Microfinance in the Australian aid programme

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Introduction: How does AusAID understand microfinance?

Microfinance is about giving the poor access to the financial services they need to exploit income-earning opportunities, to meet life-cycle needs and to deal with emergencies. Microfinance can therefore both enhance the capacity of the poor to *increase* incomes and accumulate assets and *protect* them from further impoverishment in times of economic stress.[1]

High-quality microfinance is characterised by services that are easily accessible to the poor, responsive to the full range of their financial needs and reasonably priced. With the partial exception of some informal arrangements,[2] effective microfinance is available on a long-term basis, since the need for the lump sums that microfinance makes available is on-going. One or two doses of small scale credit rarely make a substantial difference to the lives of the poor. Long-term and reliable access to a range of financial services can make a big difference.

Long-term access to finance requires *sustainable providing organisations*, whether these be self-managed financial coo peratives such as savings and loans associations, professionally managed microfinance institutions (MFIs), formal financial institutions or some other organisational form.

Sustainable financial organisations have learned to protect against delinquency and default, to keep their costs down and to charge interest rates that cover the full cost of delivering their services. They recognise that permanency in the community is essential to fulfilling their mission of serving the poor, as well as being a powerful incentive for repayment. They are normally led by people with a clear vision of their organisation as something for the long term, not an isolated aid project with a limited life.

However, relatively few microfinance organisations have reached financial self-sufficiency, and in many cases this limits their access to the funds needed to increase the scale of their operations. Worldwide, a relatively small number of MFIs account for a disproportionately large share of microfinance clients. A ‘second generation’ of high quality organisations is needed to help meet the gap between supply and demand.

The strong emphasis placed on self-sufficiency is not without its critics, with the question of the extent to which the pursuit of self-sufficiency leads microfinance organisations to focus on the less poor remaining the subject of intense debate.

AusAID’s experience

Over the last three years the Australian overseas aid programme has made a concerted effort to build the size and quality of its microfinance portfolio. In doing this the government’s aid agency, AusAID, has focused on identifying and, where necessary, strengthening the capacity of developing country organisations showing the potential to become long-term providers of financial services to the poor. This approach is in line with the view of the Consultative Group to Assist the Poorest (CGAP)[3] that the lack of retail capacity – organisations providing financial services directly to poor clients – is the biggest single constraint to the rapid expansion of microfinance.

At the same time, AusAID has found that some MFIs which already have the capacity to scale up still lack access to the necessary funds to cover increased operational costs and additional loanable funds. Grant funding for such organisations, provided it does not weaken incentives for efficient operations that can eventually dispense with subsidies, can be an appropriate response in these circumstances.

It might be objected that focusing on individual MFIs is a ‘picking winners’ approach, and that donors such as AusAID would be better advised to concentrate on helping to improve the policy environment for microfinance in partner countries and allow the market to elicit effective providers. This objection overlooks the evidence that, while a poor policy environment (for example, unrealistically low limits on permissible interest charges) can inhibit the development of microfinance, a good policy environment does not of itself ensure a strong industry. There is much to be said for the argument that the demonstration effect of a few highly successful MFIs has been the strongest driving force in the expansion of microfinance.

Against this background, the attempt by aid donors to identify and support the growth of strong microfinance organisations is fully justified, although this need not be at the expense of interventions at the policy level or in such areas as regulation and supervision where these stand a reasonable chance of success and where the changes sought would be likely to have a high impact.[4]

South Asia and Southeast Asia

The focus on building retail capacity is heavily dependent on the existence of local organisations with the potential to become significant players. In South Asia and parts of Southeast Asia, such organisations exist in significant, although far from unlimited, numbers. As a consequence, Australia is pursuing a number of new activities in these regions. A five-year $A5.5 million project to support the expansion of a specialist microfinance organisation in Vietnam – the Capital Aid Fund for the Employment of the Poor (CEP Fund) in Ho Chi Minh City – began in June 2001. A successful scaling-up programme by CEP Fund could have a significant demonstration effect on the rest of Vietnam's microfinance sector.

