a repayment rate of not less than 95 percent during the preceding twelve month period. The BSP also requires the submission of a policy manual on the MFI operations of applicant-banks.

Data from BSP indicate a total number of 121 microfinance oriented banks with an outreach of 485, 136 as of December 31, 2003. It should be noted, however, that this figure overlaps with the figures provided by PCFC since a majority of the 121 banks included in the BSP data are also conduits of PCFC. An expert's estimate would place the overlap at around 75 percent of the outreach figure compiled by BSP. It can therefore be safely assumed that the current outreach of MFIs in the Philippines based on PCFC and BSP conduits is around 1.3 to 1.5 million clients.

INSTITUTIONAL PLAYERS AT THE RETAIL LEVEL

Recent data on the state of rural finance/microfinance in the Philippines indicate that the potential suppliers of loans at the retail level include 1,809 rural banks (including branches); about 300 NGOs; 462 credit cooperatives; 7,513 pawnshops; and 2,594 lending investors (Llanto, 2000).

- **Rural Banks**

Rural Banks are private banks that were established in the 1950s with government assistance and subsidies, to service the agricultural sector. They constitute a system of unit banks that is unique in the developing world, and many of them grew out of the operations of moneylenders.

About 71 percent of the municipalities covered by the rural banking system are classified as 3rd, 4th, 5th, and 6th class municipalities. As such, the rural banking system is a potential dominant player in the microfinance sector. The system is a significant partner of the LandBank in countryside development. Rural banks are supervised and regulated by the BSP.

- **The Cooperative Sector**

The Cooperative Development Authority (CDA) supervises the registration of cooperatives in the country. CDA reports that cooperatives have grown rapidly in recent years from a total of 2,888 cooperatives and pre-cooperatives (or Samahang Nayons) in 1987 (according to a census conducted by NATCCO, in that year) to over 60,000 registered with the CDA as of end June 2004.

- **Non-Government Organizations**

There are more than 30,000 Non-Government Organizations (NGOs) registered with the Securities and Exchange Commission as private, non-profit foundations, although only a small number of these, say two to four thousand are developmental in the strict sense of the term. NGOs received a major impetus under the 1986 constitution which requires the State "to encourage non-governmental and community-based organizations" and under Cabinet Decision 29 of the Aquino administration which calls for the nine line agencies and several government corporations implementing livelihood programs to directly channel all future assistance through financial institutions or NGOs as conduits.

However, there are microfinance NGOs, albeit small in number, which are performing well. Presumably, these are institutions which, through the years, have steadily expanded in terms of microfinance operations, outreach and assets and have reached desirable levels of sufficiency and efficiency. In fact, the sector can be seen as having two extremes: the bigger, more established NGOs, and the smaller ones. There is hardly a sector in between.

NGOs generally charge interest on loans at rates ranging from 24 percent to 40 percent per annum flat rate, inclusive of upfront service fees of 2 percent to 5 percent. Collection of loan payments is done weekly. NGOs are not expressly authorized by law to collect deposits from the public but nevertheless collect compulsory savings from member-borrowers as a form of compensating balance for members' outstanding loans. NGOs are not supervised nor regulated by any government agency. They are, however, required by law to submit audited financial statements to the SEC.

The presence of two extremes in the sector should not be seen as a setback against the microfinance NGOs' continuing role in poverty alleviation. Instead, the extremes may be seen as an indication that there are institutions which have succeeded and are successfully operating microfinance operations. In a sector still within its youth, much interaction can transpire between the two to somehow bridge the gap, and with the appropriate interventions, there is potential toward greater outreach and sustainability.

REGULATORY FRAMEWORK FOR RURAL FINANCE/MICROFINANCE

- **Regulation of Banks Engaged in Rural Finance/Microfinance**

Banks are generally supervised and regulated by Bangko Sentral ng Pilipinas or the Central Bank. The basic law that paved the way for the creation of the favorable environment for banks engaged in microfinance is the General Banking Law of 2000. It recognized the special features and peculiarities of microfinance and asked the BSP to issue appropriate implementing guidelines. Sections 40, 41 and 44 mandated the formulation of appropriate rules and regulations for microfinance operations. Section 40 recognizes the "peculiar characteristics of microfinancing, such as cash-flow based lending to the basic sectors that are not covered by traditional collateral." Section 41 provides for the issuance of regulations covering unsecured loans and Section 44 recognizes that "the schedule of loan amortization shall take into consideration the projected cash flow of the borrower and adopt this into the terms and conditions formulated by banks."

- **Regulation of Cooperatives**

The Cooperative Development Authority (CDA) is tasked to regulate cooperatives under RA 6539. The CDA does not supervise nor examine the books of credit cooperatives (NCC, 2004). To help build the architecture for the effective regulation and supervision of credit cooperatives, the National Credit Council prepared a standard chart of accounts, an accounting manual and set of performance standards for credit cooperatives called the COOP-PESOS. The CDA Administrator issued a circular asking all credit cooperatives to use the COOP-PESOS performance standards starting January 2003. However, CDA has yet to fully train its field personnel in the application of the standard chart of accounts and the COOP-PESOS performance standards to credit cooperatives.

- **Registration of NGOs**

The NGOs are required to register with the Securities and Exchange Commission (SEC) as non-stock, non-profit organizations. They are not subject to prudential regulations. At present, there is no government agency that has supervision over the NGOs. The NGOs do not report to any oversight agency and hence, there is no single institution that has a complete set of relevant information on the financial performance of NGOs (NCC, 2004).

NGOs collect "forced" savings or the so-called "capital build-up" as compensating balance or the proportion of the loans of their microfinance clients (NCC, 2003). The consensus among the NGOs is that they should be allowed to collect savings from their clients without being subject to any prudential regulation provided that these collected savings do not exceed their total loan portfolios. Those that collect savings beyond the compensating balance shall be required by the government to transform themselves into either a bank or credit cooperative, both of which are regulated entities.

The present view of the NCC is that only regulated financial institutions shall be allowed to take deposits from the public. Banks which are regulated by BSP are considered 'deposit-taking institutions'. Cooperatives which are regulated by CDA mobilize deposits among their members. On the other hand, NGOs are not regulated entities and thus, no external body monitors their performance and imposes sanctions for poor performance, implying that depositors would not be adequately protected from misbehavior by NGOs. Thus, NCC has ruled that NGOs shall not be allowed to mobilize deposits from the public. The NCC also ruled that the total 'forced' savings collected from clients shall not exceed the value of their total loan portfolio at any point in time.

PROPOSED INSTITUTIONAL FRAMEWORK FOR REGULATION OF MFIs

The proposed institutional set-up shows a comprehensive framework where regulators have their respective regulatory focus and there is coordination between BSP and CDA. Private institutions such as MCPI and a credit bureau also play an important role. With respect to recent developments on the proposed Credit Bureau for microfinance institutions, the legislative bill on its establishment has already been passed and BSP will raise 49 percent of the total capital while private banks will shoulder the remaining 51 percent.

- **Performance Standards**

Land Bank of the Philippines as well as PCFC both have their own accreditation criteria when screening prospective microfinance institutions (MFIs). The National Credit Council has also formulated a set of standards for both credit cooperatives and NGOs in order to ensure their financial efficiency and effectiveness in their microfinance operations. Annex B presents the different set of performance standards.

- **AMCFP Implementation Structure**

Since the AMCFP is the rural finance program for agriculture and fisheries as provided for in the law, it is important to understand the structure of implementation. Given that banks are regulated by BSP, banks participating under the AMCFP are also governed by policies and procedures of the AMCFP which are reviewed and whenever necessary, amended by the Agricultural Credit Policy Council or the ACPC as oversight of the program.

The AMCFP is implemented through three key players: (1) The Agricultural Credit Policy Council as Program Oversight Committee tasked to oversee the utilization of the AMCFP fund and ensure that the requirements and objectives of the program are being met; (2) Fund wholesalers including Land Bank of the Philippines and Quedancor; and (3) Fund retailers including private banks such as rural banks, cooperative rural banks, cooperatives and NGOs.

ROLE OF THE AGRICULTURAL CREDIT POLICY COUNCIL (ACPC)

As the agency tasked to oversee the country's rural financial system, the ACPC adopts a holistic approach towards an efficient, effective and sustainable delivery of rural financial services in the countryside. Towards this goal, the ACPC performs the following:

- **Policy Formulation, Planning and Advocacy**

As mandated by Executive Order 113 of 1986, ACPC provides policy directions on agricultural credit towards a healthy and sustainable rural financial system. It reviews and makes recommendations on the socio-economic soundness of ongoing and proposed agricultural credit programs, legislations, and other policies that aim to increase the flow of credit to agriculture. The ACPC makes sure that the alternative strategies and policies being proposed are able to address the needs of its stakeholders particularly financial institutions, the policymakers and the small farmers and other smallholders and that these proposed policies are accepted by them.

- **Credit Facilitation**

Credit facilitation means allowing credit to flow to the countryside by bridging the gap between the lenders (supply side) and the borrowers (demand side). The problem of poor access to credit is, therefore, addressed as the credit requirements of small farmers and fisherfolk are determined and private financial institutions are encouraged to finance these requirements. Small farmers and fisherfolk, even those without collateral to offer, are given the opportunity to have access to formal financing while banks are able to reduce the risk of lending to these borrowers. Through the implementation of the Agro-Industry Modernization Credit and Financing Program and innovative schemes developed by ACPC, credit facilitation can help the government spur growth in the agriculture and fisheries sector by responding to the financial requirements of small farmers and fisherfolk needed for agricultural production.

