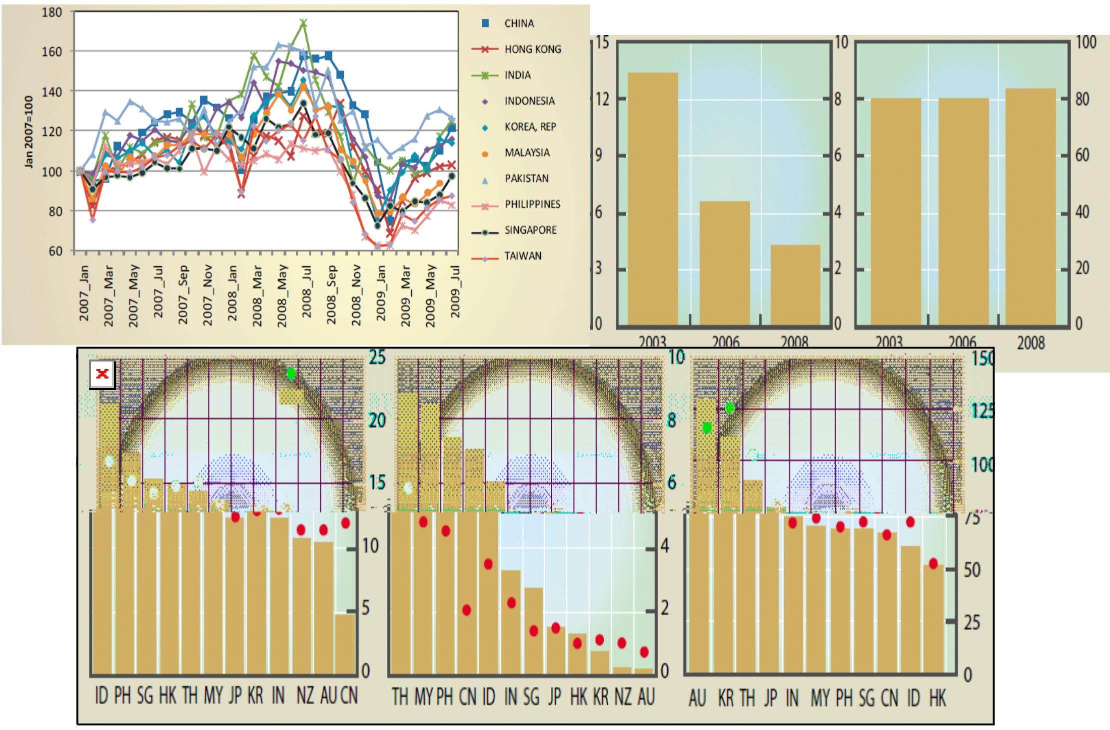
APRACA FinPower Programme

RURAL FINANCE ENVIRONMENT IN ASIAN COUNTRIES:

Policies, Innovations, Financial Inclusion



Gilberto M. Llanto
Jocelyn Alma R. Badiola

An APRACA FinPower Publication with the Special Sponsorship of the International Fund for Agricultural Development (IFAD)

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This book is published during the incumbency of Mr. Abdirakhob Tamikaev, APRACA Chairman, and Mr. Won-Sik Noh, APRACA Secretary General.

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LIST OF ACRONYMS

ADB	Asian Development Bank
APRACA	Asia Pacific Rural Agricultural Credit Association
BAAC	Bank of Agriculture and Agricultural Cooperatives
BDFC	Bhutan Development Finance Corporation
BRI	Bank Rakyat Indonesia
CMA	Cambodia Microfinance Association
CSFI	Center for the Study of Financial Innovation
EMI	Ekpatthana Microfinance Institution
EU	European Union
FAO	Food and Agriculture Organization
GDP	Gross Domestic Product
LBP	Land Bank of the Philippines
MADB	Myanma Agricultural Development Bank
NABARD	National Bank for Agriculture and Rural Development
NGO	Non-Government Organization
SHG	Self-Help Group
VBARD	Vietnam Bank for Agriculture and Rural Development
UNICEF	United Nations Children's Fund

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Won-Sik Noh
APRACA Secretary General

1. Introduction

This paper has two objectives. First, it reviews the rural finance policy and regulatory framework in Asian countries and secondly, it highlights the emerging innovations in financial products and use of technology, the commitment to deeper professionalization, and development of financial inclusion approaches, which have been recently adopted by rural financial institutions and microfinance institutions amid the many challenges brought by the changing global environment.

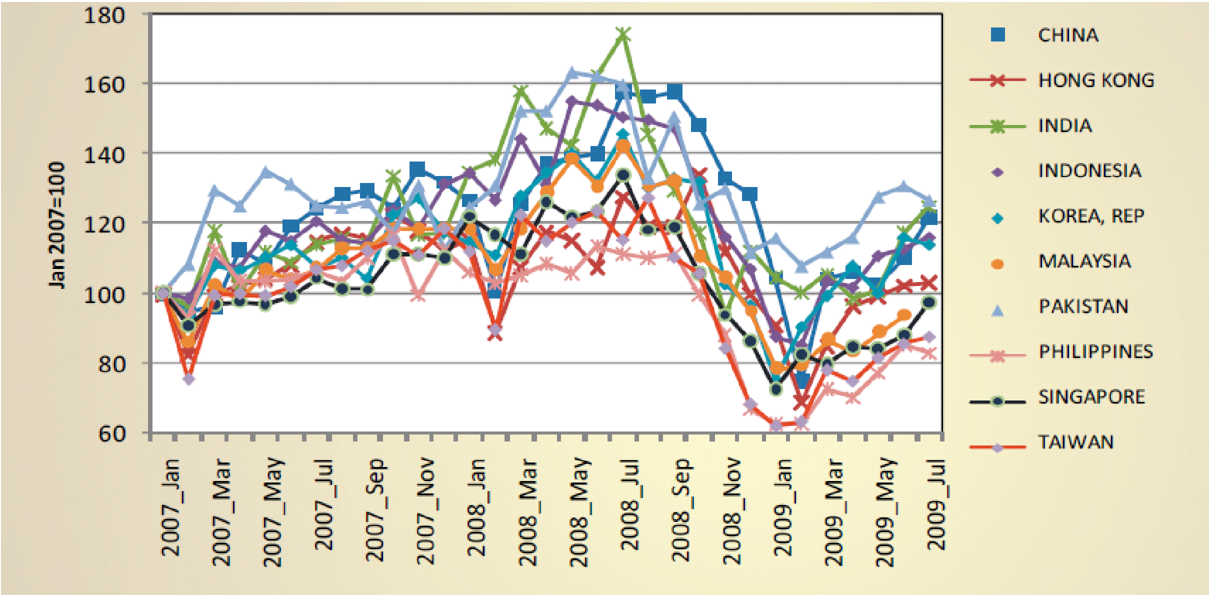
It is organized as follows: after a brief Introduction, Section 2 provides an environment scan touching broadly on the global financial crisis, climate change and rising food and fuel prices, which motivate the rural financial institutions (RFIs) and microfinance institutions (MFIs) to develop creative responses and strategies. Section 3 discusses the rural finance policy and regulatory framework in selected Asian countries. It pays particular attention to the institutional structure and outreach in rural finance as reported by APRACA member countries. Section 4 describes the innovations and financial inclusion approaches adopted by Asian RFIs and MFIs. The final section spells out some outstanding issues in rural and microfinance waiting to be addressed by policy makers, RFIs and MFIs and signals pathways to further rural and microfinance reforms through some recommendations that would help contribute to developing sound rural financial markets in Asia.

2. A Challenging Global Environment for Rural and Microfinance Institutions

In 2008-2009, the worst economic crisis since the Great Depression of the 1930s hit Asian countries after wreaking havoc on Western economies. Yap and others (2009) recalled the events leading to the crisis as follows. On September 15, 2008 the global investment bank Lehman Brothers filed for bankruptcy protection, sending shock waves across the international financial system. This was soon followed by other bankruptcies, bailouts and takeovers of financial institutions in the US and Europe. Subsequently many economies—Germany, Japan, Singapore and Hong Kong among others—were declared to be in recession. The high point came when the National Bureau of Economic Research announced on December 1, 2008 that the US economy was in recession since December 2007. Global growth slowed substantially in 2008, and a recession was in place in the US, Europe and Japan while growth in the emerging economies has come down sharply as well (Loser 2009).

The severe crisis in subprime mortgage markets in the United States triggered global and financial crisis, which led to widespread recession among OECD countries. Global trade contracted and many low income countries were caught in a bind. Exports plummeted (see Figure 1), and capital markets were in turmoil, while those low-income countries, which have relied on remittances of overseas workers (Table 1 and Figure 2), dreaded the loss of overseas jobs as the global economic downturn continued with its onslaught on rich and poor countries alike[1].

Figure1. Exports Collapsed in Asia since Sep 2008, but recovering slowly



Source: **Chibber, Ghosh and Palanivel (2009)**

Initial reports supported the expectation of increased unemployment of overseas foreign workers with evidence of decelerating remittances from countries that relied strongly on them such as in Pakistan and the Philippines. However, as the crisis unfolded, it has also become clear that the pattern of migration and remittances may be more complex than was previously imagined. Chibber, Ghosh and Palanivel (2009) showed that while the growth of remittance flows moderated in some countries, overall flows remained resilient (Figure 2). In fact, in several countries such as Bangladesh, India, Pakistan, Philippines, Nepal and Sri Lanka, remittances have actually increased instead of declining. To some extent, according to Chibber, et al, this too can be expected because even if the crisis leads to large-scale retrenchment of migrant workers who are forced to come home, they would obviously return with some accumulated savings. In such a case, there could even be temporary spikes in remittances

[1] The reader is referred to the following articles, which gave an account of the global and economic crisis: Felton, A., and K. Reinhart (2008). 'The First Global Financial Crisis of the 21st Century; Barth, J. R. (2008) 'US Sub-prime Mortgage Meltdown'. Paper presented at the 14th Dubrovnik Economic Conference, 25 June; Taylor, J. B. (2009) 'The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong', NBER Working Paper 14631.

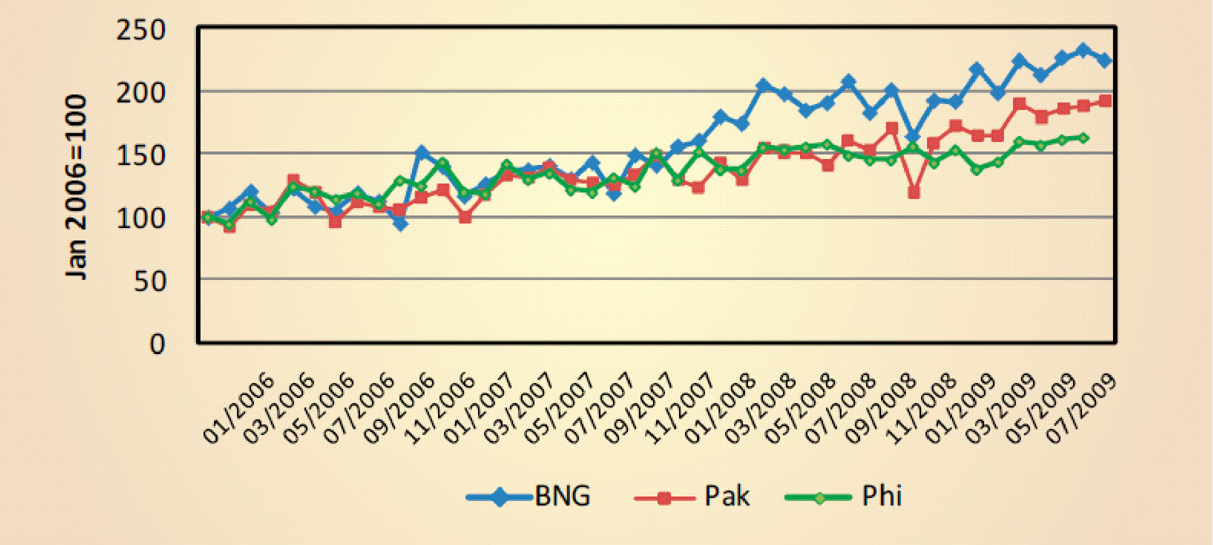
rather than a continuous decline because of the crisis. Eventually though, as the adverse conditions for overseas employment worsened, there were dips in remittance inflows.