In Nepal, AusAID began a collaboration last year with a wholesale microfinance provider: the Rural Microfinance Development Centre (RMDC).[5] In countries such as the Philippines and Bangladesh, local wholesale MFIs are playing an increasingly important role in developing the microfinance industry. RMDC may come to play a similar role in Nepal. In Pakistan, AusAID and CGAP undertook in October 2000 a joint appraisal of KASHF Foundation, one of the few specialist microfinance providers in the country. This has resulted in joint funding of KASHF by CGAP and AusAID.[6] Pakistan's microfinance sector is one of the weakest in South Asia, and the development of a market leader such as KASHF Foundation is likely to be an important stimulus for the sector's growth.[7]

Project designs have been prepared for multi-year scaling-up programmes in northwest Bangladesh through the Bangladesh Rural Advancement Committee (BRAC) and in the Chittagong Hill Tracts of Bangladesh through the Integrated Development Fund (IDF). The BRAC proposal focuses on one of the poorest regions of the country, while the IDF expansion would take in relatively remote areas that include significant tribal populations.

Funding decisions on these activities will be made shortly.

East Timor

In East Timor, AusAID is supporting two microfinance initiatives: the non government organisation Moris Rasik, and the Trust Fund for East Timor-funded, Asian Development Bank-managed Microfinance Project (MFP).[8] Moris Rasik established a group-based microfinance programme in October 2000 exclusively for poor, rural women. After one year of operations it is providing loans to 400 households in the Bobonaro district and has just begun an expansion to the Suai district. AusAID support will help to strengthen the financial and management capacity in Moris Rasik, with a particular focus on East Timorese staff. More information on Moris Rasik is provided in the article by Helen Todd in this issue.

The MFP is seeking to develop a strong policy framework for microfinance, to rehabilitate, strengthen and expand credit unions and to establish a financially sustainable Microfinance Bank serving the poor. AusAID is supporting the MFP, both as a contributor to TFET and as Trustee of the Foundation that will act as initial owner of the Microfinance Bank.

Papua New Guinea and the Pacific

In some of the regions of major interest to the Australian aid programme, prospects for sustainable microfinance are uncertain. In many of the South Pacific countries, no 'market leader' has emerged. There have been few demonstration effects to kick-start the microfinance sectors in the various countries, and these remain very weak.

A variety of arguments based on cultural and economic features of South Pacific countries have been put forward to explain the lack of successful microfinance in this region.[9] However, it is difficult to determine whether the lack of success reflects inherent features of these countries or, rather, the absence to date of the innovation needed to introduce microfinance successfully into an environment very different from its South Asian or Latin American heartland.

AusAID is supporting a project on Bougainville that may point the way towards a more successful model of small-scale finance for the South Pacific. Bougainville Haus Moni is a savings-first approach, with a focus on establishing the capacity for self-management of the provision of financial services. This project is discussed in more detail in the article by John Newsom in this issue.

AusAID is also supporting a small project aimed at providing microfinance to the rural and outer islands of a number of South Pacific countries through credit union savings clubs (CUSCs). These are essentially a simpler version of a credit union, requiring fewer officials and a much simplified level of bookkeeping. The first part of the project has confirmed the demand for CUSCs. The second phase will facilitate their establishment through changes to the credit union standard by-laws, development of systems, and training of officials in the operations and monitoring of CUSCs.

China

AusAID has on occasions supported the provision of credit as a component of larger projects dedicated to objectives such as increasing agricultural productivity or expanding income-generating opportunities. Particularly where the credit component has been small, this approach can result in insufficient attention being given to the sustainability of the provision of credit and other financial services beyond the life of the project, and of the conditions necessary to ensure this sustainability.

The Qinghai Community Development Project in China represents a sounder approach. This project began in 1994 and was completed in August 1998. Credit provision was one of the three core components designed to increase the income-earning opportunities of poor villagers. Initially the credit programme was managed through the project, in conjunction with the Haidong Branch of the Agricultural Bank of China (ABC). However, in April 1998 management of microcredit provision was transferred to the ABC under a separate board of management, with AusAID representation to monitor performance. This transfer of responsibility was designed to ensure that the microcredit programme would continue when the project finished.

Subsequent assessments by both AusAID and CGAP have shown that, while the project has established the basis of a sustainable microfinance programme in Qinghai (among a number of other positive outcomes),[10] much remains to be done in areas such as portfolio management, information systems and client targeting to give Qinghai a realistic chance of sustainability while maintaining a focus on the poor. As a result, the Qinghai Microcredit Consolidation

Project has been designed to address these shortcomings. At the time of writing it is in the tendering process.

