

Llanto, Gilberto M.; Fukui, Ryu

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Philippine Institute for Development Studies  
*Surian sa mga Pag-aaral Pangkaunlaran ng Pilipinas*

## Innovations in Microfinance in Southeast Asia

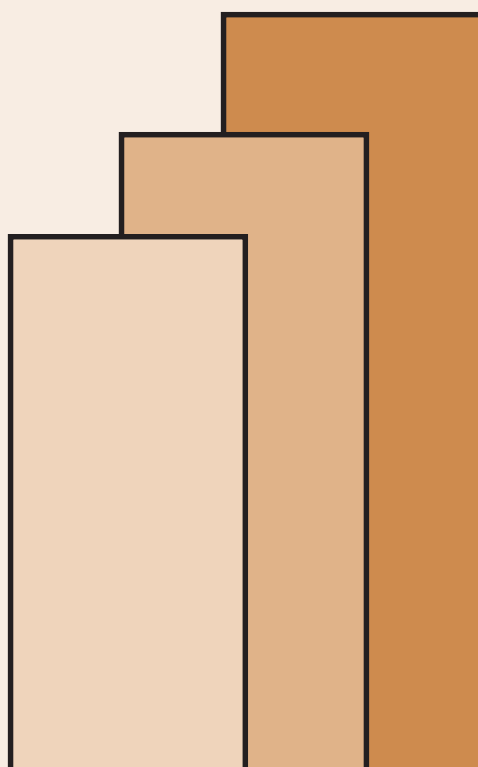
*Gilberto M. Llanto and Ryu Fukui*

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For comments, suggestions or further inquiries please contact:

The Research Information Staff, Philippine Institute for Development Studies  
3rd Floor, NEDA sa Makati Building, 106 Amorsolo Street, Legaspi Village, Makati City, Philippines  
Tel Nos: 8924059 and 8935705; Fax No: 8939589; E-mail: [publications@pidsnet.pids.gov.ph](mailto:publications@pidsnet.pids.gov.ph)  
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### ***Abstract***

The recent experience in microfinance of developing countries, e.g., Bolivia, Bangladesh, Indonesia and the Philippines to name a few, has shown its significant function in creating access to finance services by the poor. Access to finance services provides critical investment opportunities for the poor who have been traditionally shut out of financial markets. Access to finance services provide poor households the liquidity for consumption smoothing when confronted with economic and social shocks, e.g., sudden sickness in the household, crop failure.

This paper describes some emerging innovations in microfinance observed in Southeast Asian microfinance markets that make it possible for microfinance institutions (MFIs) to reach a greater number of poor households on a sustainable basis. It discusses the nature, importance and types of innovations. Innovations help reduce the MFIs' transaction costs and risks. They also make it possible for poor households to satisfy their investment and consumption smoothing requirements.

The paper draws some lessons from the experience with innovations and makes a case for government's important role in ensuring the proper functioning of markets. It points out government's pivotal role in system innovation because of the likelihood of its under-or-slow production by the private sector. MFIs have a clear advantage in process and product innovation to meet the requirements of poor clients. Thus, they should be given room in doing this.

Innovations arise in competitive conditions as MFIs try to tackle the challenge of developing products and services suitable to their clientele, of expanding and maintaining market shares. This role includes the installation of an appropriate regulatory and supervisory framework for MFIs, promoting a competition policy and providing an environment conducive to the commercialization of microfinance and to the rise of institutions that support the microfinance industry, e.g., credit bureau, microfinance trade associations and networks.

***Keywords:*** microfinance, innovations, policy and regulatory environment, investments, consumption smoothing

# INNOVATIONS IN MICROFINANCE IN SOUTHEAST ASIA<sup>1</sup>

Gilberto M. Llanto and Ryu Fukui<sup>2</sup>

## I. Introduction

The recent experience of developing countries, e.g., Bolivia, Bangladesh, Indonesia and the Philippines to name a few, in microfinance has shown its significant function in creating access to finance services by the poor. Access to finance services provides critical investment opportunities for the poor who have been traditionally shut out of financial markets. Access to finance services provide poor households the liquidity for consumption smoothing when confronted with economic and social shocks, e.g., sudden sickness in the household, crop failure. Thus, microfinance provides poor households not only opportunities to make investments; it also plays a welfare-enhancing role. Agosin (1999) asserts that finance allows economic agents to make investments that are larger than their availability of capital.<sup>3</sup> In the case of poor households without neither any marketable asset nor capital, microfinance takes on a far more crucial role than it has for non-poor households.