Table 1. Migration Status of Asian Countries

Labour Sending	Bangladesh, Cambodia, China, Indonesia, Lao PDR, Myanmar, Nepal, Philippines, Sri Lanka, Vietnam
Labour Sending and Receiving	India, Malaysia, Pakistan, Thailand
Labour Receiving	Brunei Darussalam, Hong Kong SAR, Japan, Middle East, Republic of Korea, Singapore, Taiwan China

Source: **Chibber, Ghosh and Palanivel (2009)**

Figure 2: Remittance Inflows in Bangladesh, Pakistan and the Philippines



Source: Chibber, Ghosh and Palanivel (2009)

Altogether, Loser (2009) summarized the impact of the global and financial crisis. He viewed it in terms of the sharp decline in commodity prices by about one half from their peak; a drastic reduction in demand for manufactured goods all over the world; a decline in stock market valuations by about one half or more; and a depreciation of currencies in many emerging countries and a reversal of capital flows to emerging economies, that now sought to find a safe heaven[2].

[2] Loser, Claudio (2009), Global Financial Turmoil and Emerging Market Economies: Major Contagion and a Shocking Loss of Wealth? Asian Development Bank.

While the economic storm had its epicenter in the developed countries, its fury quickly spread to developing countries, which are connected to the United States and Europe through investment, trade and financial links. The economies of countries in the Asia-Pacific region were thus, affected by the crisis in varying degrees depending on how deeply they were linked and integrated to developed nations, especially the United States. Table 2 shows the extent of dependence of developing Asia on exports to developed country markets as percent of their gross domestic product (GDP). Major vulnerability factors included: current account deficits, reliance on external funding, significant foreign exchange participation in domestic equity and bond markets; and domestic macro imbalance. Those that were more highly dependent on external demand contracted more sharply than the rest. Countries that were more open in terms of high dependence on exports and external fund sources suffered more as compared to those that were not as open (ADB, 2010).

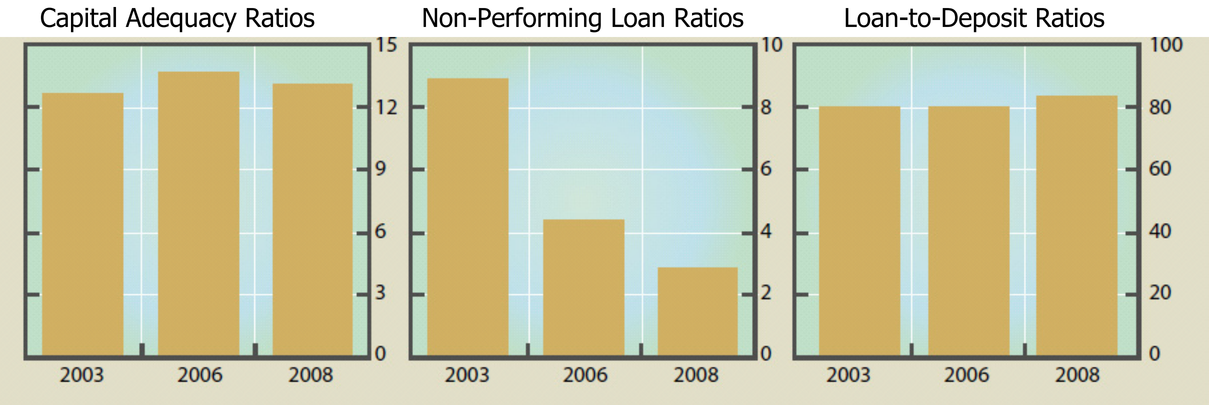
Table 2. Extent of Dependence on Exports to US and EU (as % of GDP)

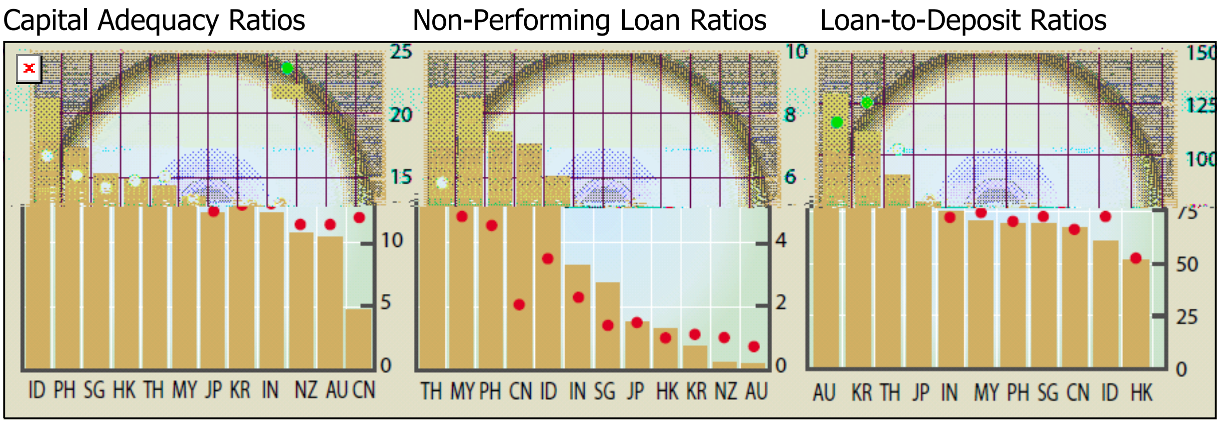
	Exposure to the U.S.				Exposure to the EU-15			
	Direct		Total[1]		Direct		Total[1]	
	1994	2006	1994	2006	1994	2006	1994	2006
China	5.6	9.6	7.6	12.0	3.9	7.7	6.0	12.0
India	1.7	2.4	2.0	3.1	2.6	3.1	3.3	4.5
Korea	4.9	5.1	6.1	8.7	2.7	5.0	3.9	8.2
Singapore	23.9	17.3	31.9	31.0	17.0	20.1	25.5	36.0
Indonesia	3.3	3.5	4.5	5.6	3.4	3.7	4.8	6.4
Malaysia	18.0	22.7	25.0	32.0	11.4	13.8	18.3	25.0
Philippines	8.8	8.0	9.8	12.0	3.7	7.1	5.0	13.0
Thailand	7.0	10.5	8.9	15.0	5.2	8.7	7.5	15.0
Vietnam	1.4	15.2	2.8	19.0	6.6	15.0	8.6	21.0
Emerging Asia[2]	9.2	10.8	12.0	16.0	6.8	9.7	9.8	16.0

Source: **Chibber, Ghosh and Palanivel (2009)**

However, it should be noted that unlike the Asian crisis of 1997-1998 and unlike the evolution of the current crisis in many other parts of the world, the banking system in most of the emerging Asia has thus far not been particularly badly affected. There are several reasons for this: the relatively limited exposure of Asian banks to sub-prime financial products in the US (with some exceptions such as in Malaysia and Singapore); and the greater emphasis on supervision and regulation in the banking systems of the Asian-crisis affected economies, among others.

Figure 3. Soundness of Banking Systems in Asia-Pacific Region





Legend: ID (India); (I; PH (Philippines); SG (Singapore); HK (Hongkong); TH (Thailand); MY (Malaysia); JP (Japan); KR (Korea); IN (Indonesia); NZ (New Zealand); AU (Australia); CN (Canada)
Source: **Bank of International Settlements (2009)**

Figure 3 shows that capital adequacy ratios have been healthy on average and non-performing loans have formed a low and declining proportion of total loans. However, there is substantial variation across countries in this regard, with non-performing loan ratios being much higher in Thailand, Malaysia and the Philippines.

Despite the greater domestic stability of banking and financial systems in developing Asia, the region was nonetheless affected, at least temporarily, by a sudden reversal of capital inflows, with attendant effects on reserves, currency values, liquidity and even in the growth rates of most Asian countries in 2008 which continued into 2009 as shown in Table 3. In 2009, global output dropped by 2.2 percent and the global unemployment rate increased to close to 7 percent, the equivalent to having 35 million more people out of work (Calvo 2010).

Table 3. Growth Rates of Selected Asian Economies

	2006	2007	2008	2009
Central Asia	**13.3**	**12.1**	**6.1**	**2.7**
Armenia	13.2	13.7	6.8	–14.4
Azerbaijan	34.5	25.4	10.8	9.3
Georgia	9.4	12.3	2.3	–3.9
Kazakhstan	10.7	8.9	3.3	1.2
Kyrgyz Republic	3.1	8.5	8.4	2.3
Tajikistan	7.0	7.8	7.9	3.4
Turkmenistan	11.4	11.6	10.5	6.1
Uzbekistan	7.2	9.5	9.0	8.1
East Asia	**9.4**	**10.4**	**7.3**	**5.9**
China, People's Republic of	11.6	13.0	9.6	8.7
Hong Kong, China	7.0	6.4	2.1	–2.7
Korea, Republic of	5.2	5.1	2.2	0.2

Mongolia	8.6	10.2	8.9	–1.6
Taipei, China	5.4	6.0	0.7	–1.9
South Asia	**9.0**	**8.7**	**6.4**	**6.5**
Afghanistan	8.2	12.1	3.4	15.1
Bangladesh	6.6	6.4	6.2	5.9
Bhutan	6.4	14.1	11.5	6.0
India	9.7	9.2	6.7	7.2
Maldives	18.0	7.2	6.3	–3.0
Nepal	3.7	3.3	5.3	4.7
Pakistan	5.8	6.8	4.1	2.0
Sri Lanka	7.7	6.8	6.0	3.5
Southeast Asia	**6.1**	**6.5**	**4.3**	**1.2**
Brunei Darussalam	4.4	0.2	–1.9	–1.2
Cambodia	10.8	10.2	6.7	–2.0
Indonesia	5.5	6.3	6.0	4.5
Lao People's Democratic Republic	8.7	7.8	7.2	6.5
Malaysia	5.8	6.2	4.6	–1.7
Myanmar	7.0	5.5	3.6	4.4
Philippines	5.3	7.1	3.8	0.9
Singapore	8.7	8.2	1.4	–2.0
Thailand	5.1	4.9	2.5	–2.3
Vietnam	8.2	8.5	6.2	5.3

Source: **Llanto and Badiola (2009)**

The threat of high inflation and economic recession loomed high over both the economies of rich as well as poor countries. As indicated earlier, the global recession and more pointedly, the slowdown in the individual economies of the Asia-Pacific region led in general to lower outputs, higher unemployment and lower demand for goods and services. This has affected RFIs and MFIs as borrowers reduce their demand for loans because of a decline in demand for the goods and services that they produce. Rural households dependent on overseas remittances exercised various coping mechanisms such as reduction in food intake and other expenditures, withdrawal of savings for consumption smoothing and to cope with income loss or reduction. Calvo (2010) noted that at the heart of this global crisis is a credit crunch that has put financial strains on firms and individuals and has led to a large number of job losses and drops in income from other sources[3].