The Qinghai model is unusual in that it combines the facilities of an established financial institution (the ABC) with commission-based village collection agents. This approach was designed to reduce the cost of providing services to widely dispersed population groups. While this innovation appears to have worked well in terms of facilitating a significant take-up of the services on offer, there have been difficulties in ensuring that the rules of the scheme have been fully understood by villagers, and that the rules have been applied equitably and consistently. One of the tasks of the Consolidation Project will be to address these problems.

The approach AusAID has taken in Qinghai is a form of 'downscaling', whereby a formal financial institution is encouraged to develop new financial services and new methods of service delivery to reach clients who were previously excluded. While this approach has had some notable successes,[11] generally speaking it has been the 'upscaling' of non government organisations (NGOs), whereby they have developed the tools needed to put the provision of financial services on a sustainable basis and to expand their programmes to reach far larger numbers, that has been the key feature of the development of microfinance.

China lacks a strong NGO sector on which such an 'upscaling' programme could be based. However, there are some promising initiatives. Funding the Poor Cooperative (FPC) is the leading non government microfinance provider in China, with more than 13,000 active clients. FPC uses the Grameen Bank solidarity group methodology to provide loans to the poor, and it has demonstrated that the basic model can work in China. This is confirmed by CGAP, which undertook a detailed appraisal of FPC in October 2000. AusAID, through the microfinance seed fund, is supporting FPC's expansion programme in Nanzhao County in Henan Province and Yixian County in Hebei Province.

China is an enormous potential market for microfinance, given the millions of low income households that lack access to basic financial services. However, microfinance is a relatively new industry in China, with only five to ten years of experimentation in rural areas. A number of pilot projects have been successful in reaching the poor and have generated important lessons about the local market for small scale financial services. However, for the most part (FPC may be an exception), the pilots appear to lack the management systems to support rapid expansion and long-term sustainability.

In this context, the work that AusAID is undertaking, though small in scale, has the potential to provide important lessons for how best to realise the vast potential of microfinance in China.[12]

Microfinance and poverty reduction

Reducing poverty and achieving sustainable development is at the heart of the Australian aid programme. A recent policy paper on the programme's approach to reducing poverty identifies four 'pillars' of the programme's poverty framework: growth, productivity, accountability, and vulnerability.[13] Facilitating access by the poor to key productive assets, such as land and credit, is one of the ways in which the aid programme seeks to increase the productivity of the poor.

The policy paper draws a distinction between activities that *directly* target clearly defined poor beneficiaries, and those *indirect* activities that operate at sectoral or national/state levels. These include governance, policy dialogue and institution-building activities. The paper makes the point that indirect activities often have the greatest medium- to long-term impact.

Most of the microfinance work that AusAID has done to date falls closer to the 'direct' end of the spectrum. Indeed, one of the powerful features of microfinance as a means of tackling poverty is that it puts financial resources directly into the hands of the poor. It provides the financial capital that in the right circumstances allows the poor to make more effective use of the human and social capital they already possess.

But there is also a strong 'indirect' element to AusAID's support for microfinance. This is evidenced by the focus on building the capacity of organisations to deliver services on a long-term basis to increasing numbers of the poor. Indeed, some critics of microfinance argue that practitioners and donors give *too much attention* to the microfinance organisation, as if creating financially self-sufficient organisations is an end in itself and not a means to the end of poverty reduction.

AusAID believes that this criticism, while understandable, is misplaced. Building organisations focused on serving the poor, whatever form these organisations take in terms of the role of members and the reliance on professional as against voluntary labour, is crucial to the reduction of poverty. Indeed, it is hard to see how sustainable solutions to poverty are possible without the existence of an organisational infrastructure that is accessible to the poor and that addresses their needs. The microfinance sector is surely right in placing the need to build sustainable organisations at the centre of its attention.

The framework developed by CGAP for appraising microfinance organisations is a very useful tool in this respect. It focuses attention on the various factors that underpin organisational success: the history and mission of the organisation; its ownership and board of directors; its leadership, alliances, human resources, organisational structure and internal controls; its target clients and the services it offers; its loan portfolio quality and financial performance; and its near to medium-term objectives. Performance and potential in terms of these organisational features determine whether it is worth investing in a given microfinance organisation.

AusAID is making increasing use of this framework in its appraisal of potential partner organisations. Although the format has been designed for use with 'relatively mature' MFIs, AusAID has found that it can be adapted for use with organisations at very different levels of development.