On the other hand, the Asian Development Bank (2000) stated that microfinance institutions (MFIs) have indeed brought the poor, particularly poor women, into the formal financial system and enabled them to access credit and to accumulate small savings in financial assets, reducing the households' poverty. However, there is general agreement among researchers and practitioners that the poorest of the poor are yet to benefit from microfinance programs in most countries partly because most MFIs do not offer products and services that are attractive to this category.<sup>4</sup> There is a growing literature on whether microfinance reaches the poorest of the poor (Gulli 1998; Hulme and Mosley 1996; Buckley 1997; Rogaly 1996). A recent study by Navajas and others (1998) found out that five microfinance organizations in Bolivia most often reached not the poorest of the poor but rather those just above and just below the poverty line. Navajas and others (1998) conjecture that most microfinance organizations will probable serve this niche. An interesting question is whether it would be possible for MFIs to reach the poorest of the poor through innovative products and services and not compromise their viability. While there is no easy answer to this question, certainly the challenge is there for the MFIs to take in the future.<sup>5</sup>

This paper describes some emerging innovations in microfinance observed in Southeast Asian microfinance markets that make it possible for microfinance institutions

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<sup>2</sup> Gilberto M. Llanto is Vice-President, Philippine Institute for Development Studies and Research Fellow, Rural Development Consortium, University of California, Berkeley, USA; and

Ryu Fukui is Deputy Director General, Development Bank of Japan.

<sup>3</sup> Agosin (1999) provides a comprehensive analysis of the role of financial intermediation in development.

<sup>4</sup> Asian Development Bank (2000) quoting Hulme, D. and P. Mosley (1996)

<sup>5</sup> Navajas and others (1998) indicate a contrary viewpoint. They maintain that the empirical results show the limits of microcredits for the poorest of the poor and that there is a need for more scrutiny of funds allocated for loans to the poorest. Referring to the research of Mosley and Hume (1998) and Morduch (1998), they state that even when microcredit does reach the poor, it may not increase incomes as much as smooth consumption and diversify income.

(MFIs) to reach a greater number of poor households on a sustainable basis. Section 2 briefly discusses the nature, importance and types of innovations. It points out government's pivotal role in system innovation because of the likelihood of its under-or-slow production by the private sector. MFIs have a clear advantage in process and product innovation to meet the requirements of poor clients. Thus, they should be given room in doing this. Section 3 discusses three innovations corresponding to the main financial products provided by MFIs to their clients, namely: (a) model credit union building and branding (Philippines); (b) micro-insurance for the poor (Philippines); and (c) innovation in savings mobilization (Indonesia). Based on available information, it seems that the innovations help reduce the MFIs' transaction costs and risks. They also make it possible for poor households to satisfy their investment and consumption smoothing requirements. The final section draws some lessons from the three innovations and makes a case for government's important role in ensuring the proper functioning of markets. Innovations arise in competitive conditions as MFIs try to tackle the challenge of developing products and services suitable to their clientele, of expanding and maintaining market shares. This role includes the installation of an appropriate regulatory and supervisory framework for MFIs, promoting a competition policy and providing an environment conducive to the commercialization of microfinance and to the rise of institutions that support the microfinance industry, e.g., credit bureau, microfinance trade associations and networks.

## **II. The Nature, Importance and Types of Innovations**

We may understand an innovation as a production technology developed by the MFI that produces a product or service for poor clients at the least cost possible.<sup>6</sup> It could be a new way of screening and lending to clients that surmount problems of information and dispersal of clients over a geographic area, e.g. village banking. An innovation could be a product that meets the risk-management requirement of poor people, e.g., micro-insurance or that enables the poor to smooth their consumption and to create financial assets, e.g., micro-savings. Lariviere and Martin (1998) characterize innovations in microfinance by any changes in the banking technology, the type of financial services offered, the strategic behavior of the institution, the institutional arrangement or the structure of incentives that result in improved viability and/or outreach.

It is well-known that formal financial markets are notorious for shutting out poor people from accessing much-needed finance products and services. Informal credit markets have filled the gap providing credit to small scale borrowers. The recent development of microfinance in developing countries has, thus, spelled hope for million of poor households as they find a better alternative to the traditional moneylender and other informal sources of credit. In this light, the emergence of innovations in microfinance markets has created the possibility of reaching poorer households that have not yet benefited from microfinance programs according to the ADB (2000).<sup>7</sup> Innovative products and services could, thus, increase the overall impact of microfinance on poverty reduction. However, the challenge to the MFI in the words of Lariviere and Martin (1998) is to find ways to increase access for a significant number of poor and micro-entrepreneurs to financial services without destabilizing fragile financial markets or compromising the development of viable financial institutions.

Von Pischke (1991) spells out the importance of innovations in financial markets: they create additional value because of the reduction in transaction costs of access to financial

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<sup>6</sup> See Gonzalez-Vega.