Agro-Industry Modernization Credit and Financing Program. Through Resolution No. 1 series of 1999 issued by the Council of the ACPC, the ACPC was given the oversight function over the AMCFP. As program oversight, ACPC is tasked to steer program implementation, address policy issues, and monitor and evaluate fund utilization.

The ACPC is also mandated to handle/administer the funds to be transferred from directed credit programs previously implemented by the government to the AMCFP. Part of the function is to conduct a full inventory and accounting of all directed credit programs (DCPs) in agriculture and review their enabling laws/instruments; and to exercise due diligence in ensuring that loans released under these DCPs are collected and that these funds are transferred to the AMCFP. The primary objective is to ensure that the program is able to increase credit access of its intended beneficiaries, i.e., the small farmers and fisherfolk and that the loans released under AMCFP are returned to the program for sustainability.

Innovative Financing Schemes. The ACPC continuously designs and pilot-tests innovative financing schemes particularly those who for some reason do not have access to bank loans or lending facilities of formal institutions. With these schemes, the ACPC is able to identify credit delivery mechanisms that can work for small farmers and be adopted by financial institutions, particularly government as well as private financial institutions for implementation on a wider scale.

CHALLENGES TO PHILIPPINE RURAL FINANCE/MICROFINANCE

Based on the experience of rural finance/microfinance practitioners as well as policymakers, some of the more urgent challenges today are the following:

- **Making Microfinance Work in Agriculture**

Despite continued efforts to increase the flow of credit to agriculture and fisheries, the sector has not been well served by the microfinance industry nor have they been effectively reached by financial services primarily because the provision of agricultural credit is viewed to be difficult to do effectively due to geographic dispersion in the rural areas, weak market linkages, higher costs, lack of extension support services and inherent risks.

- **Credit Pollution**

Another issue is the emerging credit pollution that has been detected by the MFIs themselves which found out that some of their borrowers have overborrowed. Some borrowers have taken advantage of the earnest drive by some MFIs to expand their outreach to more poor people. MFIs encountered loan collection problems from this group of borrowers when these failed to repay their loans according to loan repayment schedules. It was found out that those borrowers got loans from a MFI in order to repay their loans with another MFI.

In order to address this problem, the National Credit Council as well as the ACPC have proposed the establishment of a private risk-rating agency for all financial institutions involved in the delivery of microfinance services. The regulatory authorities may use the risk ratings of the MFIs in their off-site supervision activities. Donors may also use the rating for determining the necessary technical assistance to MFIs. A credit bureau for microfinance has also been proposed to act as repository of all credit information regarding microfinance clients. A credit bureau would create a more transparent information system that would discourage credit pollution. At the same time, it would improve the credit process of the financial institutions, and may lower the cost of lending to end clients. Despite the recognition of its importance, approval of the establishment of a credit bureau is still being sought.

- **Risk-based Supervision**

Another important issue is the development of a risk-based approach to the supervision of MFIs and the corresponding training of BSP bank examiners in risk-based supervision. Traditionally, the BSP and banks alike have concerned themselves mainly with credit risk and with the provision of the usual collaterals, e.g., real estate, government securities, etc. to ensure loan security. Thus, it is not unusual for bank examiners doing field supervision to check on the types of collateral required by banks to secure their loans. However, a different approach to bank supervision called "risk-based supervision" seems more appropriate for microfinance banks. Risk-based supervision is based on a more comprehensive understanding of risks faced by a microfinance bank. Microfinance is different from regular lending because of the nature of clientele, their income status and inability to provide the traditional collaterals, the nature of microfinance loan products and the use of collateral substitutes, e.g., peer pressure, third party guarantees to secure the loan. The personal circumstances of the clientele (poor, without bankable assets, with or without basic education, among others), the use of informal financial information, cash-flow based lending and non-traditional loan collection techniques, among others, create different types of risks and show the inadequacy of traditional prudential regulation and supervision approaches to deal with those risks. The BSP has started to implement, on a pilot basis, a risk-based approach to supervision. Banks are encouraged to look into the cash-flow of the borrowers and not just base loan approval on collateral offered. BSP has received technical assistance from the United States Agency for International Development in the development of expertise in risk-based supervision. MFIs should also be educated on the requirements of risk-based supervision. The education of both regulator and regulated entity in risk-based supervision will lead to efficient supervision and the overall strengthening of the microfinance industry.

- **Need for New Standards**

One major challenge facing rural finance is the impact of new banking regulations such as the imposition of new BASEL standards. As it is, lending to support agricultural production and other agricultural enterprises are already perceived riskier than lending to other economic activities. Many private/commercial banks resort to alternative compliance (to the Magna Carta on small farmers and fisherfolk and SME) instead of directly lending to the rural industries.

Inasmuch as the new BASEL standards used risk weight approach, many financing institutions may all the more refrain from lending to agricultural and rural enterprises considering that production loans and rural enterprises are short in or lacks collateral. Under the new standard, unsecured loans carry a risk weight that corresponds to the risk weight by an eligible guarantor (e.g. Philippine national government, the Bangko Sentral ng Pilipinas). For the existing players supporting rural finance, the risk weight methodology will limit their present operations because higher risk weighted accounts impact on the institutions capital adequacy. Thus, lending expansion will be constrained.

Though the new BASEL standards are meant to ensure a more stable banking system, the national government will have to implement programs that will promote lending to the sector. In as much as guarantees with sovereign cover are weighted zero risks, effort to promote guarantee programs should be pursued.

RURAL FINANCE IN SRI LANKA

Mr. B.A.C. Fernando, General Manager/CEO, Bank of Ceylon

AGRICULTURAL POLICY AND INSTITUTIONAL SUPPORT

Successive governments during the last five decades have endeavoured to develop agriculture. Since independence, substantial public investment has been made to support the development of agriculture. Investments have been made especially for irrigation infrastructure, and setting up of a network of agricultural institutions to promote policy development, research, extension services, marketing infrastructure, provision of subsidies and safety nets. Yet, the agriculture sector needs better co-ordination within this network aiming at more focused and effective support for adoption of higher technology through demand driven research and extension services.

The export agriculture sector received continuous support from relevant institutions. The Department of Export Agriculture (DEA) under its cluster villages system assisted the sector through distribution of inputs, providing post-harvest handling facilities and equipment, technical advice, establishing marketing links and providing financing facilities.

Government support for farmers takes several forms, including the provision of credit for producers, the setting of minimum prices for agricultural produce, the building of irrigation works and the encouragement of internal migration to newly irrigated areas. Since the late colonial period, the government has played a growing role in the provision of credit to smallholders on favorable terms. Until 1986, the main instrument of this policy was through cooperative societies. Agricultural credit took three forms: short-term loans to farmers for the purchase of seeds and fertilizers; medium-term loans intended for the purchase of machinery; and long-terms loans for capital expenditure on storage, transport and rice-milling apparatus. The long-term loans were not available for individual farmers, but were used by the cooperative societies to acquire infrastructure facilities.

The actual performance of credit provision through cooperatives generally fell short of expectations. Institutional credit did not displace the older sources of credit, such as the village money lender, friends and relatives. The inability to repay loans, procedural difficulties, and the existence of unpaid loans already taken from the cooperatives were some reasons given by farmers for preferring non-institutional credit sources. Another problem with the credit furnished by cooperatives was the high rate of default. This rate may have been an attributable party to real difficulties in repayment, but it also was the result of a widely held impression that government loans were a form of social welfare and that it was not necessary to repay them.

SRI LANKA'S ECONOMY

Sri Lanka scores well in fiscal freedom and freedom from government. Income and corporate tax rates are moderate, and overall tax revenue is relatively low as a percentage of GDP. Total Government expenditures in Sri Lanka equal slightly more than one fifth of GDP, and State-owned businesses generate only a small portion of total tax revenue.

As a developing Asian nation with widespread civil unrest, Sri Lanka faces serious challenges. Investment freedom, financial freedom, monetary freedom, property rights and freedom from corruption all score poorly. The government generally welcomes foreign capital, but a host of formal restrictions and the security situation are deterrents. Sri Lanka's financial system is small but growing and would benefit from greater transparency. Inflation is high, and the government directly subsidizes a wide array of goods.

Sri Lanka's financial system remains subject to extensive government influence but has been growing rapidly as the government has pursued privatization and liberalization. Regulations are largely consistent with international standards, but supervision and enforcement are insufficient.

Foreign investors are free to access domestic capital markets, and the Government allows 100 percent foreign ownership of commercial banks, insurance services and stockbroker services.

The Government influences the allocation of credit and has a virtual monopoly on the management of long-term savings, using half of domestic financial resources to finance Government borrowing. The two State-owned banks control 45 percent of banking assets. The insurance sector has 13 insurers, and the largest firm, which controls 40 percent of premiums, was privatized in 2003. Capital markets are centered on the Colombo Stock Exchange, which is modern but relatively small.

POVERTY ALLEVIATION

From 1986 to 1991, the Government initiated an array of policy measures to expand credit facilities to the poor under its poverty alleviation strategies. The Janasaviya Program was the major instrument of the government's poverty alleviation strategy. The Government established the Janasaviya Trust Fund in 1990.