Conclusion

Australia has made a concerted effort over the last three years to expand its contribution to the development of the microfinance sector in those countries where it provides development assistance.

The microfinance seed fund has greatly helped in the process of identifying and developing initiatives that in some cases have then been handed on to the relevant AusAID country programme for further funding.

In undertaking this work AusAID has drawn on both Australian experience and expertise and that of developing country organisations and consultants, in recognition of the fact that much of the innovation in microfinance has been the work of people and organisations in developing countries.

As the money economy continues to spread, requiring the poor to pay for more and more of the services they require, access to lump sums to exploit investment opportunities, smooth consumption or meet emergencies will become increasingly pressing for increasing numbers of poor households. Microfinance is about expanding this access. The Australian aid programme will continue to play a significant role in supporting this expansion.

Notes

1. See Stuart Rutherford, *The poor and their money*, Oxford University Press, 2001.
2. In Rotating Savings and Credit Associations (ROSCAs), members meet on a periodic basis for as many times as there are members. At meetings each member contributes a fixed sum, with one member taking the full amount. The order in which the lump sum is taken can be decided by agreement, by lot or by auction. When the round is finished the group might start anew, re-form with some change of membership or disband. While an individual ROSCA is not permanent, the need for continued access to lump sums is met by a process of regular founding of new associations.
3. The CGAP is a microfinance donor grou p, comprising 29 member donors (including Australia) and a policy advisory group of experienced microfinance practitioners. Its secretariat is based at The World Bank in Washington. Its website (<www.cgap.org>) contains a wealth of material on microfinance, as well as links to other relevant sites. It also includes a link to the Microfinance Gateway, which includes an online library of microfinance literature.
4. An example of such an intervention is the Promotion and Capacity Building of Small Financial Institutions (ProFI) project of the German Agency for Technical Cooperation (GTZ) in Indonesia. ProFI focuses on developing/improving regulatory and supervisory tools primarily for the Bank Perkreditan Rakyat or Small Rural Banks (BPRs). The project involves the establishment of a deposit protection scheme for BPRs, the provision of training and the development of an accreditation process for BPR managers, a thorough review of current practices and tools of BPR supervision, and capacity building of the BPR umbrella body, Perbarindo.
5. A microfinance wholesaler provides training and/or loanable funds to retail microfinance organisations.
6. AusAID funding for RMDC and KASHF came in part from the Microfinance Seed Fund. The purpose of this three-year $A3 million fund, announced in the 1999–2000 Australian Government Budget, was to act as a catalyst for increased microfinance expenditure through the overseas aid programme. The 2001–02 financial year is the final year of the seed fund.
7. This issue of the *Development Bulletin* contains an article by KASHF's managing director, Roshaneh Zafar.
8. TFET, the Trust Fund for East Timor, is managed by the World Bank and the Asian Development Bank and receives funds from Australia, Finland, Ireland, Japan, New Zealand, Norway, Portugal, the UK, the USA, the European Commission, and the World Bank.
9. For example, C.A. Gregory, 'South Asian economic models for the Pacific? The case of microfinance', *Pacific Economic Bulletin*, 1999, 14(2).
10. An evaluation of the Qinghai Community Development Project, Quality Assurance Series No. 21, is available on the AusAID website (www.ausaid.gov.au/publications).
11. The best-known case of 'downscaling' is the Unit Desa system of Bank Rakyat Indonesia (BRI). There is a substantial literature on this, including Marguerite Robinson, *The microfinance revolution*, World Bank and Open Society Institute, 2001, vol. 3: *Lessons from Indonesia*; and Richard Patten, Jay Rosengard and Don Johnston, 'Microfinance success amidst macroeconomic failure: The experience of Bank Rakyat Indonesia during the East Asian crisis', *World Development*, 29(6), June 2001. However, questions remain about how far down the poverty scale BRI's units reach, and their inability to turn a large proportion of the deposits they mobilise into loans for the poor. See Detlev Holloh, *ProFI microfinance institutions study*, Bank Indonesia and GTZ, March 2001, 54–5.
12. The article by Jonathon Unger in this issue contains more information on rural credit in China.
13. *Reducing poverty: The central integrating factor of Australia's Aid Program*, April 2001, available from AusAID website or from Canberra Mailing Centre, PO Box 650, Fyshwick ACT 2609, (tel) 02 6269 1209, (e-mail) books@ausaid.gov.au.