The Future of Microfinance Institutions: 
Fostering Financial Inclusion for the World’s Poor

by

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Introduction

*Microfinance institution* is an umbrella term that includes state-owned programs and banks, member-owned savings and loan institutions, small rural or community banks, NGOs, and commercial banks specialized in microfinance or financial cooperatives. The main mission of microfinance institutions is to provide financial services to a growing number of people who have been excluded from the traditional financial system. The range of services offered by microfinance institutions is extremely diverse, covering everything from individual or solidarity loans for business or family needs, savings, micro-insurance for goods, and money transfers or pensions.

Microfinance has occupied an important place in the development landscape of the last three decades. It was initiated in the 1970s by the Nobel Laureate Mohammad Yunus. The United Nations declared 2005 the International Year of Microcredit. Microfinance is seen as an important part of the strategy to achieve the Millennium Development Goal of halving poverty by 2015.¹ Nevertheless, a growing number of studies disagree that microfinance can achieve this goal. According to supporters of the industry, microfinance reduces poverty and stimulates gender empowerment. However, its opponents argue that microfinance has no social impact and does not alleviate poverty; in some cases it even increases the level of vulnerability and exclusion of its beneficiaries. Nowadays, the “microfinance

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¹ The United Nations Millennium Development Goals are eight goals that all 191 UN member states have agreed to try to achieve by the year 2015. The United Nations Millennium Declaration, signed in September 2000 commits world leaders to combat poverty, hunger, disease, illiteracy, environmental degradation, and discrimination against women. The MDGs are derived from this Declaration, and all have specific targets and indicators. World Health Organization, http://www.who.int/topics/millennium_development_goals/en/
“schism” is getting deeper and the positive effects of microfinance are increasingly refuted. Microfinance is no longer understood as a silver bullet for poverty alleviation.

Although microfinance is usually defined as all types of financial services that are provided to low income people and often seen as a tool to fight poverty, a more accurate description takes into account microfinance as a tool to fight “financial exclusion,” a root cause of poverty. Thus, a more appropriate term to designate the activities that are usually described by term “microfinance” would be “financial inclusion.” By providing financial services to low income people, microfinance may be able to help alleviate poverty through financial inclusion.

This definition allows the reader to think of microfinance in a broader scheme and does not over-emphasize the importance of microfinance in alleviating poverty. It directs the attention of the readers towards what microfinance actually does for low income people which is financial inclusion, instead of the supposed goal of microfinance, that is, to help the lower income class to continuously improve their lives to the stage where they are no longer living in impoverished conditions.

An important question is: How do we transform microfinance, which provides financial inclusion for low-income people into the right tool for poverty alleviation? This thesis argues that microfinance institutions must first accept the limitations of what microfinance actually does for low income people. They should focus on what microfinance actually does achieve, which is financial inclusion, rather than focus on

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3 In this thesis, I will equate the terms “low income people” and “the poor,” and use them interchangeably. The terms refer to individuals who se PPP are below $4/day. I use the term “extremely poor” to identify individuals who live under the international poverty line at $.125 per person a day. I am aware that some economic literatures, such as Banerjee and Duflo (2008), use the term “the lower middle income” to identify individuals whose PPP are between $2-$4/day. I use the terms identified in this thesis to interpret their findings.
its impact on poverty. This is because the hope that microfinance can end poverty is a future goal that rests on how microfinance institutions can genuinely benefit the low income people to whom they provide services today. This thesis will argue that the criticisms of the microfinance movement stem largely from a misunderstanding of the proper target group of microfinance institutions and the ideal role of microfinance in development.

This thesis will try to understand low income people: How they live their lives, why they are initially excluded from formal financial services, and what financial services they demand. It will provide background on the financial services available to the poor before the birth of microfinance institutions: the agricultural development banks and the informal moneylenders. The thesis will show the advantages and limitations of the financial services that agricultural development banks and informal moneylenders provide for low income people. Then the thesis will clarify that there are two types of microfinance institutions: charitable microfinance institutions and financially sustainable microfinance institutions. Each type of microfinance institution has a different mission and goal, in providing services for low income people. Their target groups of low income people, their services, their operations, their sources of capital, are different. Charitable microfinance institutions target the poorer poor to fulfill their development objectives. Financially sustainable microfinance institutions focus on Group C to attain their goal of financial sustainability. This thesis will argue that it is essential to differentiate between the two types of microfinance institutions in order to respond constructively to increasing criticism of microfinance institutions.
To provide a clearer picture of how clear distinction between two types of microfinance institutions can be achieved, the thesis will examine one of the most successful microfinance institutions in the world, the Bank Rakyat Indonesia (BRI), as a case study to understand the different roles of microfinance institutions in helping low income people by providing them with financial services. It will ultimately argue that while two types of microfinance institutions provide different types of services to low income people, they should work collaboratively to provide low income people with sustainable financial inclusion.