<sup>7</sup> Lariviere and Martin (1998) note that there is a substantial body of literature on both microfinance and the theory of innovation, referring to Kuznets (1966), Ruttan and Hayami (1984) on the theory of innovation and the work of Ohio State University and CGAP on microfinance. However, little has been said to date on rural financial innovations.

services.<sup>8</sup> This directly benefits clients, especially the small-scale clients who have been excluded from the traditional, mainstream financial system for a number of reasons. Buchenau (1999) pointed out that those clients would have the possibility of making larger investments that improve their income and economic capacity. Financial institutions also benefit from innovations by reducing their transaction costs and improving the institution's competitiveness.<sup>9</sup> Thus, innovations contribute to expand the frontiers of finance as financial institution and clients find effective ways of contracting.

Lariviere and Martin (1998) identify five categories of innovations in the area of rural microfinance: technological innovations, product innovations, strategic innovations, institutional arrangement innovations and donor-incentive innovations. *Technological innovations* refer to improved technologies used in delivering financial services. Examples are solidarity group lending, village banking, repayment incentive schemes such as peer group monitoring, incentives for the borrower to repay through rebates and progressive lending. *Product innovations* refer to the financial services offered to individuals and groups. Examples are product mixes combining savings and credit services; farm and non-farm credit. *Strategic innovations* refer to strategies followed by MFIs to develop their clientele. Examples are risk information systems among MFIs, strategic planning for market development. *Institutional arrangement innovations* refer to changing legal status and the institutional arrangements to improve MFI performance. Examples are NGO transformation into a formal financial institution, downscaling strategy of commercial banks, developing new financial legislation adapted to the circumstances of MFIs like NGOs, credit unions. Donor incentive innovations refer to those mechanisms that are available to donors to improve the performance of MFIs. Examples are design features to improve the MFIs' outreach and viability.

Buchenau (2003) has a narrower characterization of innovations focusing on innovations in financial services. He categorizes two types of innovations in financial services: (i) completely new products which match the characteristics of intended users, and (ii) improvements or refinements in the procedures used to deliver the services, or to design contracts and to achieve their enforcement. Agosin (1999), citing work by McGuire and Conroy,<sup>10</sup> distinguishes three levels of financial innovation: (i) *system innovation* where new institutions tailored to deal with unmet needs are created or allowed to emerge, (ii) *process innovation*, the creation of new technologies for providing financial services, and (iii) *product innovation*, the supply of new financial products. An important distinction made by Agosin is that governments must concentrate on the first type of innovation because of the likelihood that the private sector will under-produce these innovations. Systemic innovation may arise but this may take time; the process may be lengthy and tedious, hence, there is a role for government to foster it.<sup>11</sup>

We do not wish to belabor the different distinctions or types of innovations discussed by these authors. Our interest is more simple and immediate: to direct the policy maker's and the reader's attention to the need to foster financial innovations in microfinance markets in order to reach poorer members of society without endangering the viability of microfinance institutions. Providing an appropriate regulatory framework for MFIs, ensuring the proper functioning of markets through competition policy and institutions that strengthen the market orientation of microfinance--this role properly belongs to policy makers and governments.

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<sup>8</sup>Von Pischke (1991).

<sup>9</sup> Buchenau (1999).

<sup>10</sup> McGuire, P. and J. Conroy (1999).

<sup>11</sup> Agosin though points out that while governments can foster financial innovations, not all of them especially those in developing countries may have the capability to do it.

### III. Emerging Innovations

In general, subsidized credit programs of governments in developing countries have failed to achieve their much-flaunted objective of providing access to credit by small scale borrowers such as micro-entrepreneurs, poor households.<sup>12</sup> One view is that subsidized credit programs seem to have been addressed to the symptoms rather than the causes of inadequate rural financial intermediation.<sup>13</sup> Various studies have shown they are flawed attempts to address a perennial problem of small scale clients, especially the poor. Microfinance initiated and developed by credit-granting NGOs and later on picked up by formal financial institutions such as rural banks has filled the gap to a great extent. An important element in the development of microfinance is the prowess and skill of MFIs in innovating technologies, products, procedures and institutions. This section reports on three such innovations.

#### *Model credit union building and branding*

The potential of credit unions for microfinance has yet to be realized. Unfortunately, this potential has been ignored because “they are seen as failed models, a legacy of the production credit programs of the 1970s and 1980s, when international donors such as the U.S. Agency for International Development (USAID) used credit unions as channels for credit to small farmers” (Richardson and Lennon 2001). Misguided operating policies and procedures cast borrowing as more important than saving. Dependence on external capital brought many to the verge of collapse when the donor spigot was turned off (ibid). However, efforts by the World Council of Credit Unions (WOCCU)<sup>14</sup> in the 1980s to revitalize credit unions around the globe have apparently paid off. Richardson and Lennon (ibid.) report on WOCCU’s methodology that has revolutionized credit unions. The result was the transformation of credit unions into commercially viable microfinance institutions (MFIs) that often reach many low- and middle-income clients. They offer a broader mix of financial products and services at more favorable interest rates than do many of the leading microfinance nongovernmental organizations (NGOs) around the world.