In 1996, the Government inaugurated Samurdhi Development and Credit Scheme to promote income generating self-employment opportunities among Samurdhi beneficiaries so as to raise their income levels, thoroughly make them self-reliant and self-supporting. As part of the program, Samurdhi Banks Societies were set up through out the country to promote savings and disburse credit.

In 1977, the Government established the Samurdhi Authority and its microfinance schemes. Apart from major microfinance institutions, there are thousands of other organizations spread all over the country involved in the poverty alleviation strategy.

Poverty is overwhelmingly a rural problem in Sri Lanka. Roughly 88 percent of the poor live in rural areas, which suffer underemployment, slow growth in agricultural productivity, lack of integration with the mainstream economy, unclear land tenure and limited access to basic services and infrastructure.

The Government's economic reform program highlights the role of rural finance in empowering the poor, especially women, and emphasizes sustainability of rural finance institutions and their integration with the financial sector. Successive governments have adopted ad hoc and short-term measures instead of mainstreaming good governance and sustainability as core values. As a result, the estimated gap-between demand and supply for rural credit is US$ 103 million, of which half relates to rural poor households. Under the project, on lending support equivalent to US$ 10 million will be provided to rural finance institutions that meet predetermined eligibility criteria enterprises.

About 10 percent of the credit will be for conflict-affected areas and three quarters for women entrepreneurs. A capacity building component will help rural finance institutions develop new client-centered products and the credit line will help in the immediate delivery of credit products in resource-poor and conflict-affected areas.

RURAL FINANCIAL SECTOR

Sri Lanka's rural finance sector includes savings, credit insurance and payment services, comprising cooperative rural banks, regional development banks, the National Development Trust Fund and Samurdhi Banking Societies. However, the sector remains fragmented and the institutions suffer from weak governance, poor repayment rates, high transaction costs, weak supervision and recurring losses.

The program loan will promote policy changes that emphasize good governance and improved operations of rural finance institutions. It will help draw up a legal and regulatory framework and institutional reforms and expand rural finance in conflict-affected areas.

It will also support the demand side of rural finance by involving rural communities in partnership with non-government organizations in identifying, planning, executing and monitoring subprojects in expanding the rural finance market. The project loans will strengthen key sector institutions that provide training in rural finance and improve efficiency of service delivery, sector supervision and outreach expansion.

The creation of a rural finance system offers the prospect of reducing rural poverty more rapidly and in a more sustainable way than through welfare-oriented assistance, which would only be a stop-gap measure.

MICROFINANCE INSTITUTIONS AND REGULATORY FRAMEWORK

In recent times, microfinance has emerged as a major instrument to provide financial facilities to small entrepreneurs in developing and developed countries. So microfinance is relatively a new concept. But its credit delivery mechanism is not strange to Sri Lanka. Some form of micro or small credit delivery had been existent in Sri Lanka since the beginning of the last century. Co-operatives, rural banks, State Banks and the Central Bank were instrumental in such small credit disbursements to farmers and other small entrepreneurs. Such credit arrangements were however not identified as microfinance while replacing the traditional state sponsored credit schemes that became a failure, microfinance is expected to pay a vital role in meeting a variety of credit, savings and risk management needs of small entrepreneurs.

In the post-independence period, the Government concentrated largely on agriculture credit, particularly for paddy cultivation. These credit facilities were granted mainly through the two State Banks, Bank of Ceylon and People's Bank under various rural credit schemes. The Central Bank provided funds to the two Banks at subsidized interest rates. These cultivation loans have been written off in many instances due to political pressures. In 1964, the government established the Co-operative Rural Banks. This was a major contribution in the field of microfinance.

At present the Social Service Department of Sri Lanka is empowered to grant permission for the establishment of a microfinance institution in the country. However, the Government is now considering to introduce a Microfinance Institutions Act. The Act will empower the Monetary Board of the Central Bank of Sri Lanka to provide license, formulate regulations and supervision of microfinance institutions.

Under this Act, the following may be licensed: a Public Company limited by shares registered under the Companies Act or a Company registered under the Companies Act as a Company limited by guarantee or a non-governmental organization registered under the Companies Act and voluntary Social Service Organizations Act or a Body Corporate formed, established or incorporated by a Special Statute to provide financial services and other support services to low income person and having a core capital of not less than:

- Rs 50 million or such other higher amount that may determine from time to time for carrying on microfinance business at National Level.
- Rs 5 million or such other high amount that may determined from time to time for carrying on microfinance business within an Administrative District.
- Rs 1 million or such other higher amount that may determined from time to time for carrying on microfinance business within a Divisional Secretary's Division.

Once the license is issued to a microfinance institution, they should not operate outside the area specified in the license or change the location of the principal office or establish or relocate or close down any branch office or service outlet without prior written approval of the Monetary Board.

A licensed microfinance institution may engage in the following businesses.

- to provide financial accommodation, with or without collateral or security in cash or kind, subject to such terms and conditions that the Monetary Board may impose to low-income persons for all types of economic activities including housing, but excluding business in foreign exchange transactions;
- to accept deposits of money to borrow funds and receive grants and donations or raise money in any other form subject to the approval of the Board;
- to accept pledge, mortgages, hypothecations or assignments to it of any kind of movable or immovable property for the purpose of securing loans and advances made by it;
- to undertake the management, control and supervision of any organization, enterprise, scheme, trust find or endowment fund for the benefit and advancement of low-income person;
- to buy, sell and supply on credit mainly to low-income persons industrial and agricultural inputs, livestock, machinery and industrial raw materials;

- to act as an agent for any organization for the sale of such goods or livestock subject to such directions as the Monetary Board may impose;
- to provide professional advice to customers regarding investments in income generating projects, small business and cottage industries;
- to provide services and facilities to customers to hedge various risks relating to microfinance activities;
- to render managerial, marketing, technical and administrative advice to customers and assisting them in obtaining services in such fields;
- to purchase, take on lease or otherwise acquire, sell, exchange, surrender, lease, mortgage, dispose or land deal in any movable and immovable property and rights of all kinds for and on behalf of its customers for the purpose of promoting development opportunities, building of assets, resource allocation, promotion of markets and adoption of better technology for economic growth and development;
- to provide storage and safe custody facilities;
- to invest monies of the licensed microfinance institutions; and
- to conduct any other business which Monetary Board may authorize from time to time.

The Monetary Board will from time to time issue directions to monitor and control the microfinance institutions with regard to their operations. Every licensed microfinance institution should prepare a Balance Sheet, Profit and Loss Account and a Cash flow at the expiration of each financial year, and statements should be audited by a qualified auditor.

INNOVATIVE RURAL FINANCIAL PRODUCTS AND SERVICES IMPLEMENTED BY BoC

- **Poverty Alleviation Microfinance Project**

In order to assist the conflict-affected communities in the Northern and Eastern Provinces, the Bank of Ceylon has implemented the above credit scheme in collaboration with the Central Bank of Sri Lanka at a concessionary interest of 10 percent per annum. By this financial assistance a large number of people have re-started their life and deriving income for their living. So far branches have disbursed 2,359 loans amounting to Rs 46.1 million.

- **Deewara Shakthi Credit and Savings Scheme**

BoC has now launched this credit scheme for the fishing population of over 800,000 in the country, both marine and inland. Hitherto financial assistance were provided to the fishermen only for the purchase of fishing boat engine and fishing gear. Due to the seasonality of this occupation, most of the fishermen are indebted to money lenders and all their hard earned income are spent as interest on loans borrowed at exorbitant rates. With this in mind, BoC formulated this unique credit scheme targeting the fisherwomen and their grown-up children to engage in fisheries activities such as processing dry fish, smoked fish, marketing fresh and processed fish and fish products. Also non-fisheries activities such as basket weaving, mat weaving, sewing, handicrafts, livestock, handlooms, tailoring, catering services or any other sustainable livelihood activities in augmenting house hold income during periods of scarcity and seasonality often experienced in fishing communities.

- **Govi Shakthi Credit Scheme**

The Govi Shakthi Credit Scheme is implemented to provide credit facilities to farmers to purchase farm machineries and equipment. This credit assistance will enhance the level of farm mechanization for timely agriculture operation and also to expand the Bank's contribution covering various stages of agricultural production for the farming community. Farmers can obtain credit facilities up to Rupees One Million under this scheme for purchase of four wheel tractors, two wheel tractors, combined harvesters, power sprayers, water pumps, draught animals, etc.

- **Cultivation Loans**

BoC since 1973 has been granting loans to the farmers for the cultivation of paddy and other subsidiary food crops, under the New Comprehensive Rural Credit Scheme implemented by the Central Bank of Sri Lanka. BoC receives an interest subsidy of 6 percent per annum from the Central Bank for the loans disbursed under this scheme. Up to now, more than Rs 5,300 million have been disbursed. These short term loans are granted to farmers to be repaid from the proceeds of the harvest at 8 percent interest per annum.

DELIVERY METHODOLOGY AND OUTREACH

Bank of Ceylon's present agriculture lending strategy is based on the principle of area approach. A branch office selects a particular area and concentrates its lending activities within this area. Credit is extended mainly for the various sectors of agriculture such as livestock, cottage industries, cultivation or crops, small business etc. Experience has shown mainly good results particularly in the agriculture finance and changes in the social-economic condition of the rural poor and noticeable. This focus has enabled the Bank to extend timely and adequate finance to the needy farmers with a comprehensive package consists of production, processing, packaging, transporting, marketing, etc.