Llanto and Badiola (2009) pointed out that the extent to which the crisis could have either reduced or stalled the growth of microfinance and rural financial institutions depended on both internal and external factors[4]. Internal factors are the individual strengths and weaknesses,

[3] Calvo, Sara (2010), "The Global Financial Crisis of 2008-10: A View from the Social Sectors," Research Paper 2010/18 United Nations Development Programme, Human Development Reports, July.

[4] Llanto, Gilberto M. and Jocelyn R. Badiola (2009), "The Impact of the Global Financial Crisis on Rural and Microfinance in Asia," Paper prepared for APRACA.

management capacity, technical ability of loan officers and staff, policies and practices of RFIs and MFIs while the external factors include the macroeconomic and financial environment, government and regulators' policy responses factors that have a direct effect on the performance of these financial institutions. Microfinance (MFIs) and rural financial institutions (RFIs) faced the prospects of liquidity crunches, a worsening of loan repayment behavior, and instability in fragile urban and rural economies in low-income countries as the economic downturn drove more people to informal economic activities. The crisis has particularly strained those financial institutions that were heavily reliant on donors and institutional investors as well as those with clients that were affected most by the decline in exports and loss of employment.

While low-income countries including those of Asia and the Pacific are still coping with the effects of the global economic and financial crisis, the phenomenon of rising fuel and food prices has created another challenge to those countries. Rising food and fuel prices have significant impacts on the rural economy and rural finance environment. The Food and Agriculture Organization (2008) reported that international nominal prices of all major food commodities reached their highest levels in nearly 50 years and prices in real terms peaking in nearly 30 years[5]. The Food and Agriculture Organization (FAO) food price index increased by 53.0 percent for the first three months of 2008 compared to the same three months of the previous year (Reyes and others)[6]. Meanwhile, according to the Energy Information Administration (2008) fuel prices have been increasing for seven consecutive years.[7] During the first quarter of 2008, the oil price index increased by 66.5 percent. The impact of higher fuel prices depends on two components, namely: 1) direct effect of said higher prices on the petroleum products consumed by the household; and 2) indirect effect of said higher prices on the prices of other goods and services consumed by the households that use fuel as an intermediate input[8].

At the microlevel, the impact of higher food and oil prices on the households are likely to be very diverse, depending upon the reasons for the price change and on the structure of the economy (Ivanic and Martin 2008). The World Food Program reports that among the poorest households, food already consumes three-fourths of their total income and many are now paying 15 percent more for food than they did in 2009-2010. News reports have highlighted the World Bank's pronouncement that "recent food price hikes have pushed about 44 million people into extreme poverty". The poor are now facing incredible pressure to feed themselves and their families and rising prices can make them more likely to reduce their food consumption. UNICEF analysis shows that poor households have already implemented coping

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[5] Food and Agriculture Organization (2008), ""Soaring Food Prices: Facts, Perspectives, Impact and Actions Required," Paper prepared for the High-Level Conference on World Food Security: The Challenges of Climate Change and Bioenergy. Rome. 3-5 June 2008.

[6] Reyes, Celia and others (2009), "Impact of Changes in the Prices of Rice and Fuel on Poverty in the Philippines," Paper presented during the 7th PEP Network General Meeting on 9-12 December 2008, Dusit Thani Hotel, Makati City, Metro Manila, Philippines

[7] Energy Information Administration (2008). Short Term Energy Outlook. July 2008. http://www.eia.doe.gov/steo#Global_Petroleum_Markets, as quoted in Reyes and others (2009)

[8] Reyes and others (2009).

strategies, such as eating fewer meals, cutting health expenditures, increasing levels of indebtedness, and working longer hours in the informal sector. UNICEF concludes that the poor's capacity for resilience is very limited. High food prices are therefore seen as a real threat as it could cause extreme poverty and endanger the lives and livelihoods of nearly one-sixth of the world's population.

The impact could also vary depending upon household incomes and expenditures patterns, products involved, and policy responses of governments (World Bank 2008). Households usually spend about 40-60 % of their incomes on food items and therefore rising food prices are expected to increase households' consumption expenditure significantly. On the other hand, the incomes of farm households may be increased by higher food prices. Overall the impact of price shocks depends on whether the gains to farming households outweigh the adverse impact on consuming households. The benefits of higher food prices to average farm households may be lower, due to the limited extent of their net sales of food items. Since the majority of households, including in rural areas, are net buyers of food, the increase in food prices

Table 4. Percentage Increase in the Food Cost Due to Increase in Cereal Prices of Poor and Rich Households, 2006-2008

	Exposure to the U.S.				Exposure to the EU-15			
	Direct		Total[1]		Direct		Total[1]	
	1994	2006	1994	2006	1994	2006	1994	2006
China	5.6	9.6	7.6	12.0	3.9	7.7	6.0	12.0
India	1.7	2.4	2.0	3.1	2.6	3.1	3.3	4.5
Korea	4.9	5.1	6.1	8.7	2.7	5.0	3.9	8.2
Singapore	23.9	17.3	31.9	31.0	17.0	20.1	25.5	36.0
Indonesia	3.3	3.5	4.5	5.6	3.4	3.7	4.8	6.4
Malaysia	18.0	22.7	25.0	32.0	11.4	13.8	18.3	25.0
Philippines	8.8	8.0	9.8	12.0	3.7	7.1	5.0	13.0
Thailand	7.0	10.5	8.9	15.0	5.2	8.7	7.5	15.0
Vietnam	1.4	15.2	2.8	19.0	6.6	15.0	8.6	21.0
Emerging Asia[2]	9.2	10.8	12.0	16.0	6.8	9.7	9.8	16.0

Source: **Chibber, Ghosh and Palanivel (2009)**

generally will have adverse effects on household consumption. **Table 4** above shows that the increase in the food cost due to increase in cereal prices of poor households is much higher than that of rich households in 2006-2008. To maintain a basic diet, Chibber et al (2009) argue that poor households, especially in urban areas, are forced to increase their food expenditures at the expense of non-food expenditures such as medical care and education. The increase in fuel price also affects households adversely through raising the cost of agricultural production. In addition, diverting food for bio-fuel production aggravates supply and demand imbalances. As poor households often spend about three-fourths of their incomes on food, fuel and transport, soaring food and oil prices jointly affect the poorest the most. This jeopardizes progress towards attaining the Millennium Development Goals (MDGs) by risking gains made in reducing poverty and in increasing social cohesion. Hence, it is not surprising that increasing food and oil prices have triggered riots in many developing countries. There is already evidence that rising food prices are likely to have affected household consumption and poverty in countries of developing Asia. In Vietnam, several studies found that rising food prices had probably led to increased incidence of poverty and cutback on other essential expenditure such as on health care. The analysis also shows that soaring cereals prices during 2006 - 08 reduced households' purchasing power substantially. Chibber et al (2009) further shows that on an average, estimates suggest that the purchasing power of poor households decreased by 24% in Asia and the Pacific, while that of rich households fell by only 4%. The decline of purchasing power varies from country to country. Real incomes of poor households in Mongolia declined by 51% because of food price changes, compared to 14% decline for poor households in India (Table 5). The unprecedented rise in food and fuel prices has exacted a heavy toll on the economies of developing countries in Asia and the Pacific in general and especially on urban wage workers and rural households with dire implications to their health status, productivity and income earning capacity. Thus, RFIs and MFIs face the risk of rural households with impaired capacity to earn incomes and repay their loans, which could lead to deterioration in the quality of their loan portfolios.

In order to mitigate the adverse impact on consumers, governments intervene in food and energy markets in a variety of ways. Some governments in the food and oil importing countries directly intervene to control the quantity of imports as well as their distribution and prices. Some other governments allow the private sector to import and distribute food and petroleum products freely, but set price ceilings and compensate private sector distributors to cover any losses. In exporting countries, governments often set domestic prices below world levels, imposing an opportunity cost on farmers. Governments can also use fiscal and trade policies actively to mitigate the adverse impact of rising global food and oil prices, but this clearly depends upon the extent of "fiscal space" available. When rising food and oil prices cause an increase in overall inflation, countries' central banks may be prompted to react with monetary tightening. At the same time, governments and central banks also need to protect the interest of domestic producers. This complicates the policy making process, as policy makers have to tread a fine line between containing inflation and supporting the growth process. As global food and fuel prices once again show of increase from June 2009 onwards, these problems are likely to become significant again for developing Asia. This also underlines the crucial need for active public intervention to regulate financial speculation in commodity futures markets (Chibber, Ghosh and Palanivel, 2009).

Table 5: Percentage Decrease in the Purchasing Power Due to Rise in Cereal Prices of Poor and Rich Households, 2006-2008

Quintiles	Bottom 20%	Q2	Q3	Q4	Top 20 %
Bangladesh	-19.9	-15.0	-11.1	-7.8	-4.1
Cambodia	-23.8	-17.8	-13.0	-8.8	-4.8
China	-28.8	-21.4	-16.2	-11.1	-6.4
India	-14.3	-10.6	-7.9	-5.4	-2.6
Indonesia	-26.7	-19.1	-13.9	-9.6	-5.0
Mongolia	-51.9	-35.6	-24.9	-15.5	-5.4
Nepal	-13.5	-11.1	-9.2	-6.9	-3.6
Pakistan	-17.1	-13.8	-11.0	-8.0	-4.1
Philippines	-26.2	-20.9	-14.4	-8.7	-3.7
Singapore	-20.0	-8.9	-4.8	-2.6	-1.0
Sri Lanka	-24.4	-17.2	-11.7	-7.3	-2.6
Un-weighted Average	-24.2	-17.4	-12.6	-8.3	-3.9

Source: Chibber, Ghosh and Palanivel (2009)

The rise of food prices has been attributed largely to the increased incidence of weather-based disasters such as droughts and floods due to climate change and slow supply adjustment vis-à-vis the increasing demand for food and fuel especially among emerging economies. Severe flooding and droughts are expected to reduce the availability of arable land even as more and more agricultural land is being devoted to bio-fuels rather than to food crops. The IMF in its web site has this to say about the effect of rising demand for bio-fuels: "rising biofuel production adds to the demand for corn and rapeseeds oil, in particular, spilling over to other foods through demand and crop substitution effects. Almost half the increase in consumption of major food crops in 2007 was related to bio-fuels, mostly because of corn-based ethanol production in the US; and the new bio-fuel mandates in the US and the EU that favor domestic production will continue to put pressure on prices"[9].

Amidst the ever changing and challenging global economic environment, Asian countries have pursued policies, strategies and innovations in rural financial markets, which are intended to overcome such challenges. We note the vigorous effort exerted by rural finance and microfinance institutions to strengthen and improve their managerial and technical capacities,

[9] International Monetary Fund http://www.imf.org/external/np/exr/faq/ffpfaqs.htm

the growing interest in establishing credit information bureaus in a number of countries, the development of mobile banking for the poor, the transformation of NGO microcredit institutions into regulated entities, and attention being given by governments and donors alike to financial inclusion as an important element their quest for inclusive growth.