The new methodology has ten linked components<sup>15</sup>:

- Accounting and reporting transparency
- Financial discipline and prudential standards
- Operating efficiency
- Financial restructuring
- Physical image enhancement
- Savings mobilization
- Product diversification
- Aggressive market penetration and expansion of new market niches
- PEARLS monitoring system
- Stakeholder equilibrium

The first five components are used to “put the house in order” so that members/clients will have trust and confidence in the MFI. Savings mobilization is mainly a function of

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<sup>12</sup> Various studies, e.g., Yaron (1994); Yaron and others (1997); and Neri and Llanto (1985); Llanto and others (1999) on the Philippine experience, have documented the failure of subsidized credit programs and the huge fiscal costs they entailed.

<sup>13</sup> Sharma (2000).

<sup>14</sup> WOCCU is the largest of several international credit union apex organizations in the world whose purpose is to provide advocacy, technology, and development services to its members. At year-end 2000, WOCCU represented more than 108 million members from 36,000 credit unions throughout 91 countries of the world with total assets exceeding \$536 billion (Richardson and Lennon 2001).

<sup>15</sup> This draws on Richardson and Lennon (2001).

attractive interest rates and trust. Successful savings mobilization requires the creation of trust and provision of adequate returns to savings. Aggressive market penetration and the expansion of new market niches becomes possible by providing a broad and diverse selection of competitively priced products and services that reach out to different segments of the population.

We report the successful efforts of a WOCCU project, the Credit Union Empowerment and Strengthening (CUES) Project in applying this methodology to a group of credit unions in Mindanao in Southern Philippines.

### ***Credit Union Empowerment and Strengthening Project<sup>16</sup>***

The Credit Union Empowerment and Strengthening Project is a project of the World Council of Credit Unions (WOCCU). It was implemented in 1997-2002 in Mindanao and it was so successful that it is now in its second phase (2003-2005). At present, it is working with 16 partner cooperatives in Mindanao. The Project will expand its technical assistance to 29 more cooperatives from the Visayas and cooperatives in conflict-prone areas in Mindanao. The expansion program in the Visayas is being implemented in partnership with a cooperative network.

CUES-Philippines transfers micro-finance technologies to partner cooperatives through two approaches: (a) model credit union building and (b) savings and credit with education. The Savings and Credit with Education (SCWE) program is an integrated financial and education delivery system.<sup>17</sup> It seeks to provide poor rural women access to financial services. It provides non-formal education on the formation of savings and credit associations, among others. Model Credit Union Building (MCUB) consists of the following: credit union institutional strengthening, savings mobilization and marketing focus, credit administration, safety and soundness and short-term technical assistance. The characteristics of a model credit union are:

- follows good business sense in operations;
- is a savings institution;
- does not depend on subsidized international and government loans;
- has adequate institutional capital;
- offers competitive market pricing;
- is a professional financial institution;
- has capable and well-trained employees

Building a model credit union means imposing financial discipline in the management and operation of the organization. **Box 1** illustrates the different measures that the model building project prescribes so that a credit union may become an efficient credit intermediary.

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<sup>16</sup> This is from Llanto (2003).

<sup>17</sup> SCWE program is a trademark of Freedom From Hunger (FFH), an international development organization promoting “self-help” to address the incidence of chronic hunger and malnutrition. It has projects in Africa, Asia, Latin America, North America and Europe. FFH is based in Davis, California.



**Box 1. Financial discipline in the model credit union of CUES-Philippines**

**Delinquency control**

- portfolio at risk method
- delinquency goal of below 5%

**Control of non-earning assets**

- maximize earning assets at 95%
- non-earning assets goal below 5%

**Capital accumulation**

- raise coop capital to 10% of total assets
- maintain adequate reserves

**Provisions**

- 100% loan loss provisioning for over 12 months delinquent
- 35% loan loss provisioning for 1-12 months delinquent

**Earnings improvement**

- establish interest rates to adequately cover all costs and provisions
- limit costs while improving collection

**Liquidity**

- maintain liquidity at minimum of 15% of deposits and withdrawable liabilities
- asset liability management

The actual experience with building model credit unions shows the significant impact of market-based policies and practices of CUES-Philippines. **Table 1** shows the results of model credit union building among partner cooperatives in Mindanao.