Increasing agriculture productivity and promoting agro-processing enterprises are critical for rural uplift and eradication of poverty. The common criteria for credit is the economic viability of the loan proposal and the repayment capacity of the farmer. Such criteria would leave out most of the small farmers who constitute bulk of the farming population of the country. Hence provision has been made in the agriculture finance to include potentially viable loan proposals by small farmers also. It means that a farmer whose credit proposal is not economically viable at present, but has a possibility to become viable as a consequence of credit has been given priority by the Bank of Ceylon. Vehicle of finance includes loans, leasing and pawning, and cultivation loans include crop diversification, farm mechanization, draught animals, dug wells and irrigation.

DEPOSIT LINKAGE

It is generally agreed that mere provision of credit alone would not be sufficient to convert potentially viable farmers into commercially viable farmers. To achieve this Bank of Ceylon felt that mobilization of rural savings should also be incorporated into our agricultural credit scheme. Accordingly, the Bank launched many innovative savings products to be of assistance to the weaker segments of the society and the popular savings scheme among the farmers is named "Ran Govi Thanpath Ginum" and the savings scheme among the fishermen is "Deevara Thanpath Ginum".

INTEGRATED LENDING

One of the critical bottlenecks for the farmer development is the provision of adequate credit for agricultural services to enable the farmers to acquire necessary production inputs and facilities. Basic credit policy should be that of an integrated nature i.e. integration of credit with input supply, marketing and extension services which require careful planning and management. For small farmer development, the credit should be utilized to develop financially non-viable farmers into viable farmers and to convert their activities into bankable and financially self-sustained one.

SIMPLIFIED DELIVERY SYSTEM

The Bank has adopted a simplified procedure and documentation in the delivery of credit to small farmers for cultivation. The prospective borrower will have to submit proof that he owns or holds lease rights to the cultivable land and an agricultural insurance, whatever applicable. Adequate and timely finance to the cultivator is the theme adopted by the bank in agricultural finance. As far as practicable loans funds are released in kind so as to ensure its end-use supportive Field Level Operation.

Continuous and constant visits to the field are undertaken by the Bank of Ceylon Field Staff as well as the Agricultural Instructors of the Department of Agriculture and provide necessary advise for the farmers to corrective action, if needed. The Bank always coordinate the field level activities with the relevant Government and Non-Governmental Organizations ensuring the input supplies at low cost and marketing the produce with maximum benefit to the cultivator.

FORWARD SALES CONTRACT

The recently introduced marketing linkage under the Forward Sales Contract Agreement has become popular and beneficial for both the farmer-borrowers and the buyers, mainly Paddy Millers and Co-operative Societies. The Bank has successfully implemented this Agreement in selected paddy growing areas and the result is encouraging. This Agreement System is very simple. It has been found that the market collapses during the harvesting seasons resulting in farmers having to incur heavy losses. Such losses could be avoided if the selling price is agreed with the buyer in purchasing and marketing.

Further they will get the opportunity to purchase good quality produce. When a profit is assured the farmers will also be keen to improve the quality of their produce with the introduction of modern techniques. Accordingly the bank will not only get a good customer but also ensure the repayment of the loan to be granted.

SOCIAL MOBILIZATION

Farmers are encouraged to save as they earn. Bank of Ceylon field staff organize meetings at grass root levels and educate the farmers and their families on the importance of savings. Farmers form groups and the leader of the group collects the money according to the individual savings capacity on a weekly or monthly basis and deposit same into the Bank Accounts. Some non-governmental organizations also educate the farming communities on savings. The moneys so mobilized are re-lent to the needy farmers at a nominal interest.

GROUP LENDING

Group Lending to undertake joint venture agricultural projects also implemented in selected villages with the assistance of non-governmental organizations, involving group responsibility for the borrowing. Village groups are generally established with women participation. They mostly provide or recommend credit within a regime of strong discipline. The group lending also offer group responsibility in the repayment of credit, while enhancing their group savings fund.

LOW-INTEREST RATE

Bank lends direct to the cultivators at a lower interest from its own funds. It also extends credit to small farmers funded by International Agencies, such as World Bank, Asian Development Bank, etc., subject to their lending criteria. Most of such lending are backed by Government Guarantee to cushion the anticipated risk. Recycling of funds also undertaken by the Bank of Ceylon to continue financial assistance to the agricultural sector. Maximum usage of incentives such as interest subsidy, refinance and credit guarantee provided by the Government and or funded agencies are being undertaken.

INSTITUTIONAL STRATEGY

Several educational and awareness programs for rural poor have been conducted by the Bank of Ceylon in rural areas with a view to engaging themselves in gainful occupation. This strategy has become popular and had enriched the knowledge in the field of agriculture, animal husbandry, small scale industries, etc. as well as on credit discipline savings habit, new technology, methodology and marketing.

SOOKSHMA MICROCREDIT SCHEME

BoC is implementing more than ten microcredit schemes for self-employment activities, Sookshma Microcredit Scheme introduced early this year had proved to be a successful one within a short period. During the first year ended 31st December 2006, 28,837 self-employment projects worth over Rs 1.46 billion have been financed by the branches island wide. By this financing not only 28,837 persons have now found permanent gainful occupation but also a similar number of persons have found part-time occupation.

This scheme has been successfully implemented with a dual purpose; increase the present income level of the rural population and with the increased income mobilize rural savings from them. No doubt this credit scheme will uplift the living standard of the rural population, which in turn will enhance the rural economy thus overall economic development of the country in the years to come.

From the review of this credit scheme in many areas, the Bank has found that most of the borrowers who were far below the poverty line have now crossed the poverty line due to the sustainable income generated by them.

TANK MODERNISATION PROGRAM

BoC has responded positively to the National need to reconstruct and rehabilitate Tanks under the Government's DAHASAK MAHAWEW Program. The Bank has allocated a sum of Rs 25 million for this national effort. By restoring selected Tanks, thousand of acres of abandoned lands have been brought under cultivation and the production has substantially increased during both Maha and Yala seasons. This program has also assisted the rural population to engage themselves in livestock rearing, inland water fish breeding, thus bringing income to them throughout the year.

BENEFICIARY TRAINING

Farmers are given training on the adoption of new technology, farm mechanization, quality produce selection of improved variety of seed materials, application of fertilizer and chemicals and marketing the produce, as well as on controlled environmental agriculture such as farm house, drip irrigation and poly tunnel This has enabled thousands of farmers to reap an increased cultivation and in turn an enhanced income.

SPECIAL PROJECTS IN SELECTED AREAS

BoC now implement special projects in selected areas through its closest branches in order to have a close co-ordination and collaboration with the participating agencies (such as ginger cultivation, gherkin cultivation, dairy development, sugarcane cultivation). In addition to the field level co-ordination, the Development Banking Division in Head Office also make periodical visits in order to assess the progress of the projects. This new approach has proved successful as the BoC intends expanding this to cover more projects and areas.

CONSTRAINTS AND ISSUES

Inadequate infrastructure development in rural areas, the concentration of industry and financial services close to the main ports and the airport, and the poor performance of the agricultural sector have led to an unequal distribution of the benefits of the economic growth. The Western Province hosts the port and the airport and generates 50 percent of GDP, 55 percent of services and 57 percent of total industrial output. Labor productivity in industry and services is also highest in that province. The inhabitants of Western Province have the highest income per head, followed by North Western, Central and Southern Provinces. The Northern and Eastern Provinces are the poorest. Plantation, fisheries and other agriculture are concentrated in Southern, Central, North Western and Sabaragamuwa Provinces which generates close to 60 percent of agricultural output.

The Plan of regional industrialization has been implemented to establish 300 industries outside Colombo and Gampaha Districts in the Western Province. Fiscal incentives such as tax holidays, duty free import of machinery will be offered to these industries, subject to the condition that they should employ a minimum of 200 workers.

The marketing of agricultural produce becomes difficult and the prices decline sharply soon after the peak harvesting period when there is a glut in the market, thereby depriving farmers of a dependable income.

With a view to maintaining the market prices at a reasonable level, the government intervened in the market at a specified purchasing scheme. A sum of Rs 2,000 million has been allocated for the purchase of paddy through Bank of Ceylon during current season. In addition, Bank of Ceylon will provide financial assistance to the paddy millers and paddy stockists to purchase paddy and other agricultural produce.

PROSPECTS FOR THE FUTURE

Being a State-owned Bank, the BoC recognizes the important role it has to play within the scope of its national commitment and social responsibility. BoC extends full backing and co-operation to the Government's new approach towards accelerated national development. The implementation of novel scheme, viz: Gamata Naya (credit to villages) and Sookshma (a new microcredit scheme) are producing excellent results.

BoC has planned to enhance its microfinance schemes to reach 100,000 new entrepreneurs during the current year. The target group will be selected from 3,000 villages island-wide. For this purpose a BoC Sookshma Entrepreneurs Development Centre (SEDC) will be formed at each selected village. Each SEDC will have minimum of 10 groups of 5 members, preferably family relatives. Since globally women constitute the majority of microfinance clients, it is envisaged to encourage more women to joint the SEDC.

It is proposed to create a BoC "Microcredit Projection Fund" to which each borrower should contribute one percent of the loan at the time of obtaining the loan. In case of death or permanent disability of the borrower the balance outstanding on the loan will be set off from this fund and the families of the deceased/ disabled will not be required to pay off the debt any more.