3. Rural Finance Policy Environment and Regulatory Framework in Asia

In the past three decades, the governments in Asian countries have intervened in their rural financial markets in vastly different ways. Often the intervention has been motivated by the objective of providing farm households with access to cheap credit in order to stimulate production and greater farm investments. Thus, in the 70s and 80s governments provided target clients with subsidized credit funded by donor money and government budgets. The range of governmental interventions have included interest rate regulation, lending quotas, directed and subsidized credits, special refinance facilities for agricultural lending, credit guarantees for small farmers, and creation and state-funding of specialized agricultural development banks. Loan repayment problems and loan defaults led to massive agricultural loan write-offs and rehabilitation and recapitalization of state-owned financial institutions.

The high transaction costs and risks of providing financial services in rural areas underscore some of the problems encountered by rural financial institutions, but poor governmental policies and inappropriate interventions also play a role. In some cases heavy government intervention in rural financial markets created distortions and disincentives to the participation of private financial institutions. In retrospect, the huge credit subsidies proved burdensome and unsustainable because of the huge fiscal cost implications.

Whereas twenty five years ago the rationale for government interventions in rural credit markets was to stimulate the adoption of green revolution technologies, especially by small farmers, today the goal is to provide adequate and sustainable financial services to the rural and farm sector to make them more productive, but with an additional goal of promoting financial inclusion. The microfinance revolution has demonstrated the efficacy of adopting a market-oriented policy and regulatory environment, and allowing private institutions to work with the poor in designing loan and savings products that are responsive to the demand of poor households. In turn, rural financial institutions have adopted a more open mind to the benefits of market orientation. Governments, prodded by the success of the microfinance revolution, have started to craft policy and regulatory frameworks that would enhance and not distort rural financial markets. Meyer and Nagarajan (2000) observed a recent shift to more rural- friendly policies and a market approach to financial market development but these authors are pessimistic about the ability of Asian rural financial markets to meet the challenges of the 21st century. They argued that past negative policies and interventions have contributed to a fragile financial system in many Asia countries characterized by limited outreach and sustainability.[10] According to these authors, "many institutions are weak and survive only because of government and donor funding. They lack technical competence to evaluate credit risks, the financial infrastructure is not supportive, and governmental policies are often more destructive than supportive" (page 21).

Notwithstanding the pessimism of Meyer and Nagarajan, it is noted that most Asian countries have continued to work on establishing a sound financial infrastructure, that is, sound policy and regulatory frameworks that include better supervision of financial institutions, which enabled those countries to endure the global economic and financial crisis of 2008[11].

The ADB (2008) gave the following factors behind the resilience of regional banking and financial systems in East Asia: (i) the very limited direct exposure of the region to subprime and other related securitized products; (ii) relatively strong bank balance sheets with a return to profitability—as impaired loans from the 1997/98 Asian financial crisis have been worked off; (iii) improvements in risk and liquidity management; (iv) strengthening of supervisory and regulatory systems; and (v) moves by banks into new and profitable domestic business lines such as consumer lending. The move into consumer lending implies an absence of the strong search for yield that led many banks and other financial institutions in industrialized countries to take on too much leverage and risk[12].

In the last two decades starting from the emergence of microcredit NGOs in Bangladesh, India, the Philippines and Latin America, which demonstrated the feasibility and viability of providing micro-credits to poor borrowers, a number of Asian countries have started to focus on the creation of an enabling policy and regulatory environment for sound rural financial markets. As earlier noted Asian countries have strengthened their supervisory and regulatory frameworks, which resulted among others in making financial institutions adopt better risk and liquidity management.

Countries like the Philippines and India have laid the ground work for an efficient policy regulatory and supervisory framework for microfinance. The Philippines, in fact, has been adjudged very recently for the second year in a row, as one of the global leaders in microfinance by the Economist Intelligence Unit's Global Microscope on Microfinance. Out of 54

[10] Meyer, Richard and Geetha Nagarajan (2000), "Rural Financial Markets in Asia: Flagships and Failures," Paper Presented at the Mini-Symposium on Building Financial Markets in Developing Countries for Tomorrow's Agriculture: Status, Reforms, and Innovations XXIV International Conference of Agricultural Economists August 13-18, Berlin, Germany

[11] It must be pointed though that the developing countries of Asia were less exposed to toxic assets, which caused the collapsed of financial markets in the more developed countries.

[12] The paragraph is from page 46 of Asian Development Bank (2008): ***Asia Economic Monitor***, December.

countries, the Philippines is ranked as the second best performing country for microfinance overall from 3rd place last year and was ranked as top country in the world for the sub-category of policy and regulatory framework for microfinance.

On the other hand, Cambodia, Vietnam, Myanmar, Lao PDR and Bhutan, being transition countries are still on their way towards becoming a market economy from their status as centrally-planned economies. Vietnam and Cambodia are ahead of this group in adopting market friendly policies. Although their financial sectors are still relatively underdeveloped, most of these countries are already undertaking financial reforms that are needed for a functioning market economy.

In contrast, countries that continue to have partially deregulated financial policies include Thailand, Bangladesh, Nepal, Sri Lanka, Indonesia and Malaysia. Partially deregulated means that the government of a country allows financial institutions to charge market-based interest rates but the government continues to provide subsidized loans to certain targeted sectors.

Following the 2008 global financial crisis, Central Banks in Asian countries have become more aware of the importance of putting greater emphasis on stronger bank supervision anchored on managing risk exposures and the reduction of non-performing loans as well as on relying more on local equity and local deposits as sources of funds. There has also been an increased emphasis on institution building to build up local capacity for efficient financial intermediation. In the case of microfinance, the Philippines, India and Cambodia have recognized the special features and peculiarities of microfinance and have issued appropriate regulations and adopted supervisory practices attuned to the needs of banks that are engaged in the provision of microfinance products and services. With respect to performance standards for microfinance institutions, the Philippines is reported to be the first country in Asia that has developed microfinance performance standards for banks, cooperatives and NGO-MFIs.

Financial inclusion has recently generated great interest in various countries and donors alike. Financial inclusion involves the delivery of a wide range of financial services such as savings, credit, insurance, remittances and payment services to the poor who traditionally could not participate in the formal financial systems. A basic strategy is to bring more poor people into the financial system through wide and ubiquitous delivery channels (both bank and non-bank institutions), which can be designed to reach more effectively the financially excluded. Financial inclusion can be promoted through financial innovations, which provide the poor with better access to financial services amid the harsh environment of poverty and exclusion. Modern information and communications technology offer great potential in developing systems for access to and participation in financial markets by the unbanked. India and the Philippines are pioneers in using mobile banking technologies to address the problem of financial exclusion of the poor who have remained unbanked despite the progress made in financial reforms. Taking advantage of the growing usage of mobile phone among a wide segment of the population, Indian and the Philippine rural financial institutions, including MFIs have started to offer deposit taking, withdrawal of savings, payment transactions and other traditional banking services through mobile communications technologies.

The rural and microfinance industry in Asia may have generally survived the global financial crisis but some new problems have arisen. There also have been changes in the perception of risk among players in the dynamic and fast-moving microfinance industry.

In a survey done recently by the Center for the Study of Financial Innovation (CSFI, 2011), the negative impact of competition was identified as a very pressing concern in the East Asian region including the Philippines, Thailand, Indonesia, Malaysia and Cambodia. The competition for clients is fierce and this is seen to be "encouraging bad lending practices and declining business ethics. In particular, it is contributing to the widespread problem of over-indebtedness, with the risk of potentially severe loan losses for MFIs".

This is compounded by the inability of MFIs to monitor the status of indebtedness of clients. Loan officers who are over-concerned of loan quotas or targets, which are geared to profitability and performance targets, may be less careful in their screening of clients. Given the opportunity of access to more liquidity, highly indebted clients may not let the opportunity pass away: they may take still another loan to repay loans that are becoming due or simply use the additional loan for consumption purposes. In the process the probability of non-repayment of the loans becomes real. There is now a real concern over saturated microfinance markets. Gonzalez (2011) of MIX pointed out that not all recent troubles were caused by financial crises, as many problems started before the most recent financial crisis, or were intensified by other elements including saturated microfinance markets, deficient systems and governance structures, and negative policy interventions[13].

Another of the region's preoccupations is with the institutional strength of MFIs. Management quality and corporate governance are both among top ten risks. Compared to other regions, however, the East Asia region seemed more optimistic than other regions about its economic prospects since macro-economic risk was placed at the bottom of its list of biggest risks.

In South Asia MFIs consider political interference as the biggest risk. Risks of the political and reputational kind are seen as more severe than credit risk which tops the ranking in most other regions. Even so, over-indebtedness is also a major problem in this area, made worse by economic uncertainty, food price inflation and in Pakistan, a difficult security situation. There is also concern about the institutional strength of MFIs in these countries. The quality of management and corporate governance remain in the top ten risks faced by MFIs. In the study Microfinance Banana Skins (2011), investors surveyed noted that "while growth of the industry

[13] Gonzalez, Adrian (2011), "Microfinance, Financial Crises, Fluctuations in Food and Fuel Prices," MicroBanking Bulletin, March.

is good in terms of extending access and creating innovative products, if it leads to over-indebtedness via harassment, then microfinance is not delivering on one of its main objectives: to create real and sustaining social and economic value for low-income persons".

Overall, the policy and regulatory framework in microfinance has helped provide an enabling environment for microfinance institutions composed of different types of organizations to offer financial services. The private sector has responded with alacrity to the market opportunities offered by a permissive but prudential regulatory environment by establishing microfinance institutions, initially as non-governmental organizations providing microcredits, cooperatives, cooperative banks, rural banks, finance companies and other types of organizations. Some microcredit NGOs have also transformed into regulated entities although others have opted to remain as such. Some countries have also initiated market-friendly reforms in rural finance although others continue to intervene in rural financial markets through subsidized credits, loan quotas, and regulated interest rates while at the same time, allowing private rural finance institutions to provide financing to agriculture and the countryside. However, the threat of political interference looms in some other countries where the authorities have become concerned about the burden of clients over-indebtedness.

3.1 Institutional Structure

Microfinance Information Exchange (MIX, 2009) reports that that there has been no sector-wide catastrophe in Asia following the 2008 global financial crisis. In fact, growth continued in most of Asia and that trouble spots were seen only in some sectors often due to a combination of external factors and internal institutional management. While most if not all state-owned banks benefited largely from government support, private MFIs that have performed better have been those not subject to events beyond their control and who have sound portfolio management policies and procedures (MIX, 2009). Table 6 below presents the outreach of some MFIs from selected countries in Asia for 2009.

Table 6: Outreach of MFIs, Selected Countries, 2009

Country	MFIs	Number of active borrowers	Gross loan portfolio (in USD)
Cambodia	16	1,115,106	832,945,584
China, People's Republic of	13	1,629,253	18,627,931,537
East Timor	2	13,325	4,247,031
Indonesia	20	298,715	176,755,647
Laos	1	1,427	344,560

Country	MFIs	Number of active borrowers	Gross loan portfolio (in USD)
Malaysia	1	206,379	185,030,340
Papua New Guinea	2	7,444	8,286,200
Philippines	63	2,810,391	603,247,088
Samoa	1	4,795	1,423,037
Tonga	1	698	278,803
Vietnam	16	7,805,106	3,979,270,466
Afghanistan	16	300,601	110,270,726
Bangladesh	28	20,571,831	2,347,258,316
India	96	26,807,252	4,446,038,600
Nepal	26	618,691	101,156,155
Pakistan	21	1,337,946	199,478,859
Sri Lanka	18	939,441	273,674,325

Source: **MIX (2009)**

Countries in Asia, thus, continue to use different types of institutions including government and private banks as well as non-banks like self-help groups, non-government organizations and other grassroots-based organizations in rural finance and microfinance delivery. A common characteristic of countries in Asia is the dominant role of specialized banks and non-government organizations (NGOs) microcredit institutions as formal credit providers. Those countries have adopted and developed financial institutions or intermediaries, which can most suitably provide rural finance and microfinance services given the different economic and financial environments obtaining in different countries.