**Table 2. Impact of model credit union building**

Measure	Dec 1998	Dec 1999	Dec 2000	Dec 2001	Dec 2002	Mar 2003
Delinquency ratio (%)	63.00	19.64	12.36	10.53	7.05	7.07
Non-earning assets (%)	20.44	28.64	18.55	12.65	9.69	9.27
Net institutional capital (%)	-16.89	2.02	4.18	7.63	10.44	11.38
Provisions for loans 12 >months (%)	10.32	44.76	100.00	100.00	100.00	100.00
Provisions for loans 1-12 months (%)	0.00	60.90	100.00	83.05	99.83	100.00
Net income (%)	2.10	4.09	5.10	5.95	6.88	5.24
Net operating expenses (%)	8.12	9.92	10.62	10.54	9.83	9.68
Liquidity (%)	23.97	31.68	36.33	30.83	34.03	38.09
Savings (%)	35.11	47.97	54.48	57.47	57.65	58.78
External credit (%)	7.03	2.89	1.52	0.76	0.50	0.47

Source: CUES-Philippines

Two things stand out in the CUES' approach: (i) emphasis on savings mobilization and (ii) strict credit discipline and adherence to performance standards. An innovation introduced by CUES Philippines is the cooperative branding strategy. It is the first Asian country to adopt it. The brand name is Finance Organizations Achieving Certified Credit Union Standards or FOCCUS. A coop that is certified FOCCUS means it has achieved certain international prudential financial ratios geared towards providing members the best financial service. Similar movement-wide branding strategy is implemented in the US, Poland, Australia, Central and Latin America. To achieve a FOCCUS brand, a cooperative must adhere to a set of prescribed ratios and other operational criteria. The introduction of cooperative branding has given a big boost to the objective of maintaining the soundness of the financial condition of the cooperative, thereby generating trust and confidence in the cooperative. The key international prudential standards adopted by FOCCUS are shown in *Table 3*.

**Table 3. Key international prudential standards in FOCCUS brand**

<b>FOCCUS Ratios</b>	<b>Silver</b>	<b>Gold</b>	<b>Platinum</b>
LLP > 12 months	100%	100%	100%
LLP 1-12 months	100%	100%	100%
Solvency	-	> or = 110%	> or = 110%
Net loans	> or = 60%	70-80%	70-80%
Savings deposits	> or = 50%	60-80%	70-80%
Net institutional credit	> or = 4%	> or = 8%	> or = 10%
Total delinquency	< or = 15%	< or = 10%	< or = 5%
Non earning assets	Decreasing	< or = 10%	< or = 7%
Member shares	-	> or = inflation	> or = inflation
Operating expenses	< or = 12%	< or = 10%	< or = 10%
Liquidity	> or = 15%	> or = 15%	> or = 15%
Membership	> or = 5%	> or = 5%	> or = 5%
Total assets	> or = inflation	> or = inflation	> or = inflation

Source: CUES-Philippines

Note: LLP means "loan loss provision."

### ***Micro-insurance: CARD Mutual Benefit Association***

Low income clients face a range of risks such as death risks, health risks and property risks that in principle are insurable. Brown and Churchill (2000) observe that low-income households are highly vulnerable to economic shocks caused by various events, e.g., the death of a family member, illness, destruction of a valuable asset or a disabling injury. The formal insurance system has developed insurance products to deal with those risks but ironically, low income clients, the majority of the population, have been excluded from that system. Various reasons explain this: the very low incomes of those types of clients, the seasonal nature of their jobs, severe information problems, high transactions costs, etc.<sup>18</sup> In a study for the ILO, Barbin and others remarked that a major reason is that insurance is one of the most difficult of all financial services to provide. Insurers face risks getting the prices wrong, fraud, moral hazard and adverse selection. Those who provide insurance face the challenge of trying to cover their costs and make a profit through the sale of relatively low-cost insurance policies.

Thus, the development of micro-insurance products for low income clients is a very significant innovation in microfinance markets. MFIs have developed various types of insurance products for their low income clientele and mechanisms for dealing with problems of fraud, moral hazard and adverse selection. A survey of 32 MFIs, cooperatives and private companies indicated that MFIs are increasingly recognizing that new financial services, in

<sup>18</sup> For the same reasons, they are also excluded from the formal credit market.

particular, targeted savings, emergency loans, and insurance can respond to households' needs to reduce their vulnerability while improving the results of their existing credit and savings portfolios.<sup>19</sup>

Brown and others (2000) offer a definition of micro-insurance for clarity of discussion. There are two parts to the definition: first, 'insurance' refers to a financial service that uses risk-pooling to provide compensation to individuals or groups that are adversely affected by a specified risk or event. Risk-pooling according to Brown and others, involves collecting large groups or pools of individuals or groups to share the losses resulting from the occurrence of a risky event. Second, the 'micro' portion of the definition refers to the subset of insurance products that are designed to be beneficial to and affordable for low-income individuals or groups.

This sub-section discusses the micro-insurance developed by a Philippine NGO for its member-clients. Initially, the insurance product was a simple mutual fund called the Members Mutual Fund (MMF) introduced by the Center for Agriculture and Rural Development (CARD) NGO in Laguna, Philippines to address the problem faced by the institution upon the passing away of a member-borrower.<sup>20</sup> The primary purpose of the mutual fund is loan redemption in case of death of member-borrowers. The strong support provided by the members who benefited from the loan redemption scheme led to rapid growth of assets and membership. Thus, the MMF was later on used to cover death, disability and pension benefits. On October 29, 1999, the MMF was registered with the Securities and Exchange Commission as CARD Mutual Benefit Association (MBA). On May 29, 2001, the Office of the Insurance Commission gave CARD MBA a license to operate as a mutual benefit association for client members.