RURAL FINANCIAL SYSTEM IN THAILAND

Mr. Thiraphong Tangthirasunan, President
Bank for Agriculture and Agricultural Cooperatives

EMERGING DEVELOPMENTS IN THAILAND'S RURAL AND AGRICULTURAL FINANCE

Rural financial markets are important because financial intermediation facilitates general economic growth and poverty reduction. Financial intermediaries mobilize funds, allocate them among competing uses, create money, and function as a payments system. The efficient provision of loan, deposit, payment, and insurance services enables entrepreneurship, innovation, and production to develop and flourish. Safe savings facilities, payment services, access to credit, and reliable insurance mechanisms enable poor households to reduce vulnerability by smoothing consumption and mitigating risks. Since rural income cycles are particularly volatile, financial intermediation is especially important to shift purchasing power over time, as well as between net savers and net investors or spenders at any given time.

The availability of appropriately-designed financial services is an essential component of the enabling environment for rural economic growth and poverty reduction. Access to working capital or investment credit offered by rural finance institutions can substantially accelerate the adoption of modern agricultural technologies and production patterns which improve the ability of the rural sector to provide for the subsistence needs of the poor, produce the surplus in primary and intermediary products required for urban consumption and export, and avoid environmental degradation. Suitable credit products can also permit entrepreneurs to take advantage of investment opportunities in processing and off-farm enterprises. The availability of liquid and term deposit services encourages remunerative saving and the accumulation of financial assets, whether for "lumpy" investments and expenditures or for consumption smoothing by offsetting irregular income flows and mismatched expenditures (expected or unforeseen). Other means of coping with vulnerability to income and expenditure shocks include reliable *payment services* for transfer of remittances between rural and urban areas and affordable *insurance* services (crop, life, health).

Traditionally, micro- and rural finance activities exist in Thailand for a long time, mostly in the form of cooperative- and agricultural loans. The Government believes that micro- and rural financial services are a key tool for the development of the rural economy, poverty alleviation. Moreover, with the believe that a strong domestic demand is necessary for economic recovery during this time, the government launched an economic stimulating package by aiming to strengthen the domestic economic foundation, especially activities at the grass-root levels. The Government is supporting these activities by providing assistance to promote development and to create necessary infrastructure in the local communities.

HISTORICAL BACKGROUND OF BAAC

With the needs for rural and agricultural credit mentioned above, the Bank for Agriculture and Agricultural Cooperatives (BAAC), as an important arm of the rural development of the Government, was established in 1966 as a Government-owned financial institution to enhance agricultural production through the provision of financial services to farmers. It has steadily developed as a major agricultural financial institution in the rural area with the support of the Government and international donor agencies.

BAAC's OPERATIONAL OUTREACH

A major factor behind the BAAC's success in client outreach was the massive expansion of the retail network over the past decade. The first twenty years of operation, BAAC had maintained only one branch office in each of the country's 76 provinces. In 1988, BAAC's management took the major decision to decentralize and down-scale its banking operations from the provincial to the district level and issued a policy of upgrading 10 to 25 field offices into sub-branches and, ultimately, into full branches every year. Until 1998, the number of branches has increased substantially. At the same time, additional filed units were opened. At the end of fiscal year 2005, BAAC had 75 provincial offices, which supervised a total of 848 branches located throughout the country. Of these branches, 567 were classified as district branches, 281 as mini branches (under the supervision of the district branches). In addition, bank had 938 field units scattered around the local areas of districts, which served as places of contact for its client farmers countrywide.

The total number of staff members is 13,267 of which 90 percent work at branches and field offices to provide agricultural and rural financial services directly to farmers. BAAC's financial services target mainly farmers, agricultural cooperatives and farmer associations. By the end of fiscal year 2005, a total of 5.54 million farm families, or 95.68 percent of all farm families countrywide (based on the agricultural consensus of the National Statistical Office which indicated that there were 5.79 million farm families in 2003) had accessed credit services from the bank. Of this total, 4.01 million farm families were individual farmers that received credit directly from the bank, 1.52 million farm families were members of agricultural cooperatives and 0.01 million farm families were member of farmer associations.

The number of savings accounts of almost 9.6 million provides significant proof that rural clients in Thailand have high demand for the financial services of BAAC. The pro-active rural savings mobilization[1] of the BAAC led to an almost revolutionary change in the financial resource base. The BAAC has become financially self-reliant and was able to significantly reduce its dependence and loans from domestic and foreign sources.

CONDUCIVE RURAL FINANCE POLICY ENVIRONMENT AND REGULATORY FRAMEWORK

- **Policy intervention**

The development of BAAC has been influenced by national policy interventions which have regulated the lending interest rates, limited target groups of BAAC, provided special privileges, and enforced the implementation of special programs to BAAC.

Table 1: National Policy Interventions

Policy	Details of the policy
Special privileges on BAAC in comparison with commercial banks	• Exemption of condition for making branches (such as requirement to provide certain credit equivalent to at least 60 percent of deposits in the local area of which 1/3 was mandated for agriculture). • Exemption of income taxes • Exemption of reserve requirements on deposits • Subsidized interest rates for Bank of Thailand (BoT) funds
Ceiling on lending interest rates	• Necessity of government approval on lending rates • Reduction of lending rate (example) • In 1994/1995, the lending rate was ordered to drop from 11 percent to 9 percent
Special government project	Implementation of many special programs, particularly since 2001. Credit operations under the government policies at the end of fiscal year 2004 • People-Sector Debt-Problem Solving Project • Assistance to farmers in the Southernmost provinces • Assistance to farmers in the 6 Tsunami-affected provinces • Village Bank • Asset Capitalization
Amendment to the BAAC Act	Amendment in 1992, 1998 and 2006 (under process)

[1] The Thai-German Microfinance Linkage Project supported BAAC in its savings mobilization efforts.

BAAC has to accommodate the particular interests of Ministries and Government agencies by implementing a considerable number of special projects in addition to its regular lending operations.

REFORMS AND TRANSFORMATIONS BEING IMPLEMENTED

The development of BAAC can be divided into four development periods: 1) foundation of organization, 2) expansion of lending operation, 3) striving for viability and self-reliance, and 4) adjustment and diversification, based on the national policy intervention, macroeconomic situation, and internal policies as show below:

- **First Period: Foundation of the Organization (1966-1974)**

The first period of the development is regarded as the foundation of the organization from 1966 to 1974, before the government initiative in 1975 to impose upon commercial banks to provide credit in the agricultural sector. During this period, the main focus was on the development of operation mechanisms and a branch network to provide low interest credit services to small farmers directly and indirectly through agricultural cooperatives and farmers' associations at the national level. Provision of small-scale loans to farmers without proper collateral was enabled by the development of innovative loan mechanism through the Joint Liability Groups (JLGs).

Like other public rural financial institutions established in developing countries, BAAC concentrated its service on low-interest lending with public financial resources. However, the quality of loan portfolio and cost effectiveness of the operation were also important concepts of BAAC from the early stage. Follow-up and supervision of the lending were recognized as important functions of the organization since the establishment. Provision of training sessions both to internal staff and JLG members was also emphasized to overcome the problems of high delivery cost and low repayment rates.

- **Second Period: Expansion of Lending Operation (1975-1987)**

The operation from 1975 to 1987 is considered the second development phase of BAAC. BAAC's operation has steadily developed and the source of operating fund has been significantly changed by the inflow of the fund from commercial banks and international donor agencies. In accordance with the government policy to urge commercial banks to play a more important role in agricultural development, commercial banks were required to provide agricultural credit or deposit with BAAC any portions of the quota that they did not lend directly. The quota was initially set as 5 percent in 1975 and increased gradually to 20 percent (14 percent to agriculture and 6 percent to non-agriculture in rural areas) in 1987. With this privilege, BAAC was able to expand its lending for agricultural investment favourably. The portion of this obligatory deposit from commercial banks has continued to take the largest portion of the operating fund of BAAC throughout this period ranging from 46 percent in 1978 to 31 percent in 1986. During this period, financial support was also provided by international sources. Accordingly, the proportion of borrowing in total operating fund also increased from 4 percent in 1975 to 20 percent in 1987.

It should be noted that, despite the increase of the operating fund, the loan portfolio of BAAC did not change significantly. As shown in the table below, the repayment rate of the loan remained stable and average loan amount per client farmer did not increase rapidly in comparison with the consumer prices despite increase in the availability of the operating fund. These figures indicate that the increase of operating fund from external sources was utilized effectively under the consistent loan mechanism. Establishment of appropriate loan approval and repayment mechanism developed at earlier stage of development, and solid implementation in the field are considered as major contributing factors to this consistency.

During this period, BAAC shifted the target of lending to individual farmers, who had shown better repayment performance compared with agricultural cooperatives and farmers associations. Accordingly, the portion of agricultural cooperatives and farmers' associations in annual extended loan decreased from 37 percent in 1975 to 17 percent in 1987.

- **Third Period: Striving for Viability and Self-Reliance (1988-1996)**

During this period, BAAC focused on striving for viability and self-reliance under the conditions of controlled interest rates by savings mobilization, improved loan portfolio, and increased staff productivity.

In the 6th National Economic and Social Development Plan (1987-1991), the Government of Thailand put savings mobilization as one of national strategies to utilize the domestic financial resource more effectively for the development of the nation. BAAC's role in the savings mobilization in rural areas was described in the Plan as well as role in expansion of short-term credit, support to the government programs, and other.