Southeast Asian Countries. While Thailand has the Bank for Agriculture and Agricultural Cooperatives (BAAC), Indonesia has Bank Rakyat Indonesia, both of which have been very successful in providing financial services to small farmers, and micro and small entrepreneurs. BRI's Unit Desa (unit banking, literally village unit) is known worldwide for its successful savings mobilization, which has generated millions of dollars of savings from the countryside. The Bank for Agriculture and Agricultural Cooperatives (BAAC) is also a highly successful rural financial institution. Based on updated data from the Management Department of BAAC, a total of 6.25 million farm families had access to BAAC's credit services representing nearly 98% of Thailand's total number of farm households as of March 31, 2011.

The Philippines has Land Bank of the Philippines, Development Bank of the Philippines, People's Credit Finance Corporation and Small Business Corporation while Malaysia has Amanah Ikhtiar Malaysia, Bank Pertanian Malaysia, Yayasan Tabung Ekonomi Kumpulan and the Usaha Niaga Nasional. The Philippines has close to 60 NGOs active in microfinance, the largest of which is CARD Rural Bank, a very successful microfinance institution. Bangko Sentral ng Pilipinas reports that as of April 30, 2010 there are 202 microfinance-oriented banks from only 30 in 2000.

Transition Countries. Cambodia has the ACLEDA Bank while Myanmar has Myanmar Agricultural Development Bank (MADB), a state-owned bank which is virtually the only major source of institutional credit in the rural areas of Myanmar. While ACLEDA Bank used to be the only privately-owned microfinance institution (MFI) in Cambodia, a total of 20 licensed MFIs and 26 registered NGOs have been reported as of end 2010, encouraged no doubt by the successful experience of ACLEDA and other MFIs in providing micro-entrepreneurs and rural households with access to financial services. Many of those Cambodian MFIs can trace their origins from non-government organizations, which were involved in humanitarian work while at the same time, implementing micro-credit projects among refugees in the Cambodian-Thai border. While those MFIs are financial service retailers in rural areas, the Rural Development Bank of Cambodia has been organized as a small state-owned apex organization, which wholesales funds to microfinance institutions for retailing to micro and small enterprises.

Vietnam, in turn, has the Vietnam Bank for Agriculture and Rural Development (VBARD), which has been the major source of credit and savings in rural Vietnam since its establishment in 1988. Vietnam also has the Vietnam Bank for Social Policies, Vietnam Postal Saving Company and the People's Credit Funds including almost 60 internal non-government organizations and 4 government-recognized microfinance organizations.

In the case of Lao PDR, the Agriculture Promotion Bank, with its mandate to develop agriculture, is the bank most engaged in delivering financial services in the rural areas. Ekpatthana microfinance institution (EMI), on the other hand, is the leading microfinance institution throughout Lao PDR which aims to provide innovative financial and non-financial services to marginal clients and other stakeholders.

South Asia. India has the National Bank for Agriculture and Rural Development (NABARD) which has successfully increased its outreach by linking with self-help groups (SHG) through the SHG-Bank Linkage Program. The SHG-Bank Linkage Program represents a successful approach to breaking barriers to formal credit faced by informal self-help groups and similar organizations. Many of Indian microfinance institutions have patterned their microfinance lending techniques after the Grameen Bank model of Bangladesh.

In Pakistan, a specialized agricultural bank named Zarai Taraqiati Bank, Ltd along with several commercial and microfinance banks continue to address the credit requirements of farmers and other small borrowers.

Nepal, on the other hand, has quite a diversified financial sector but its rural microfinance banks are mostly Grameen Bank replications such as the Grameen Bikas Banks operating in the five development regions of Nepal. The Paschimanchal Grameen Bikas Bank Ltd., which operates in the western development regions, is considered the most successful of those banks. Nepal also has Sana Kisan Bikash Bank or the Small Farmers Development Bank which is considered the apex microfinance bank as it provides wholesale credit to other cooperatives and microfinance institutions. In addition, the Agricultural Development Bank Limited (ADBL) of Nepal provides loans for the agricultural sector. Sri Lanka too has different types of rural and microfinance financial institutions including cooperative rural banks, regional development banks, the SANASA Development Bank, the National Development Trust Fund and Samurdhi Banking Societies and the SANASA Thrift Societies.

In the case of Bhutan, the government-owned Bhutan Development Finance Corporation (BDFC) was given the mandate to engage in lending to agriculture as well as to other micro and small enterprises but it has quite a small share of the country's total rural lending portfolio at less than 20% relative to private commercial banks. Bhutan, too, has active NGOs like the National Women's Association of Bhutan and the Tarayana Foundation which is a non-profit organization established by Her Majesty the Queen Ashi Dorji Wangmo Wangchuck.

Bangladesh has Grameen Bank, ASA (formerly Association for Social Advancement) and BRAC (known formerly as Bangladesh Rehabilitation Assistance Committee and later as Bangladesh Rural Advancement Committee), which are considered the top MFIs in the country in addition to several large, medium and small MFIs. There is also the Development Banking Cell of the Bank of Maldives in South Asia, which has 25 branches covering the entire country.

3.2 Outreach in Microfinance

Transition Countries. As of March 2010, the Cambodia Microfinance Association (CMA), the country's main microfinance support network, reported that their members MFIs operate in all 24 provinces and have over 1 million borrowers with a gross loan portfolio of almost US$510 million, and 770,000 depositors with US$750 million in aggregate deposits. These figures represent a nearly 20 percent increase in gross loan portfolio and a 56 percent growth of total deposits from December 2008. VBARD (Vietnam) has likewise achieved a sizable outreach of as much as 50 percent of the nation's total households as of June 2010 from around 35% in 2008. The Myanmar Agricultural Development Bank has also reached almost two million rural households as of end 2010 from around 1.5 million in 2008. These figures are consistent with the finding that domestic financial sectors of the transition countries have not been directly affected by the global financial crisis because their banking systems have remained relatively insulated from the regional and global financial systems (CGAP, 2009).

Southeast Asia. The Philippines and Malaysia have reported sizeable increases in the number of their active borrowers in 2009. Data from MIX (2009) indicate that the number of active borrowers in the Philippines jumped from 235,059 in 2008 to 2,680,065 in 2009. As of April 30, 2010, microfinance has reached nearly one million households with an outstanding loan portfolio of Peso 7 Billion and savings of over Peso 3.5 Billion (Bangko Sentral ng Pilipinas, 2010). The relatively sound Philippine MFIs were able to expand operations and outreach even during the crisis. The Microfinance Council of the Philippines noted that MFIs were able to provide financing to livelihood ventures of those who lost jobs because of retrenchment or closure of firms. Malaysia, on the other hand, reported 206,379 active borrowers in 2009 from 165,286 in 2008.

However, in contrast, Indonesia registered a sharp decline from 4,728,662 active borrowers in 2008 to 286,124 in 2009 (MIX, 2009). The global financial crisis has greatly affected Indonesian financial institutions because of their relatively open capital account, significant foreign holdings of equities and debt, the relatively large foreign ownership of Indonesian banks, and the lingering memories of the 1997 Asian financial crisis that have made investors wary of exchange rate volatility (World Bank, 2008).

South Asia. Compared to those in Southeast Asia, countries in South Asia particularly Bangladesh, Pakistan and Sri Lanka showed decelerated growth in their outreach (MIX 2009). The loss of some 100,000 borrowers in Pakistan is attributed to the failure of one of the country's largest rural support programs, which is "likely also related to a combination of security issues and financial management" (MIX, 2009). Only India and Nepal posted increases in the number of their active borrowers. India, in particular, showed a sharp rise in outreach to 215,554,931 in 2009 from 1,461,343 in 2008 which could be due largely to its successful SHG-Bank linkage program. In the case of Bhutan, most of the microfinance and rural finance borrowers are serviced by Bhutan Development Finance Corporation (BDFC). Its outreach has been growing steadily over the years but only less than 20% of total potential poor borrowers in the country have been covered, so far. This is attributed to the lack of infrastructure and communication facilities in the rugged terrains of the country which make it very costly and time consuming for farmers and other micro and small entrepreneurs to go to a credit service center. For Maldives, the number of borrowers of the Development Banking Cell of the Bank of Maldives has likewise been growing through the years, from 5,818 in 2004 to 21,623 in 2007.[14]

[14] There is no available information on their outreach after the 2008 global financial crisis.

3.3 Outreach in Rural Finance

There is lack of information on the actual number of small farmers and fishermen reached by financial institutions in Asian countries. Microfinance outreach shown earlier does not have separate information on small farmers and fishermen and/or agricultural households. It is known, however, that some MFIs cater to small farmers and other countryside borrowers, e.g., rural micro-entrepreneurs.

Like microfinance, agricultural credit can facilitate and support economic transactions, enable borrowers to adopt technology, make farm and non-farm investments, smooth consumption expenditures and act as some sort of social protection against various risks faced by rural households. For very well known reasons, e.g., high transaction costs, absence of insurance market and information asymmetry, many formal financial institutions shy away from lending to smallholder agriculture and generally countryside activities. In the case of the Philippines, the average share of agricultural loans to total loans granted by banks for the period 2001 to 2010 has remained low at around 3% (ACPC, 2010). Likewise, the average share of agricultural production loans to total loans granted by banks for the same period was also low at 1%. The shares of agriculture loans and agricultural production loans were highest during 2001 at 6% and 2%, respectively and lowest in 2006 at 2% and 0.5%, respectively. However, from 2006 to 2010, the proportion of agricultural loans – including those used for production – to total loans granted by the banking sector have shown an increasing trend. Nonetheless, the relative importance of credit to total production has been increasing as indicated by the increasing trend of the loan to output ratio from 11% in 2006 to 20.3% in 2010.

In Thailand, around 4.5 million families were extended direct credit services on an individual basis, while 1.6 million families were members of agricultural cooperatives and 6,664 were members of farmers associations as of December 31, 2009 (2009 BAAC Annual Report). Updated data from the BAAC Management Department indicate that BAAC has an outreach of 6.25 million farm families representing nearly 98% of Thailand's total number of farm households as of March 31, 2011.

A major factor behind BAAC's success in its client outreach has been the massive expansion of the retail network over the past decade. As of March 31, 2011, BAAC has 75 provincial offices which supervises 1,026 branches throughout Thailand. To date, the Bank also has 968 field units scattered around the local areas of districts, serving as places of contact for its rural clients (BAAC Management Department). In addition, BAAC has a five-year service network expansion plan for FY 2010-2014 with the objective of establishing no less than 1,300 branch offices nationwide (2009 BAAC Annual Report).

4. Innovations, Financial Inclusion in Addressing Rural and Microfinance Challenges

The risks and challenges posed by the changing global environment such as the 2008 financial crisis, climate change and rising food prices, have motivated rural and microfinance players in Asia to innovate. They are conscious of the deleterious effects that the different risks spawned by the changing and challenging global and regional environment, which could weaken their institutional capacities to continue with providing finance services to clients, and/or adversely impact on their urban and rural clients, including micro-businesses and rural, and countryside economic activities. In either case, their balance sheets would be put at risk and future plans for expansion and intensification of rural and microfinance service provision could be put on hold or postponed until better times come.