The unique feature of CARD MBA is that client-members own and manage it. Management was turned over to members in 1999. The Board of Trustees is elected from the membership of the association. **Box 2** provides summary information on the association.

***Box 2. Summary information on CARD MBA***

- As of May 31, 2002, CARD MBA has a total membership base of 94,854 households. This compares with the membership base of 49,887 households by the end of its first year of operation in December 31, 2001;
- In terms of individuals, the CARD MBA is serving 474,270 individuals as of May 31, 2003 (at an average of five individuals per household);
- CARD MBA had total assets of Pesos 27.1 million (US\$525,292) on December 31, 2001; the assets stood at Pesos 94 million (US\$1.8 million) as of May 31, 2003;
- CARD MBA operates in 9 provinces, of which seven are poor provinces.

<sup>19</sup> Brown and Churchill (2000)

<sup>20</sup> The CARD Group of Companies called the CARD Mutually Reinforcing Institutions is composed of CARD NGO, the mother institution; CARD Rural Bank; CARD Training Center and CARD MBA. Ninety eight (98%) percent of CARD members are poor women. CARD NGO started in 1988 as a non-profit organization that provides assistance to landless coconut farmers. It experimented on using a Grameen type credit operation in 1990. The successful experiment led to the establishment of CARD Rural Bank in 1997 to provide both savings and credit services to members and to the general public. CARD Rural Bank is a licensed MFI regulated and supervised by the Bangko Sentral ng Pilipinas (Philippine Central Bank).

The basic infrastructure of CARD's Mutual Benefit Association<sup>21</sup> is the prevalent practice of *damayan*, a local custom in the Philippine rural areas where the members of the community, relatives contribute cash to the family of an individual who passed away. The practice is "mutual" since everybody expects to be treated the same when a death occurs in the family. Ingrained in this custom is the feeling of oneness and solidarity with the bereaved. CARD used locally available information and the advantage of informal monitoring and enforcement system to build a solid mass of client-members united in the vision that they would someday be co-owners of an insurance company. Thus, CARD introduced the MBA to address a particular market niche that is not served by traditional insurance companies. Ninety eight percent of CARD clients are poor women, a large number of which are landless coconut workers. As mentioned above, vis-à-vis this segment of the population, traditional insurance companies face problems of high transaction costs, the perception of lack of capacity of poor households to afford the regular insurance premiums; the perception that the poor are not creditworthy; and information problems that work to exclude the Philippine poor from the formal financial systems.<sup>22</sup>

CARD MBA has three major products: life insurance program with total and permanent disability cover; a provident fund/retirement savings fund; and an all-loans insurance package. It has successfully metamorphosed from the simple loan redemption insurance provided under the Members' Mutual Fund. CARD MBA serves to protect CARD Rural Bank and CARD NGO from loss in the event of the death of the member-client. It also protects the dependents of the member who has passed away from being saddled with an outstanding loan with CARD Rural Bank. The loan redemption insurance is compulsory and the premium equivalent to 2.5% of loans above 10,000 pesos is automatically deducted from the loan. All borrowing members are included in the scheme. An actuary computes the premiums, benefits and policies of the members. Not more than 20% of total premium collections are used for administrative, maintenance and operating expenses. As well, the borrowing members have benefited from the different insurance products offered by CARD MBA.

It is noteworthy to point out the ingenuity of using a credit-insurance link to protect a lending institution and also a savings-insurance link to provide members a range of financial instruments for their surplus. CARD NGO has several thousand clients, a strong information base on clients organized into cohesive solidarity groups and regular and stable savings from members before it conceived of establishing the MMF and later on the MBA. The savings history was important in providing a good track record for clients. Today, the MBA members have savings accounts with CARD Rural Bank and this helps in loan evaluation and establishing their creditworthiness.

### ***Innovations on savings mobilization: Bank Rakyat Unit Desa***

Robinson (2002) entitled Chapter 11 of Volume 2 of her monumental work, *The Microfinance Revolution*, "How to Fail in Financing the Poor: Bank Rakyat Indonesia's Unit Desa System, 1970-83. The reason is simple. She wanted to highlight the unwanted results of a subsidized credit financing system and the long and difficult process of the organizational restructuring of the Unit Desa system in Bank Rakyat Indonesia (BRI) that turned around the floundering state-owned bank. Robinson documented the change of the Unit Desa system in 1984 "from a loss-making channeling agent for government credit subsidies to a commercial

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<sup>21</sup> Mutual Benefit Associations are not-for-profit insurance schemes that operate for the mutual benefit of members. These are regulated by the Insurance Commission of the Philippines. They must conform to capitalization and other financial standards as well as reporting requirements of the Insurance Commission.