Besides, the Bank of Thailand liberated interest rate in 1989 in the financial reform. All the interest rate ceilings were lifted and restrictions on banks for opening new branches were gradually removed. The scope of agricultural credit quotas imposed on commercial banks was broadened to include all types of rural credit. Accordingly, commercial banks expanded credit operation in rural areas to meet their quotas. It also encouraged BAAC to increase its own financial source.

With the savings mobilization effort, deposit from the general public in BAAC's total operating fund increased significantly from 29 percent to 61 percent while the reliance on the deposit from commercial banks and borrowings declined from 36 percent to 2 percent and from 18 percent to 11 percent, respectively, between 1988 and 1996.

BAAC was finally allowed to provide loans to agriculture-related activities by the amendment to the BAAC Act in 1992. Though the target was still limited to the farmers, it was an important breakthrough for BAAC to diversify its services.

Another milestone in this period was the establishment of Agricultural Marketing Cooperatives (AMCs) in 1998 to support the provision of quality agricultural inputs and marketing channels of agricultural products for client farmers. The background of the establishment is presented in Thailand experienced a high economic growth during 1986 and 1996, based on both favorable external factors and sound policy fundamentals, including prudent fiscal management, aggressive export promotion, trade policy liberalization, and market-friendly policy interventions. Though the manufacturing sector was the engine of the growth, the agricultural sector also continued to grow. It is fair to say that this high growth in the national economy and the agricultural sector pushed the demand for agricultural production, and thus, for rural credit.

- **Fourth Period: Adjusting to the environment after the financial crisis and diversifying of its services (1997-present)**

The Thai economy was severely hit by the financial crisis in 1997, which was triggered by the devaluation of the Thai Baht. The crisis also affected BAAC negatively by the losses from the devaluation of the Thai Baht and the increase of non-performing loans. After the crisis, BAAC came under the supervision of the Bank of Thailand and became subject to prudential regulations, such as capital adequacy and loan loss provisioning. The repayment rate of loan to principal matured dropped from 87 percent in 1996 to 75 percent in 1998.

In 1999, the BAAC Act was again amended to allow BAAC to lend for "non-farm" activities in addition to farm activities by the government. This change could help BAAC channel more of its funds to small-scale farmers who have a high portion of non-farm activities in their incomes.

LENDING AND SAVINGS SCHEMES

- **Credit Products**

BAAC credit services can be divided into two broad categories according to two delivery channels:

RETAIL CREDIT

Retail credit to individual farmers (organized in joint liability groups) accounts for 94 percent of the portfolio. Retail credit to individual farmers is again broken down into normal lending which accounts for 81.85 percent in 2005 and government-secured lending which accounted for 7.63 percent in 2005.

Therefore, normal lending to individual client farmers represents the mainstream credit program of BAAC compared to the total loan portfolio in 2005.

The normal lending can be distinguished by two core credit products: working capital loan and investment loan.

WHOLESALE CREDIT

Wholesale credit to farmer institutions (agricultural cooperatives and farmer associations) accounts for 6 percent of the portfolio.

LOAN TYPE

The working capital loan is for farmers and family members for agriculture purpose and for farmers with non-farm loan purpose. The loan duration is between 12-18 months. The investment loan is for medium-term and long-term periods. A loan can be used to finance agricultural activities, but also industrial, commercial and services enterprises are permitted as long as the borrower is also a farmer.

For almost 30 years, BAAC had been restricted in its lending policy exclusively to agricultural production. Only in 1993, was the Bank given permission to extend loans also for farm-related activities, such as agro-processing and marketing, up to a maximum of 20 percent of its portfolio.

CLIENT ORIENTATION THROUGH CREDIT TECHNOLOGY

The development of the Joint Liability Groups concept dates back to the foundation of BAAC in 1966. Since few Thai farmers had land title documents to use as collateral in the 1960s, BAAC adopted joint liability, as principal form of security for small loans. Joint liability has been at the heart of the BAAC's lending ever since.

Joint Liability Groups are formed by people who know and trust each other. They vary in size from a minimum of 5 to a maximum of 30 and as average of about 15 members. In general, Joint Liability Groups are primarily client groups and not what is normally understood as self-help groups with organization and administration. BAAC Joint Liability Groups do not function as financial intermediaries. Individual loans up to baht 150,000 (US$3,400) are granted on the basis of joint liability. Loans above this amount must be secured by tangible collateral, usually through mortgage of land and buildings.

All transactions are conducted between the BAAC and the individual members, also the group leader has no role in disbursements or recovery of loans. The group leader is responsible for distributing repayment notes and reminding the members of their obligations.

Since in the more recent years, the majority of the BAAC borrowers earn income from agricultural and non-agricultural activities, the loan assessment has to become more in line with the total household cash flow of the borrower and not just follow agricultural harvesting schedules.

BAAC'S FUTURE MARKET SEGMENT: NON-FARM LENDING

For many years, BAAC has tried hard to secure amendment of the 1966 Act and to obtain permission to expand its lending operations to non-farm activities in rural areas. In 1993, a first window was opened when BAAC was allowed to provide loans for farm-related activities. As a second step in the beginning of 1999, the Government approved amendment of the BAAC Act. This allowed the expansion of lending operations into non-farm activities for farmers. Up to 20 percent of the total portfolio. In 1997, a small grant of 10 million baht (approximately US$380,000) was provided by GTZ as part of its technical cooperation with the BAAC for establishing a revolving fund for non-farm lending.

GOVERNMENT-SECURED LENDING

In addition to its normal lending business, the BAAC grants a large number of Government-secured loans or so-called "special agricultural development projects and policy and programs", some nationwide, some of them regionally concentrated. The outstanding loan volume in 2001 accounted for 13 percent of total loan portfolio. However, the workload associated with these special projects is heavy, which results from the decentralized branch controlling.

SAVINGS AND DEPOSIT PRODUCTS

During the first twenty years of operations, BAAC concentrated almost exclusively on credit services while savings largely remained, like in many agricultural development banks elsewhere, the "forgotten half" of rural finance. During the early years, BAAC implemented a compulsory savings scheme for borrowers, requiring that each borrower deposit an amount equivalent to 5 percent of the loan value in a savings account. The scheme was terminated in 1979 because it was costly to administer, especially since its branch offices were at that time ill-equipped to manage funds.

Only since the mid-1980s, BAAC has recognized the importance of voluntary savings mobilization, not only from its own perspective of deposits as a stable and reliable source of funds, but also from the viewpoint of its farmer clients, who need safe, liquid and convenient deposit facilities. The Bank realized that there is a strong demand for synchronizing income and expenditure in the course of the agricultural production cycle. Furthermore, savings act as a buffer against the uncertainty, which governs the rural economy. In the wake of unforeseen events and emergencies, financial savings perform a basic insurance function.

Over the past decade, the Bank has campaigned effectively to mobilize rural savings. The Savings Promotion Division was established in the head office and assigned the task to develop strategies and designing appropriate savings products. The branches were instructed to set annual mobilization targets, and savings mobilization became one of the major achievements.

DEMAND-ORIENTED SAVINGS PRODUCTS

BAAC offers a range of savings products aimed at different target groups. Standard instruments are the normal savings passbook on the one hand and fixed deposits for three, six and twelve months on the other hand. Normal savings carry an interest rate of 1.75 percent, while fixed deposits are generally higher-yielding , e.g. at two and a half percent to three percent in 2002. Interest rates on both types of products closely follow the market rates of commercial banks.

In addition, BAAC offers a Special Savings facility, which requires a minimum balance of 10,000 baht (US$228) and, therefore, addresses the more well-to-do customers. Interest rates are now only at two percent per annum (2006) and comparable to fixed deposit rates.

The liquidity of this facility is limited as depositors may withdraw only once a month. However, the feature of this product is that interest income is exempted from taxation. Only Government-owned banks, including BAAC, are entitled to offer this kind of facility, which provides them with a comparative edge over private commercial banks.

In 1995, BAAC introduced an innovative savings product, called Om Sap Thawi Choke or Save and Get a Chance, primarily targeted at the low-income market. This product was developed by BAAC Savings Promotion Division together with the GTZ-supported Microfinance Linkage Project. The minimum opening deposit is only 50 baht (US$1.15) and, although the interest rate of 0.75 percent paid on deposits is one percent below the standard rate BAAC pays for savings account, and the account holder is entitled to participate in semi-annual tombola-drawing parties offering goods popular in rural areas as prizes. After successful pilot-testing in selected branches, the product has been launched nationwide in early 1996 and has so far attracted more than 2.1 million depositors with an average deposit of 3,800 baht (US$87) per account holder by end of 2005.

The most recent product introduced in 1997, with the objective of attracting medium-term funds is the BAAC Savings Bond (Thawi Sin). The savings bonds have a nominal value of 500 baht (US$11.4) each and a term of three years. The three-year bonds carry the low interest rate – but as a compensation for the low yield – bond holders participate in a highly publicised prize draw at national level.

More than 75 percent of BAAC's deposits are generated mainly through the four core products, which are mentioned above, while fixed deposits accounted for less than 25 percent at the end of fiscal year 2005.

INDIVIDUAL AND INSTITUTIONAL DEPOSITS

Depositors are broadly classified into (a) private individuals and (b) institutions. Fifty-three percent of the deposits are from individual and 47 percent are from institutional depositors. The latter include primarily provincial and district government offices and line agencies and, to a lesser extent, agricultural cooperatives and farmer's associations. The BAAC has benefited from the regulation that local government offices must keep their budget funds in an account with a government-owned bank.