Some immediate objectives of different product and process innovations are to reduce credit risks and high transaction costs; improve the access of the poor, mostly entrepreneurial poor, to financial services; facilitate the inclusion of hitherto un-banked and financially excluded people into the financial systems, Innovations range from the formulation and deployment of new finance products; new delivery channels; new methodologies; institutional changes; to various risk reducing mechanisms.

For example, many of the unbanked are poor, and mobile technology offers the possibility of both filling financial gaps and improving the economic lives of customers. Transactions can be facilitated through the use mobile phones. Clients can make loan repayments via the mobile phone by entering a code that transfers funds from a personal account to the bank's account (Kapoor, Morduch, and Ravi, 2007)[15].

4.1 Innovations

Products

Some of the new products being implemented by rural and microfinance institutions in Asia include: 1) microagriculture loans; 2) housing microfinance loans; and 3) microinsurance products.

The Philippines and Bangladesh are already implementing micro-agriculture loans. Microagriculture loans are loans for agricultural activities of small farming households. The MFIs allow a lump sum payment with incremental small payments from income derived from

[15] Kapoor, Mudit, Jonathan Morduch, and Shamika Ravi, (2007)," From Microfinance to m-Finance," April; http://www.financeaccess.org

off-farm activities. Collateralmay not be required and small farmers only have to accomplish simple documentation. Microagriculture loans are different from the regular and traditional agricultural loans of banks where payments are usually made after harvest and collateral, usually agricultural land is required. Being a relatively new scheme, there is no evidence yet of the efficiency of micro-agriculture loans in reaching small farming households.

Indian RFIs are able to extend microagriculture loans through the Self-Help Group (SHG) linkage banking. A CGAP (2007) study on sample SHGs found that the proportion of loans used for agricultural purposes was on average, 55%.

Housing microfinance provides loans to existing microfinance clients and other poor and low-income households who are unable to access traditional housing finance for house acquisition, construction and repair. This new loan product is seen as a way to improve the living conditions of the poor and the low-income households, which will contribute to better health, productivity and quality of life. Countries like the Philippines, India and Bangladesh are already pilot-testing the effectiveness of this product. The idea is that small loans for incremental housing repair has a great demand among low income clients but this has not been satisfied because traditionally banks provide loans covering the purchase of a residential lot and construction of a house, or a purchase of an already built housing unit.

Microinsurance has been added to the portfolio of many MFIs in Asia because of the felt need of low income households for social protection. Too often rural households face a crisis and are pushed deeper into debt and poverty whenever catastrophic events occur, e.g., death of the principal breadwinner, floods and drought, debilitating illnesses which prevent members of the household to earn income, and others. The two microinsurance products which most MFIs bundle with their microcredit services are: 1*) health insurance* to help the poor cope with debilitating illnesses, improve health in low-income households and thus, reduce mortality; and 2) *life insurance* to help mitigate the financial shock brought by the death of a household's main bread winner. In case of death of a household's main bread winner or the occurrence of debilitating illness the households face the problem of repayment of outstanding debts. Table 7 provides an overview of social protection systems in Asia and the Pacific.

Table 7. <u>An Overview of Social Protection Systems in Asia and the Pacific</u>

Country	Labor Market and Social Insurance initiatives	Social Assistance and Welfare Service Programs (including social sector initiatives)				Emergency Transfers	Child Protection
	Sickness, unemployment, old age, health, insurance (e.g public service, formal sector).	Poverty related: (universal or means tested)	Health related transfers (e.g. maternity benefits)	Education related transfers (e.g. school meals, stipends)	Employment related transfers (e.g. public works schemes)	Transfers to cope with shocks, conflict and natural disasters	
Afghanistan	X	X			X	X	
Bangladesh	X	X	X	X	X	X	
Bhutan	X	X		X			
Cambodia	X	X		X	X	X	
China	X	X	X	X	X	X	X
Fiji	X					X	X
India	X	X	X	X	X	X	
Indonesia	X					X	X
Korea (ROK)	X		X	X	X		X
Lao PDR			X		X	X	
Malaysia	X	X			X	X	X
Maldives	X	X		X		X	
Mongolia	X		X	X	X		
Nepal	X	X	X	X	X	X	X
Pakistan	X	X	X	X	X	X	X
PNG	X					X	X
Philippines	X			X	X		
Samoa	X					X	
Sri Lanka	X	X	X	X	X	X	
Thailand	X	X	X		X	X	X
Vietnam	X		X	X	X	X	

Source: **Chibber, Ghosh and Palanivel (2009)**

Delivery Mechanisms/Channels

Through innovations in delivery mechanisms or channels, countries in Asia are able to make financing available even in remote areas at reduced risk and lower transaction cost. Some of the innovations include: 1) schemes that link formal financial intermediaries with informal financial intermediaries, or the use of grassroots-based associations as conduits or direct link to the poor; 2) wholesale lending approach of big banks; and 3) use of information and communications technology, e.g. mobile telephony as earlier described.

Box 1. Linking banks with self-help groups: case of India

The SHG Linkage Banking in India is a very successful program. The pilot project was initiated in 1992 with 500 SHGs which increased to 637 SHGs from 11 states by 1994. By 1997, there were more than 10,000 SHGs covering around 200,000 families. Each SHG has 10-20 members (women), who meet once or twice a month and maintains their membership, savings and loan records. As of 2002, cumulative loans to 461,478 SHGs amounted to $ 186 million. Ninety (90%) of SHGS were exclusive to women groups. As of 2004, SHG linkage banking expanded to 30 states, involving 2800 partner organizations involved in social mobilization and guidance, 560 banks operating in 36,000 branches (including cooperatives). Commercial banks account for 50% of credit linkages, regional rural banks for 39% and cooperatives for 11%. Cumulative number of SHGs linked to banks is 1,079,000 with an estimated 16 million members making the SHG Linkage Banking as one of the largest rural microfinance programs in the world in terms of outreach (Karduck and Seibel, 2004). As to financial performance, the SHG linkage banking proved to be profitable and sustainable: return to asset ratio of 1.4% to 7.5%, and operational self-sufficiency ratio ranging from 110% to 165% (APRACA, 2007). A further study by Karduck and Seibel (2004) confirmed low transaction costs both on the part of the bank and of the SHGs. Transaction costs (real costs) incurred by SHGs were found to be only 0.6% of loans outstanding (APRACA, 2007).

Linking formal financial intermediaries with informal institutions enables banks to increase their outreach at a lower cost. While the banks provide the funds for lending, the informal organizations are responsible for organizing the rural borrowers/clients, monitoring their progress, disciplining the members especially on the use of credit and loan repayment and in promoting savings and other non-credit financial services of the bank; providing training and technical assistance on business or enterprise development; and linking the borrowers/clients to viable markets in the supply chain. Examples of models using this approach include India's Self-Help Groups (SHG) Linkage Banking; Vietnam's VBARD-Central Farmers' Union Linkage Banking wherein VBARD provides loans to borrower-savings groups which are, in turn, supervised or managed by the Central Farmers' Union especially with regards to loan utilization and repayment, among others; Cambodia's AMRET-Village Association Linkage Banking which enables AMRET, leading MFI in Cambodia, to lend more to poor households by providing funds thru the village associations which, in turn, lend to their members. **Box 1** provides an assessment of SHG linkage banking by Karduck and Seibel (2004) and APRACA (2007).
Other countries like Nepal, Sri Lanka and Bhutan have also adopted India's SHG Linkage Banking concept.

Various examples of innovations in delivery mechanism are seen in various parts of Asia. The ICICI Bank in India links with microfinance institutions that serve individuals and SHGs to reach larger numbers of poor clients. AVIVA, an international insurance company, is providing insurance services in rural areas in India by linking up with microfinance institutions that have a comparative advantage in servicing rural clients. In Bali, Indonesia, small commercial banks called Bank Pembangunan Daerah (BPDs) lend to non-bank village-level financial institutions called *Lembaga Perkreditan Desas* or LPD at a commercial interest rate. The People's Credit and Finance Corporation in the Philippines lends long-term funds to microfinance institutions so they can expand credit into new areas without having to immediately engage in savings mobilization.[16].

With wholesale banking, bigger banks such as commercial banks or a government bank provide wholesale loans to smaller banks, which in turn cater to the retail side of the credit markets, that is, directly lending to individual clients or enterprises. Wholesaling, in this case, includes not only the provision of funds but other support services as well aimed at helping retail institutions like cooperatives become viable financial intermediaries. Support services include capacity building opportunities that enable retail financial institutions to mobilize deposit apart from managing and lending funds. Land Bank of the Philippines has been successful as a wholesaler and has been able to indirectly reach more farmers and fishermen through accredited cooperatives and rural banks. The advantage of the wholesale-retail lending strategy is that end-borrowers do not get their loans directly from government banks, in case the country uses a government bank, e.g., Land Bank of the Philippines as a wholesale bank, or some sort of apex bank that courses its loan funds through eligible retail conduits or channels. There could be a weak incentive to repay a loan if taken from a government agency or government bank. The disadvantage is that the additional layer created by this lending structure, that is, after a wholesale loan, comes retail lending to end-borrowers, may result to interest rates to end-borrowers, which may be higher than the interest rates that will charged has there been only one lender to the end-borrower.

Information and communication technology is increasingly being used by agricultural development banks as well as microfinance institutions in improving their business processes (e.g. loan appraisal, loan monitoring) and in reaching out to clients. Mobile banking and electronic money have become the means to extend outreach of microfinance and banking services to a large number of potentially bankable but un-banked clients, especially those in rural and hard to reach areas at lower costs and higher efficiency. In countries like the Philippines, Thailand, Indonesia and Malaysia, the mobile phone industry is serving all income

[16] The examples are from Meyer, Richard, (no date) "Innovations in microfinance in rural areas" http://www.ifad.org/newsletter/pi/19.htm#11

groups including low income groups. In the Philippines alone, more than 60% of the populations have mobile phones; nearly a billion SMS/"text messages" are sent per day and thus, this situation presents an enormous potential for the convergence of mobile technology, electronic money and traditional brick and mortar networks and for the formation of bank-non-bank strategic partnerships. **Box 2** narrates the experience of a MFI in using ICT for remittance of loan collections to the head office.

A host of applications of information and communications technology and mobile telephony can be seen in Asian countries. SafeSave in Bangladesh uses Palm Pilots for loan assessments and recording loan payments. In the Philippines, Smart Communications uses cell phones for making financial transactions. The National Bank for Agriculture and Development in India is backing a special credit card for farmers. Lines of credit have been extended to 25 million farmers for use with agricultural suppliers. Computerized credit-scoring models are being tested to evaluate the risks of lending to low-income, self-employed borrowers[17].

[17] These examples are from Meyer, Richard, (no date) "Innovations in microfinance in rural areas" http://www.ifad.org/newsletter/pi/19.htm#11

Box 2. Case study of a MFI in Philippines using ICT

- A bank satellite office and mobile banking technology bring financial services *to Laur*, a small 3rd class municipality composed of around 5,500 households.
- Mobile banking technology addresses the need of an area or community, which may be too small to justify the establishment of a bank branch but has many unbanked yet potentially bankable people;
- Mobile banking technology addresses barriers to financial access. Before it, MFI clients have to take the available means of transportation, which is costly for those rural households.
  - Transportation options: sporadic jeepney schedule in a neighboring city at Peso 50 for the full trip; renting tricycles for Peso 150, bus service from Aurora, a neighboring province at Peso P60.
- At the time the case study was written, the technology enabled the MFI to service 96 new loans; open 56 new deposit accounts for its nearest branch; and in general to serve micro-entrepreneurs.
- With the added efficiency made possible by mobile banking technology, the MFI is able to serve a large number of micro-entrepreneurs in the municipality. For example, a client who makes and peddles rice cake started with a Peso 500 deposit which has now grown to Peso 30,000 because of the ease of making deposits.
- Loan officer who collects weekly payments and sends them to the main branch's g-cash wallet. The technology has enabled him to save time spent for the regular commute to the branch to remit his collections.