<sup>22</sup> Philippine poverty is mainly a rural phenomenon. Rural poverty incidence is 41.3 while urban poverty incidence is 13.2 in 2000. See Balisacan (2003).

financial intermediary” (Robinson 2002). The restructuring was radical and involved crucial support from the Ministry of Finance and other government agencies. There was “strong commitment to sustainable banking for the economically active poor” which “was a sine qua non for the transformation of the system” (Robinson 2002). At the heart of the package of policy and institutional reforms affecting BRI was Unit Desas’ resolute saving mobilization campaign and the creation of a simplified but effective unit desa structure.

BRI is a state-owned bank with 23 divisions. The Business Unit Desa (BUD) Division was one of those divisions. Only this division and its managing director were directly responsible for the unit desa system.<sup>23</sup> Lending and deposit taking are the units’ main activities although other services like payments for telephone and electric bills, payments for property taxes are provided for a fee. Unit desas are mostly located at sub-district capitals and are decentralized. Some unit desas operate village service posts whose days of operation depend on client demand. During 1993-96 total supervision costs at all levels for the unit desa system averaged 1.2% of loans outstanding. Fiebig and others (1999) note the effective strategy of BRI Unit Desas. BRI mobilizes savings from different levels of the rural economy with a mix of liquid and non-liquid savings products and varying levels of return, based on the deposit amount. This mix of liquidity and return respects the depositors’ demand. It also permits BRI to provide manageable and profitable savings services from the institution’s perspective.

The Unit Desa system has enabled millions of poor Indonesians gain access to a savings facility that provides liquidity and return. The poor put a high value on savings services as indicated by the response of millions of poor depositors with the Unit Desas. Depositors outnumber borrowers, expanding BRI Unit Desa’s client base. Security of deposits and relatively high returns serve to attract those depositors. *Table 4* shows information on savings and loans outstanding in BRI Unit Desas over the period 1984- July 2000.

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<sup>23</sup> The detailed information on the Unit Desas came from Robinson (2002) unless otherwise indicated. Other sources are Maurer (1999) and Seibel (2000).

**Table 4. Savings and Loans Outstanding in BRI Unit Desas**

<b>Year</b>	<b>Savings deposits</b>		<b>Loans outstanding</b>		<b>Total savings to loan ratio</b>
	<b>No. of accounts</b>	<b>Amount (Billion Rp.)</b>	<b>No. of accounts</b>	<b>Amount (Billion Rp.)</b>	<b>(percent)</b>
1984	2,655	42.2	640,746	111.1	38
1985	36,563	84.9	1,034,532	229.0	37
1986	418,945	175.8	1,231,723	334.3	53
1987	4,183,983	287.5	1,314,780	429.6	67
1988	4,998,038	493.0	1,386,035	542.3	91
1989	6,261,988	959.1	1,643,980	846.5	113
1990	7,262,509	1,694.8	1,893,138	1,381.8	122
1991	8,587,872	2,540.5	1,837,549	1,455.7	174
1992	9,953,294	3,399.1	1,831,732	1,648.5	206
1993	11,431,078	4,325.2	1,895,965	1,957.4	220
1994	13,066,854	5,231.9	2,053,919	2,458.1	213
1995	14,482,763	6,015.7	2,263,767	3,191.2	189
1996	16,147,260	7,091.7	2,488,135	4,076.2	174
1997	18,143,316	8,836.5	2,615,679	4,685.4	188
1998	21,698,594	16,146.0	2,457,652	4,696.8	344
1999	24,235,889	17,061.4	2,473,923	5,956.5	286
July 2000	25,098,169	18,472.1	2,577,180	6,869.3	269

Source: Seibel (2000)

The savings facility has provided poor households access to funds for investments, emergencies or consumption smoothing needs. This is a very important service provided by BRI since savings-in-kind can be risky. Buchenau (2003) noted that “savings in the form of cattle is subject to diseases and accidents, savings in gold invite theft.” The savings history of those households also reveals critical information that helps establish a relationship with BRI Unit Desas. The experience with the savings innovation introduced through the Unit Desa system confirms the reports made by microfinance NGOs that the poor save and are good credit risks. This is in stark contrast to the long held belief of policy makers and development planners that poor people do not have a significant savings capacity. Fiebig and others (1999) note that for the past several years, practitioners have realized that this is attributable to inappropriate deposit facilities and institutional structures. Thus, the record of BRI Unit Desa system in savings mobilization crushed old beliefs and biases against the poor.