Institutional deposits are made up of a relatively small number of accounts with large amounts. They are held in both savings and fixed deposits on an almost equal balance. Furthermore, institutional deposit accounts are subject to considerable fluctuations, depending on budget allocations and expenditures, which exposes the Bank to a considerable liquidity risk.

FEE-BASED AND OTHER PRODUCTS

Recently, BAAC has been paying greater attention to fee-based services, similar to what Thai commercial banks have done since the financial crisis. While Thai commercial banks mainly focus on the urban and better-off rural customers, BAAC targets the mass of the rural people with its extensive branch network. A client who borrows from BAAC has also a savings account and normally, he/she needs a life and accident insurance, as well. Fee-based income services are to complement the cross selling of BAAC core banking products. Additionally, they also can contribute to reduce credit risk and stimulate savings mobilization.

INVESTMENT FOR RURAL FINANCE

Though there are various factors that determine the demand for rural financial services, the demand for agricultural production, which reflects the conditions of the international, national and local economies, has been a key factor in setting the demand for rural finance. The composition of the national economy in Thailand has changed since the 1970s. The share of the agricultural sector in GDP dropped from 27 percent in 1970 to 10 percent in 2004. Though the growth rates have been less than those of the manufacturing and service sectors, the agricultural sector have steadily developed to generate increasing demand for rural finance. Also, the spread of more capital intensive production pattern and diversification of products in agricultural sector increased the demand for rural finance.

COOPERATION/COMPETITION FOR RURAL FINANCE

It is fair to say that BAAC has been free from severe competition with commercial banks and other public financial institutions for small agricultural credit until recently. BAAC may have to face increasing competition in the near future as these organizations have been expanding their operation in rural areas.

SUCCESS FACTORS, INNOVATIVE PRACTICES, AND CHALLENGES

Although much innovation has taken place in microfinance that is useful for rural finance operations, the majority of microfinance institutions (MFIs) operate either in urban and peri-urban areas or in densely populated rural areas with a strong non-agricultural economy. However, BAAC, working in rural areas, offers loans for agricultural purposes. As a financial institution, BAAC has mobilized financial resources domestically while providing positive real returns to their depositors, to have loans repaid, and to have operational costs covered from the operational income.

MOBILIZATION OF LOCAL RESOURCES

BAAC has successfully mobilized domestic financial resources through strong savings mobilization since the 1980s. Though the direct motive for the savings mobilization appears to be the Government policy to enhance the savings to utilize domestic financial resources more effectively for the investment, BAAC developed and provided demand-oriented deposit schemes for client farmers who needed not only credits but also savings services to keep their financial assets in reliable and easily accessible place. The strong branch network, supported by trained field staff, and trust fostered by the close relationship between BAAC field staff and client farmers, is the foundation of the period expansion of savings services.

REPAYMENT

BAAC has a relatively low rate of overdue debts to overall credit (less than 5 percent) despite the exclusive focus on agricultural credit which has agricultural production risks due to the vulnerability to the nature and markets. As discussed earlier, it is also noted that BAAC has maintained a relatively higher repayment rate through the entire operation period regardless of source of operating fund.

The development of appropriate loan approval and repayment mechanism and follow-up by the BAAC field staff are considered as key contributing factors for the this achievement. The mechanism includes important components, such as peer pressure for timely repayment by other JLG members, annual repayment schedule matched to the production cycle, progressive loan amount based on the repayment performance, and others, It is considered that a solid relationship between client farmers and BAAC staff based on the mutual trust has also highly contributed to this achievement.

PROFITABILITY

Traditionally, the operating cost of outreaching rural agricultural credit was considered high due to the small loan size and spread of the farmers in the vast operation areas. BAAC has overcome the problem by introduction of JLGs to reduce the transaction costs and enhances the efficiency of screening, monitoring of and enforcing repayment. Accordingly, the number of registered farmer clients per field staff has reach 458.

FINANCIAL SUSTAINABILITY

Higher dependence on subsidy threatens the longevity of the organization, BAAC has been reducing the risk by savings mobilization effort, cost effective credit delivery and recover, and other efforts. Though BAAC is still receiving financial privileges from the government, its financial sustainability has been steadily improving. The deposit to loan ratio of the bank increased dramatically to 93 percent in 2004 from 21 percent in 1980 and 66 percent in 1993.

Concentration of lending portfolio in agricultural activities, which are seasonal in nature and fragile for weather and other natural factors, increases the co-variant risk, BAAC realizes the risk and has been seeking for relief from the policy constraint to reduce the risks. Accordingly, BAAC has gradually expanded its loan target and field to include agriculture-related activities and non-farm activities through the amendment to the BAAC Act in 1992 and 1999. Through the new amendment to the BAAC Act, which is under process of approval, BAAC will be allowed to expand its lending to any kind of cooperatives to provide more diversified services.

DEMAND-ORIENTED APPROACH

BAAC has a strong client-oriented mindset and provides demand-let financial services. This is evidenced by the large number of repeat borrowers who have been clients for many years. The ability of BAAC to provide high quality services depends on its extensive branch network and motivated staff. For instance, the success in small savings mobilization was the result of ability to develop and provide services which savers wanted.

DEVELOPMENT OF APPROPRIATE LOAN MECHANISMS

BAAC has developed its loan mechanism at the early stage of the development. The mechanism includes the following:

- Non-collateral lending through JLG;
- Peer monitoring through JLG;
- Flexible repayment schedule, such as annual repayment and calculation of interest rate base on the date of repayment;
- Simple and quick procedure for the loan disbursement; and
- Progressive lending based on the repayment performance.

Particularly, the introduction of JLG mechanism has been essential for the development of BAAC. BAAC has utilized JLGs since their establishment to help in loan screening and peer monitoring on timely repayment. Training for JLG leaders is organized by BAAC on such topics as values and attitudes that foster awareness and responsibilities as a good bank client.

BAAC's main concern from its establishment has been to maintain a cost-effective mechanism for lending to farmers. Thus, BAAC has developed the JLG concept as a cost-effective tool to lend to a large number of small farmers in locations where normal loan collateral instruments are not available.

STRONG COMMITMENT BY THE FIELD STAFF

Field staff has taken the crucial role in the development BAAC. Regular meeting and on-site training by BAAC field officers have been a major factor in keeping JLGs active. Close relationships between clients, particularly the leaders of JLGs and BAAC field staff members strengthened by frequent visits are a precious social capital for BAAC in fostering a high repayment rate and savings mobilization.

BAAC spends about 1 percent of its administrative budget on training or related activities. Sustained investments in training have helped BAAC acquire expertise in agricultural financing. Currently, a 10-day intensive training program is provided to all new credit officers. The provision of training by satellite communication system is regarded as a contributing factor to enhance the capability of staff at district level.

Besides the provision of the training, BAAC has an attractive incentive mechanism for its staff based on the performance of branch and individual staff. The performance of each branch is assessed annually based on the indicators agreed between the headquarters and branch office. The indicators include financial efficiency, performance efficiency, decrease in overdue loan, progress on special programs initiated by the government, performance of AMC, and others.

The performance of each staff is assessed also annually by indicators according to the position of each staff. For instance, indicators for loan officers are visit to clients and village fund, resolution of debt problem, and amount of overdue loan. The staff receives the bonus according to the performance while any staff who gains less than 70 percent of scores will be trained to improve capacity for effective operation.

DECENTRALIZATION

BAAC's management took the major decision to decentralize its banking operations from the provincial to the district level in 1997 by introducing the transfer price mechanism. The transfer price is the internal interest rate applied on funds transferred between the branches and the head office. The key objectives of this approach at the branch level are to enable branch mangers to understand where profits or losses are generated and how to act upon those figures, and eventually improvement of efficiency of the entire operation of the bank.

Currently, the branch managers can approve loans of up to baht 1 million. As almost all of the loans extended by BAAC are generally below this ceiling, lending decisions are largely in the hands of the branch managers.

MONITORING AND FEEDBACKS SYSTEM FOR APPROPRIATE POLICY MAKING

BAAC has developed an appropriate internal monitoring and feedback system for decision making based on the operational situation, trend of rural finance, and demand of clients, and other relevant issues. For example, BAAC changed the policy to direct its financial resources to individual farmers from agricultural cooperatives and farmers' associations based on the analysis on the repayment performance among borrowers. Development and introduction of demand-driven programs, such as Om Sap Thawi Choke and Om Sap Thawisin, are examples of the good monitoring and feedback mechanism of BAAC.

The following factors are considered the sources of BAAC's strength in monitoring and feedback and, eventually, flexible management of the organization: the internal sharing process by close communication among concerned departments at both at the central and branch levels, active participation of the staff, function of research and development, and monitoring process.

COST-CONSCIOUSNESS

Unlike many other rural financial institutions established in developing countries, it appears that BAAC has pursued cost-effectiveness and productivity since the early stage of its development. Based on the high awareness of the top management, cost-consciousness has to be integrated in the organization management from the planning of activities to the assessment of staff performance, and from the management level to the district level. This organizational culture has contributed greatly to improving the financial viability of the organization.

Currently, the operation cost of the branch office is closely monitored by the Branch Management Information System (BMIS). Cost-effectiveness of the branch operation is quantified monthly through BMIS system in terms of return on asset, profit per employee, expense per employee, and others. The result of the performance is reflected to the annual assessment of the branch performance to determine the bonus of the branch staff.