New Methodologies/Approaches

Value chain financing has been gaining ground as an effective method for mitigating risks, reducing the costs of lending to agriculture and eventually getting formal finance to flow to the sector. Value chain is defined as a series of activities that add value to a final product, beginning with production, continuing with the processing or elaborating of the final product and ending with the marketing and sale to the consumer or end-user. When credit or other financial services flow through actors along these chains, it is called value chain finance, and may or may not include support formal financial institutions. The value chain reduces commercial risk by providing an assured market for the produce, thus, making it easier for chain actors to obtain financing from banks and other formal sources. Efficient value chain financing is critical in agriculture since it can enable small- to medium-scale farmers, traders and processors along the chain to optimize financial investment, resource allocation and capacity expansion. The three most common value chain financing products are: (a) trader finance, (b) contract farming and out-grower schemes and (c) warehouse receipts.

Trader finance, typically provided in value chains of commodities, involves short term or seasonal loans (or advances) between buyers and sellers of inputs and products. Loans are normally provided based on established personal contacts. In case of contract farming and out-grower schemes, loans are tied up to purchase agreements. Sellers are more in a formal or captive relationship with the buyer who in turn commits to provide additional service such as technology and technical assistance. In Malaysia for instance, many farmer organizations have contract growing arrangement with poultry companies (integrators) that supply them with all necessary inputs (chicks, feeds) and veterinary services on credit (Kharoudin, 2004).

Warehouse receipts on the other hand are issued to depositors of non-perishable commodities for storing the commodity in safe and secure warehouses allowing banks to use the deposited inventory as collateral. India and the Philippines have the extensive experience in inventory credit using warehouse receipts. In the Philippine model, warehouse operators accredited by the Quedan Guarantee Corporation (a government corporation), issues warehouse receipts (called 'quedans') to farmers and traders that deposited their grain stock. The depositors in turn can go to an accredited bank for loans. To draw from the credit lines, the loan applicant presents to the bank the quedan receipt and stock inspection report by the Quedancor warehouse inspector. Loans granted by banks are then guaranteed by the Quedancor (Bathan, 1996).

India has a mixed marketing system with government procurement and distribution accounting for a quarter of marketed grain. It has efficient warehousing at national and state levels which provide secure storage. There are also appropriate warehouse laws and provisions for warehouse receipts that allow depositors of stock (traders, millers or farmers) to raise loans against the stored stock.

There are very few documented case studies on value chain financing. However, anecdotal evidence suggests that value chain financing schemes seemed have long been tried by a number of APRACA member institutions (such as BAAC, Landbank, and NACF of South Korea). These institutions used terms such as 'Agribusiness Approach" or "Integrated Approach" to refer to financing similar to value chain financing (Box 3).

Institutional Changes

Box 3. Innovative integrated approach to agricultural financing

An innovative integrated approach to agricultural financing initiated by a private rural bank is the case of PAIDCOR (Philippines). The Rural Bank of Panabo (now "One Network Bank") established marketing corporations jointly with farmers. The first corporation, set up in 1986, was capitalized with 40% by the bank, 15% by the individual owners of the bank and 45% by rice farmers. A second marketing corporation was set up in another town in 2000, with Landbank providing 40% of the equity capital. The rural bank provides loans to farmer cooperators who in turn "pay in kind" through the marketing corporation which buys the farmers' produce. Results however are mixed during the years of operation pointing to the attendant risk of the rice industry. While there were years of good profits, the corporation suffered net losses in 1999, 2002 to 2004 decreasing the number of farmer cooperators by as much as 70%. By 2004, there were 312 remaining farmer cooperators involving 669 hectares. The losses were attributed to spoilage during storage and depressed local prices of palay. The rural bank however is convinced by the scheme and has now instituted strategies to prevent similar losses such as: using mechanical driers and adopting a 'supervised" credit scheme where the bank employs agricultural technicians who supervise the production activities of the farmers and introduction of high yielding varieties. The bank has also branched out to high value crops (banana, pineapple) in other areas using the same integrated approach coupled with formal marketing contracts with long term buyers. (Buenaventura, 2007).

Some of the existing state-owned agricultural institutions undertook reforms and adopted innovative approaches and practices in order to increase outreach and sustain operations.

Bank Rakyat Indonesia had succeeded in attaining financial sustainability while providing credit and savings services to the rural low income families who previously had no access to formal financial services. Moreover, it had achieved an unprecedented level of profitability while providing such services to the rural poor. The most fundamental policy change in the BRI village banking program was the "shift from disbursing credit to motivating loan recovery and mobilizing savings." Key to the operational success is the autonomy of the village bank system, that is, the "unit desas" to operate as an independent profit center (Yaron et al, 1998). Village banks are free to set their own loan terms with transfer prices as the ones negotiated with the management. Loan processing is quick- taking only about a week for new borrowers and less time for repeat borrowers. BRI imposed rigid standards on its operations. Loan loss provisioning of BRI is higher than most state owned banks in other countries, e.g. general loan loss provision of 3% (compared to 2% in other countries), 100% reserves against loans that are three months and above overdue. As to attaining financial sustainability, BRI only took three years to shed off its subsidies.

During the past four decades, BAAC underwent transformation from a specialized agricultural lending institution to a diversified rural development bank. It underwent a gradual process of reform (Seibel, *et al.,* 2005):

- 1966-74, laying the foundation for individual lending to farmers through joint liability groups;
- 1975-87, expanding its lending operations through access to commercial bank and donor funds and consolidating its operations by substantially reducing loan channeling through cooperatives;
- 1988-96, striving for viability and self-reliance, under conditions of controlled interest rates, through savings mobilization, improved loan recovery and increased staff productivity;
- Since 1997, adjusting to prudential regulation by the central bank and diversifying into non-agricultural lending.

The result of this gradual reform has been the largest outreach of small farmers by any Agricultural Development Bank, 95% of total farmers in Thailand while maintaining institutional viability. Among the lending approaches of BAAC, the most extensively used was the joint-liability group lending. Under this scheme, BAAC extends non-collateralized loans through groups of farmers who are made co-liable for each other loan. The minimum number of borrowers per JLG is five and the average is 15. First time borrowers are provided with small loans and loan size is increased with repeat loans. The loan ceiling per borrower is B50,000 but average loan size has been less than half this amount. Group members are also eligible for additional individual loans of up to B50,000 on the basis of two guarantors. Farmers with titled land can also use it as collateral for individual loans. BAAC staff hold group meetings to encourage timely loan recovery and increase peer pressure (Muraki, Webster, and Yaron, 1998). In practice, BAAC still asks farmers for individual landholdings and may require the deed for "safekeeping" as added loan security. Loan size is set at about 60% of projected revenue of sale of the crop.

Other state-owned institutions that adopted new approaches and successfully increased outreach include Land Bank of the Philippines through the wholesaling approach; Agricultural Development Bank of Nepal which promoted the transformation of joint liability groups of farmers into small farmer cooperatives; and Vietnam Bank for Agriculture and Rural Development which made use of mobile banking offices starting with 159 vehicles equipped to travel in hilly and dirt roads enabling its bank staff to reach remote areas where it can process loan applications, disburse money, collect repayments and savings.

Risk-Reducing Mechanisms

In addition to microinsurance, there are other tools that aim to directly reduce the risk of lending to agriculture or the rural poor benefiting both banks and farmers or producers and consequently, encouraging investments in the agriculture sector. These are the index-based weather insurance and guarantee systems.

Index-based insurance products for agriculture represent an attractive alternative for managing weather risk. Pilot programs conducted in several developing countries like the Philippines, India, Mongolia and Thailand in Asia and in countries (Malawi, Mexico, Tanzania) in other regions have proven the feasibility and affordability of such products (UN, 2007). In index-based weather insurance contracts, estimates of financial losses are based on an index, or a proxy, instead of on the actual losses of each policyholder. The index could be based on variables such as regional rainfall, wind speed, temperature, regional area yields, and regional livestock mortality rates. The insurance provider starts compensating policyholders for losses when the index passes a predetermined critical threshold. Payments increase incrementally as the index deteriorates, and policyholders receive the maximum amount possible when a predetermined upper limit is reached. Experiments and pilot studies in this area are still continuing but there had been a number of studies which show that weather index insurance can work and that some programs have demonstrated real capacity to scale up.

Loan guarantee schemes, on the other hand, are analogous to insurance instruments that share the risk of lending among the lender, the guarantor and the borrower. Typically, a government corporation or agency guarantees up to about 85% of the loans from banks of the intended clients, usually marginal farmers. Proponents of loan guarantee programs indicate that the following conditions justify the use of this type of intervention: 1) when lenders place particular emphasis on the role of collateral in making their lending decisions and that most small agricultural entrepreneurs do not have the traditional collateral to offer; 2) when the high fixed cost of due diligence (relative to loan size) makes it uneconomical for lenders to extend small loans; and 3) it is an excellent opportunity for partnership or collaboration between the public and private sectors. While not entirely new, the loan guarantee system has been re-introduced in some countries by adding new features to make it more attractive to banks and thus, encourage these banks to adopt the scheme. So far, loan guarantee schemes of various designs are said to be in effect in about 85 countries (Christensen, et al, 2004). Please see Box 4.

Financial Inclusion[18]

The estimates are staggering. According to CGAP (2010a), "between 2.1 billion and 2.7 billion adults or 72% of the adult population in developing countries do not even have a basic bank account. This is the simplest way to measure financial access."[19] According to CGAP these are the financially excluded in a world where access to finance services can mean the difference between surviving or thriving. Compared to other parts of the world, the situation of financial inclusion in East Asia and the Pacific is much better. In East Asia and the Pacific (EAP) there are 1,756 bank accounts per 1,000 adults, compared with 635 accounts per 1,000 adults in developing countries. There is a wide variation among countries in the region in terms of deposit account entration, from 96 bank accounts per 1,000 adults in Cambodia, to over 5,000 accounts per 1,000 adults in Taiwan (China). Average deposit size per capita is higher in EAP (at 87 percent) than in high-income countries, but not as high as the average for developing countries, indicating that the banking sector serves a relatively broad range of clients. In EAP there are 272 bank loans per 1,000 adults compared with 245 in developing countries. There is a wide variation among countries in the region in terms of loan account penetration, from 963 bank loans per 1,000 adults in Malaysia to only 27 bank loans per 1,000 adults in Cambodia.[20].

Financial inclusion will enable poor people to participate in the formal economy and improve their economic status. It is well-known that the only other option for poor people or households is the expensive informal moneylending that continues to flourish in many rural areas, which have remained beyond the reach of formal financial institutions. Policymakers, donors, and rural and microfinance institutions in Asia have responded to the situation by using

[18] We did not receive any information on the financial inclusion initiatives from APRACA member institutions. The information in the next few paragraphs came from CGAP Financial Access 2010, East Asia and the Pacific Fact Sheet, and from available sources.