Conversely, this has enabled BRI to tap a very large supply of funds that has strengthened its role in the financial markets. That source of funds supply is the millions of Indonesian households that until then had no access to financial saving instruments. Zeller and Sharma (1998) noted that until recently, household savings were perhaps the most overlooked component of rural finance. They cite research indicating that poor rural farmers save to build a precautionary buffer to be used during lean seasons or to finance unexpected expenditures.

The ultimate test came with the collapse of the Indonesian banking system following the Asian financial crisis (Seibel 2000). BRI's Unit Desa system, the microbanking division remained profitable. At the peak of the crisis, from June to August 1998, the unit desas attracted 1.29 million new savers. The demand for credit stagnated because of lack of confidence in the future. By June 1999, the unit desa system's 12-month loss ratio had dropped to 1.5%, below its low long-term loss ratio (1984-1999) of 2.1%. Savings balances in the unit desas exceed loans outstanding by US\$1.8 billion (ibid).

BRI was able to survive the severe onslaught of the Asian financial crisis of 1997 basically because of the profitability and self-sufficiency provided by the Unit Desa System. The system was able to continue providing credit "to all levels of the economically active poor as well as to lower-middle-income borrowers. Savings are mobilized from all types of savers who live or work in a unit's service area" (Robinson 2002). The experience of Unit Desa system shows how it is possible for a formal financial intermediary to have a large outreach composed of savers and borrowers and maintain its operations in a cost effective way. Efficiency and simplicity of microfinance products, in this case the savings products of Unit Desa system are essential elements of profitable, commercial microfinance.

#### **IV. Lessons from the Experience and Concluding Remarks**

We can draw important lessons from the experience of microfinance institutions with innovations. First, it is important to underscore government's critical role in ensuring the proper functioning of markets. The Philippine and Indonesian governments were and remain fully supportive of private microfinance initiatives. Government can create a policy environment conducive to microfinance innovations or it can introduce policy distortions that make it difficult for MFIs to innovate or have sustainable operations (Llanto 2000a; 2000b). An example of a policy distortion is capping or fixing interest rates that prevents MFIs to fully cover their costs and generate a profit margin. Another is distortion is the establishment of barriers to entry to the banking industry that discourages competition. While the choice between these alternatives seems clear, that is, go for a policy environment conducive to innovations, the political calculus may lead to a contrary action.

Second, innovations flourish where the market environment is competitive. Competitive financial markets induce innovations because microfinance institutions have to develop new products or new transaction-reducing procedures or innovate on existing products in order to protect or increase their market shares. Buchenau (2003) explains that financial institutions are most likely to develop and provide innovations if they have to compete. He notes that in competitive markets institutions have to continuously improve the quality and pricing of their services to protect or increase their market shares. Otherwise, they could not cope with the competition.

Third, an important job for government in the financial markets is to effectively regulate and supervise financial institutions for the protection of depositors. In the case of MFIs, there is a need to have an appropriate regulatory and supervisory framework. Gomez and others (2000), Llanto (2000c), Fitzgerald and others, among others, make a case for risk-based supervision of banks engaged in microfinance. The removal of regulations that hinder the proper functioning of microfinance markets, e.g., rigid collateral or documentation requirements<sup>24</sup> paves the way for microfinance institutions to look for innovative products and services for poor clients. Put differently, Fiebig and others (1999) stated that inappropriate and interventionist regulations impede financial intermediation. Government interventions such as interest rate ceilings, burdensome minimum reserve requirements,

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<sup>24</sup> See Buchenau, page 31.

barriers to enter the market distort credit markets and hinder client access to adequate finance services.

Fourth, we make a case for government support of institutional innovation as opposed to product and process innovation. The private sector can handle process and product innovation and thus, MFIs should be left to their creative instincts in developing new products, procedures, technologies that will enable them to reach more poor people and remain viable at the same time. As Zeller (2000) notes that MFIs, especially if they want to benefit the poor, should focus more on credit, savings, and insurance services that mitigate risks faced by the poor. There should be room for experimentation by MFIs and a search for appropriate legal and regulatory frameworks.

Institutional innovations may be a different case in the sense that there is a tendency for the market to under-produce or not produce them, depending on outstanding circumstances. Zeller and Sharma (1998) and Zeller (2001) suggest public support in institutional experimentation and development in microfinance. The subsidies provided by donors and government organizations have enabled a range of experimentation and institutional development that generate social benefits.<sup>25</sup> The successful institutional innovations were not produced by market forces, but through heavy reliance on financial support from the state and donors. The focus was on building cost-efficient MFIs that are congruent with market principles and that can reach poorer segments of the society as clients. Zeller (2001) points out the payoff in terms viable lending methodologies and institutions emerging in developing countries like Bangladesh and Indonesia.

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<sup>25</sup> We carefully note though that the "subsidies" we mention here are not the same subsidies usually given to state-owned or sponsored banks (agricultural development banks, development banks) that were used to fund money-losing subsidized credit programs.



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