Moreover, there are some other keys features of continued success of BAAC which include:

- treating the farm household as a financial unit integrating a variety of economic activities, and basing lending decisions on repayment capacity rather than how funds are utilized;
- managing systematic risk in agriculture by three levels of diversification: (i) across rural and urban branches; (ii) across both agricultural and non-agricultural activities in rural branches; and (iii) across diverse household economic activities;
- long-term relationships to lower transaction costs for both lender and borrowers;
- using various types of collateral, including non-traditional collateral from poorer households;
- delegated and decentralized decision-making by well-trained loan officers;
- regular monitoring of clients to ensure that repayment capacity is not jeopardized, opportunities are realized, and the borrower-lender relationship is strengthened; and
- an effective management and information system (MIS) and a commitment to high loan recovery (including seizure of collateral where necessary as a signal to other clients).

CONSTRAINTS AND ISSUES BEING ADDRESSED

Rural population in most Asian countries is mainly engaged in small-scale agriculture or agriculture-related activities and are generally poorer than their urban counterparts. The characteristics of rural financial markets are largely determined by the spatial, temporal, and co-variant nature of most rural economic settings, and include the following inherent impediments to efficient markets:

- Low population density, small average loans, and low household savings increase the transaction costs per monetary unit of financial intermediation. Low population density in many countries means that financial services are spread across long distances. This makes it harder for financial service providers to reach people in a cost-effective manner.
- Lack of infrastructure (communications, electricity, transportation, etc.) and social services (education, health, etc.), lack of client information (no personal identification or credit information) and low integration with complementary markets result in highly fragmented financial markets that involve high costs of overcoming information barriers and limit risk diversification opportunities.
- Seasonality of agricultural activities and long maturation periods for others which is the cause of the unevenness of farming income, demand for loans and credit varies across seasons and makes for a highly erratic and unpredictable business.
- Risks linked specifically to such as flood, drought, pests and disease, price fluctuation, and limited access to supplier and markets heighten the probability of covariant risks (in prices and yields). These risks can also hit many poor households at the same time, with a potentially devastating impact on the financial service provider. In low-income areas, these risks are even higher.
- Lack of usable collateral, ill-defined property and land-use rights, costly or lengthy registration procedures, and poorly functioning judicial systems in poor rural areas mean that reliable collateral is rarely available.

For these reasons, formal financial institutions (such as commercial banks) have largely avoided serving rural areas. In many instances, the only financial services available are provided by informal agents or mechanisms, which offer a narrow range of financial services to limited customers. Lack of access to financing at reasonable cost leaves most microentrepreneurs dependent on self-finance or very costly, short-term credit and limits their ability to actively benefit from investment opportunities and contribute to growth.

SHORT TERM TO MEDIUM TERM PLANS AND PROSPECTS FOR THE FUTURE

Looking around the world and see the changes and paradigm shift from directed or semi-directed credit towards more commercially based rural and microfinance, BAAC is continuing its effort to change its image from an agricultural financial institution to a rural development bank. By the new amendment to the BAAC Act, which is under the process of approval, BAAC will be allowed to expand its services to all kinds of cooperatives. The policy of the government assumes that BAAC oversees more than 16,000 Village Fund in the areas that are not covered by the Government Savings Bank, which will also provide BAAC a new business chance.

CONCLUSION

Rural finance can be an important instrument for poverty reduction as it could enable the low-income and underserved segments of the population to gradually build up their assets, develop their small and microenterprises, enhance their earning capacity and manage their risk better. In many countries it has empowered the poor, especially women. There are many examples where microfinance has proved the capability to enhance economic growth and the potential to contribute to the integration of financial markets.

More and more microentrepreneurs do not have access to credit at all. People in the lower income group have a demand for efficient microfinance services that do not cause high transaction costs for the borrowers/ clients by having to wait several hours in a bank premise or by traveling many times before completing applications. Testing experiences show that micro borrowers are most willing to repay an interest rate which is cost covering for the financial institution as long as the services are efficient and competent.

Successful micro/rural finance institutions must emphasize on a demand-driven approach and therefore appraise the borrowers' credit worthiness and repayment capacity in a competent manner. A strict rule is that interest rates must fully cover cost for micro/rural finance institutions.

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Annex 2

Schedule of Activities

April 5 (Thursday)	
	Arrival of participants at Kunming Airport Registration and check-in at Lobby, Green Lake Hotel
April 6 (Friday)	
07:00-08:00	Breakfast: At "Belvedere" Dining Room, Ground Floor, Building A
09:00-12:00	ACS Frameworking and Planning Session – To be attended by Indonesian members, ACPC Philippines and CENTRAB At "Lake Side Spring Beauty" Meeting Room, First Floor, Building A.
12:00-13:00	Buffet Luncheon: At "Belvedere" Dining Room, Ground Floor, Building A
14:00-15:30	ACS Frameworking and Planning (Continuation): At Meeting Room "Lake Side Spring Beauty" Dining Room, Ground Floor, Building A
15:30-17:30	FinPower Program Steering Committee Meeting: To be Attended by IFAD Representative, APRACA Chairman, CENTRAB President, VBARD Representative and APRACA Secretary General At "Lake Side Spring Beauty" Meeting Room
18:00-19:00	Cocktail party: At Private Room, First Floor, Building A
19:00-20:00	Buffet Dinner (hosted by the Agricultural Development Bank of China) At "Belvedere" Dining Room, Ground Floor, Building A
April 7 (Saturday)	
07:00-08:00	Breakfast: At "Belvedere" Dining Room, Ground Floor, Building A
08:00-08:30	Registration: **APRACA FinPower Regional CEO Dialogue Forum** Opening Ceremony:
08:30-09:40	At "Twin Gateways Shadow Connecting Function Hall", First Floor, Building A – **Opening Remarks**: Mr. Zheng Hui, President, ADBC – Speech: Deputy Governor of Yunnan Province, China – Speech: Mr. Thiraphong Tangthirasunan, President, BAAC and APRACA Chairman – Speech: Hon. Budi Rochadi, Deputy Governor, Bank Indonesia – Speech: Ms. Jovita M. Corpuz, CENTRAB Board President – Speech: Inauguration of FinPower Program – Dr. Ganesh Thapa, IFAD Regional Economist, Asia Division – Vote of Thanks: Mrs. Usha Thorat, Deputy Governor, Reserve Bank of India

April 7 (Saturday)	
09:40-10:00	Group photo session and Coffee break
10:00-12:00	– Brief Introduction of the FinPower Program: Dr. Ganesh Thapa and Mr. Benedicto S. Bayaua – Brief Introduction on Forum Mechanics: Ms. Jocelyn Alma R. Badiola, Facilitator – Country Presentation: China, Cambodia, India, Indonesia, Iran, Japan
12:00-14:00	Buffet luncheon: At "Belvedere" Dining Room, Ground Floor, Building A
14:00-15:00	Country Presentation: Lao PDR, Myanmar, Malaysia, Nepal
15:00-15:20	Coffee break
15:20-17:00	Country Presentation: Philippines, Sri Lanka, Thailand, Vietnam E-Commerce Presentation: Mr. Edgardo Herbosa, Managing Director from b2bpricenow.com
18:30-21:00	Welcome dinner with cultural performance hosted by ADBC At "Golden Ballroom", First Floor, Building A
April 8 (Sunday)	
07:00- 08:00	Breakfast: At "Belvedere" Dining Room, Ground Floor, Building A
08:30-10:30	– Synthesis and Action Planning for the FinPower Program – Closing Note: Dr. Ganesh Thapa, Mr. Thiraphong Tangthirasunan At "Twin Gateways Shadow Connecting Function Hall"
10:30-12:30	52nd APRACA EXCOM Meeting: At "Twin Gateways Shadow Connecting Function Hall"
12:30-13:30	Buffet luncheon: At "Belvedere" Dining Room, Ground Floor, Building A
13:30-16:00	Shopping tour and return to Green Lake Hotel
17:00-17:30	Leave for Zhengzhuang Hotel from Green Lake Hotel
17:30-18:00	Deputy Governor of Yunnan Province, China meets delegation of APRACA EXCOM and other members and guests at Zhengzhuang Hotel
18:00-19:30	Dinner hosted by Deputy Governor of Yunnan Province, China at Zhengzhuang Hotel
19:40-20:00	Leave for Kunming Convention Hall
20:00-22:00	Cultural performance "Yunnan Impression"
22:00	Return to Green Lake Hotel

April 9 (Monday) Kunming Group	
07:00-08:00	Breakfast: At “Belvedere” Dining Room, Ground Floor, Building A
08:00-09:00	Leave for Anning Country
09:00-12:00	Field visit to ADBC client in Anning Country
12:00-13:00	Buffet luncheon: At “Belvedere” At “Belvedere” Dining Room, Ground Floor, Building A, Green Lake Hotel
13:00-17:00	City tour: Visit scenic spot “Stone Forest”
17:00-18:00	Return to Green Lake Hotel
18:00-20:00	Buffet dinner: At “Belvedere” At “Belvedere” Dining Room, Ground Floor, Building A, Green Lake Hotel
April 9 (Monday) Li Jiang Group	
06:20-07:35	Leave for the Kunming Airport Take off of Flight MU5947 – Breakfast will be served in Li Jiang after arrival – Field visit to ADBC Li Jiang Branch, City tour – Overnight stay in Li Jiang – Return to Kunming on April 10
April 10 (Tuesday)	
	Departure for Home Country

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