[19] CGAP (2010a), **Innovative Financial Inclusion**, Principle and Report on Innovative Financial Inclusion from the Access through Inclusion Sub-Group of the G20 Financial Inclusion Expert Group, May 25.

[20] CGAP (2010B) **Financial Access 2010 East Asia and the Pacific Factsheet**, http://www.cgap.org/financialindicators

modern technologies to provide the un-banked with access to finance services. Creative use of

Box 4. New features of loan guarantee systems

- Guarantee is provided at wholesale from a government corporation or entity to accredited financial institutions;
- In addition to banks, other institutions like cooperatives, small and medium enterprises (SMEs), non-government organizations or farmers' organizations can seek guarantee coverage;
- Guarantee can cover all risks from losses due to non-payment of loans including those caused by natural calamities and pests and diseases as well as market aberrations except fraud on the part of the conduit;
- Covers all types of agricultural production projects, including production of grains (rice and corn) and high value crops; poultry and livestock; as well as fishpond operations;
- As an incentive to participating banks, Central Banks assign relatively lower risk weights on loans covered by guarantee schemes;

Source: Christensen and others 2004

technological innovations has enabled some countries to clear the way for greater participation of poor people in the mainstream financial system.

A survey conducted by the Alliance for Financial Inclusion shows the different strategies and initiatives taken by Asian countries toward the goal of achieving financial inclusion.[21] The Bank of Thailand has emphasized the importance of financial inclusion in its recent second Financial Sector Master Plan and is entering discussions with the commercial banks on business models that can help to reach the rural poor. Malaysia's Financial Sector Master Plan includes meeting socioeconomic objectives such as improving access to financing for priority sectors (such as SMEs and Agriculture), providing advisory services to small borrowers, and providing banking services to non-urban areas. Malaysia's central bank conducts outreach activities on rights and responsibilities of customers, targeting women, students, rural communities and pensioners who may be most vulnerable. Under the Indonesian Banking Architecture, banks' annual business plan must include banking education activities that cover the benefits, risks, and fees of banking products as well as the rights and obligations of both the bank and customer. The Philippines, another leader in mobile money has enabled the use of this innovation through guidelines on the issuance of electronic money, published in BSP Circular 649 in March 2009. In Pakistan, enabling mobile money has not been limited to regulation, but supporting polices have been adopted regarding favorable taxes on imported technology which aim to ensure consistent tax treatment for mobile banking operations across provincial and district authorities to facilitate outreach.

Similarly, the Experts Group on Innovative Financial Inclusion reports various initiatives undertaken to expand financial inclusion through the use of technological innovations such as

[21] Alliance for Financial Inclusion (2010), "The AFI survey on financial inclusion policy in developing countries: Preliminary findings," Alliance for Financial Inclusion (AFI), April. This paragraph contains excerpts from the survey report.

the use of e-money and mobile phones in loan payments, deposits and transfers in the Philippines[22]. The Bangko Sentral ng Pilipinas (central bank) issued a circular tailored to the risks involved with the use of e-money and mobile phone banking, the type of financial service providers (both bank and non-bank) without sacrificing the integrity and stability of the financial system. Two private mobile phone network operators pioneered in using e-money and mobile phone banking. The mobile network operator for G-cash (e-money) was allowed by the central bank to use sub-distributors to act as cash-in/out for its G-cash product. Enthused by the success of the two mobile network operators in using these technologies to expand outreach at lower transaction cost, the Rural Bankers Association of the Philippines developed specific mobile phone banking applications that use the G-cash platform to support the microfinance services offered by their member rural banks. On the other hand, in Pakistan broad-based commitment to financial inclusion is reflected in the country's overall financial sector strategy. This is led by the State Bank of Pakistan itself. The country's policy innovations and regulations for financial inclusion include a pilot partnership between First Microfinance Bank Limited and Pakistan Post Office to use the national post office network and structure for expanded outreach among the population. The State Bank of Pakistan has also adopted policies for branchless banking and enabling regulations for the delivery of financial services through agents and mobile phones.

5. Conclusion: Outstanding Issues and Some Recommendations

Most countries in Asia have learned crucial lessons from their experience with the 1997 Asian financial crisis, which to a large extent prepared them for the assault on their economies brought about by the 2008 global economic and financial crisis. Central banks of Asian countries as well as private banks, rural and microfinance institutions, and other lending institutions put a great premium on financial stability, financial discipline and good governance. Several countries have also recently embraced as a goal the financial inclusion of the unbanked, mostly poor people who have remained outside the financial mainstream although they have potential bankability. Rural finance and microfinance institutions in Asia have increasingly focused on designing finance services and products that meet clients' needs without sacrificing institutional viability and profitability.

Financial regulators acknowledge the valuable contribution that the microfinance sector is making to financial inclusion, in enabling families to manage their household finances more effectively - allowing them to build assets, smooth consumption, and insure against risk, and

[22] This paragraph is from Innovative Financial Inclusion, Principle and Report on Innovative Financial Inclusion from the Access through Inclusion Sub-Group of the G20 Financial Inclusion Experts Group, May 25, 2010.

thus, see microfinance as a significant component of their respective country's financial infrastructure.

However, a few countries have yet to put in place an enabling policy environment and regulatory framework for rural finance and microfinance although many have adopted market friendly policies and regulations. Where the policy and regulatory environment is market friendly and at the same time prudential, rural finance and microfinance institutions have responded by expanding outreach while keeping a tight watch over their viability and sustainability. Financial policies have somewhat become less repressive than in the past years in Asian transition economies, which have opened pathways for greater participation by private lending institutions such as banks, cooperatives and other types of lending institutions in the vibrant microfinance sector. Using government banks to reach target clientele has remained a key component of some countries' strategy for providing financing the agriculture sector, especially smallholder agriculture. This, of course, entails providing significant subsidies to those government banks, which are being used for extending policy loans that meet certain socio-economic-political objectives of the concerned government. However, a bank such as BAAC has adroitly used government subsidies and its own financial resources in providing its target clients with sustainable finance service. Bank Rakyat-Unit Desa has also shown that a government-owned bank can provide sustainable loan and deposit-taking service to millions of rural-based clients when it is allowed to define and implement its own lending and savings mobilization policies and strategies. The successful mobilization of deposits undertaken by these two foremost financial institutions point to the significance of coupling market-friendly financial policies and regulations with careful institutional design, which stresses financial sustainability. Access to subsidized government and donor funds should be tied to clear, well-identified targets, and measurable performance indicators.

In a few countries, the risk of political interference remains high in view of the tension created by high interest rates, client over-indebtedness, saturation of certain microfinance markets, and financial exclusion.

Other challenges in the region that need to be addressed in order to ensure adequate and sustainable provision of financial services in the rural areas, especially the poor include the following:

- Many transition economies in the region have nascent financial systems that have to be strengthened and developed.
- Over-indebtedness among millions of microfinance customers in most countries who have accumulated larger debts than they will ever be able to repay making credit risk the biggest threat to the rural finance and microfinance industries (CSFI, 2011). This is a critical issue needing the utmost attention of policymakers and industry stakeholders. There are countries that regard high interest rates as immoral, which motivate lending

institutions to disguise interest rates and fees and thus, make opaque or non-transparent the true cost of borrowing to the borrower.

- Climate change and environmental degradation have tended to increase the increased incidence of flooding, drought and other natural calamities. Most rural and microfinance institutions are not well designed nor prepared to cope with large systemic risks, which can lead to loss of client lives, deterioration of income earning and loan repayment capacities of clients, and the destruction of local community economies.
- Developing Asian countries have poor transportation and communication infrastructure, which make it prohibitive and expensive for rural and microfinance institutions to provide residents in remote and far-flung areas with financial services.

The wide range of circumstances found in Asia and the unique problems found in vastly different rural financial markets accentuate the difficulty of making recommendations that would be universally applicable. As the saying goes, "one man's meat is another man's poison". However, in the light of the experience of countries with vibrant rural and microfinance markets, the following points may be considered by policymakers and stakeholders.

- Governments should focus on creating an enabling policy and regulatory environment and on providing the necessary support services to the rural areas in order to attract productive investments, e.g. infrastructure such as farm to market roads, irrigation, storage and post-harvest facilities; research and development; training and extension; and marketing). These will lower transaction costs, mitigate risks, facilitate the flow of finance along the supply chain and ultimately, increase value-added.

- Regulators should continue with their efforts in building the necessary financial infrastructure, e.g., credit bureaus, liquidity facility, and develop more appropriate regulatory and supervisory approaches for rural and microfinance institutions such as risk-based supervision of financial institutions, corporate governance.

- Governments as well as donors and other stakeholders should increase their support for capacity building among rural and microfinance institutions and more specifically, for providing assistance to the efforts of those financial institutions in organizing farmers and fisher, and facilitating direct and indirect linkages of farmers, fishers, micro-entrepreneurs, and small businesses to supply or value chains. Such will help provide opportunities for increasing or creating added value for farm produce and outputs of other rural-based economic agents, e.g., micro-enterprises. Priority areas for capacity building include the following: financial literacy and numeracy, product development, risk management, improved credit analysis, loan delinquency management, strengthening loan portfolio quality, streamlining operational procedures, improving governance structures, strategic planning and capacity to do better external environment scan.

- Governments, regulators and stakeholders should work for the establishment of credit information systems or credit bureaus as well as performance standards for RFIs and MFIs.

- There is a case for reviewing the impact on rural financial markets of highly regulated interest rates and comparing it with the outcomes of a more relaxed, market-friendly interest rate policy. In the light of country experiences, the latter enables financial institutions to cover costs and address some of the risks in lending to agriculture and rural areas.

- Governments, rural and microfinance institutions and other stakeholders should maintain a continuing dialogue on policies, including financial inclusion and regulations affecting the rural and microfinance markets in order to avoid disruption in the provision of finance services, and to ensure the stability of rural financial systems.
- The shift in policy from mere credit provision to providing broader and sustainable financial services observed among rural and microfinance institutions is laudable and should be supported. There should be greater emphasis on attaining a sustainable fund base, improving cost recovery and providing efficient and responsive financial services.
- Financial institutions, including rural and microfinance institutions should be given the autonomy to pursue sound banking practices within a prudential regulatory framework. Political interference, e.g., interest rate capping, out-and-out loan forgiveness may be well-intended but detrimental and tends to create significant damage to financial institutions and create unhealthy expectations by clientele.

- Rural and microfinance institutions should strengthen their financial and credit policies and processes for credit analysis, loan screening, risk management, monitoring performance and diversifying asset portfolios. The best rural financial institutions have spent great effort in building their institutional capacity.

- Rural and microfinance institutions should raise adequate capital to have a strong buffer against financial stresses and tap more domestic sources of funds. The global financial crisis experience has proven that local equity capital and a strong domestic deposit base can provide the necessary funds for lending and help shield domestic financial institutions from currency volatility and reversal of capital flows.

- Recognition of financial inclusion as a goal worth pursuing should be enhanced by allowing rural and microfinance institutions to design financial products and services that respond to client preferences and capacities but always within prudential limits allowed by regulators. A specific activity that will require government and donor assistance will be the building of a strong data base on those excluded from the formal financial system, a first important step in crafting client-responsive financial services and products. As suggested by the World Bank, "designing a financial inclusion strategy integrated with broader strategies for economic development and poverty reduction would provide clear direction for both policymakers and the private sector."[23]

[23] Doi, Yoko (no date), "Total Financial Inclusion: A Better Tomorrow for All Indonesians" http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/EASTASIAPACIFICEXT/INDONESIAEXTN/0,,contentMDK:22806456

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