**Structure of the Thesis**

This thesis will argue that there are different groups of poor people who can be different the potential targets of microfinance institutions, and that different groups of poor people need different types of services provided by different types of microfinance institutions. This is important, because a clear definition and understanding of the different types of services that different types of microfinance institutions aim to provide to different groups of low income people is essential, if we are to make different types of microfinance institutions work for their target groups of low income people.

In Chapter One, I will define who “the poor” are, what their characteristics are, and how they live. In this quest to define the poor, the first chapter focuses on two measures: How the poor earn their income, and how they spend their income. The poor often earn their income from multiple sources. They are entrepreneurs out of the necessity to earn income when they cannot find employment. After identifying who the poor are and that they face many difficulties stemming from limited access to
financial services, I will ask whether the lives of the poor can be improved if they have financial services available to them. I will briefly answer that the lives of the poor can improve if they are granted access to low-interest-rate credit and other financial services that microfinance has to offer, especially savings accounts. However, the magnitude of how much the poor can utilize this access depends on the individuals and their rationales. Access to financial services may improve the poor’s lives, but whether it can end their poverty depends on how they utilize the economic opportunities they have.

The second chapter attempts to answer the question of whether the lives of the poor can be improved by the availability of financial services. To answer this question, the chapter will separate the poor into three groups (Group A, Group B, and Group C) based on their level of poverty. Group A, the poorest group, are the individuals in the bottom half below the international poverty line (PPP=$1.25). Group B are the top half of individuals who live below the international poverty line. Group C are individuals who live just barely above the international poverty line (PPP=$1.25-$4). The thesis will argue that despite the vague understanding that microfinance aims to reach Group A, microfinance institutions are appropriate for serving only some groups of low income people, Group B and Group C. In addition, this chapter provides background on the financial services that were available to low income people before microfinance, namely agricultural development banks and informal money lending. It will outline the advantages and limitations of these institutions for providing financial services to low income people.
Chapter Three discusses the characteristics of microfinance institutions as a hybrid of agricultural development banks and informal moneylenders. Similar to how agricultural development banks and informal moneylenders target different groups and provide different types of financial services to low income people, there are two types of microfinance institutions: charitable microfinance institutions and financially sustainable microfinance institutions. The chapter explores the “microfinance schism”—the debate on whether microfinance institutions should remain charitable microfinance institutions or move towards becoming financially sustainable microfinance institutions. Although microfinance institutions were initially created as charitable organizations aiming at poverty alleviation, the growing trend of the microfinance industry suggests that if microfinance tries to achieve poverty alleviation through financial inclusion, operating as a charitable organization is not enough. In order to help a large number of people face difficulties in their lives—because they do not have access to financial services—microfinance must expand its outreach by providing financial services to as many poor individuals as possible. To provide financial inclusion for low income people, microfinance institutions must first be financially sustainable before they can expand financial services to the poor.

Chapter Four can be divided into two parts. First, this thesis chapter examines Bank Rakyat Indonesia’s microbanking unit and shows how a charitable microfinance program (BIMAS) of an agricultural development bank can undergo a reform to become a financially sustainable microfinance program (KUPEDES-SIMPEDES), within only six years after the reform. The study suggests that there are four major elements that contribute to BRI microbanking unit’s success: 1) governance and
organizational structures, 2) savings mobilization, 3) clients’ trust in the institutions, and 4) macroeconomic conditions. A microfinance institution that seeks to become financially sustainable may learn how they can execute their institutional reforms from Bank Rakyat Indonesia’s microbanking unit.

The second part of this chapter examines the charitable microfinance program (P4K-Income-Generating Project for Marginal Farmers and Landless) in which BRI collaborates with the Indonesian government and the International Fund for Agricultural Development (IFAD). While P4K was initiated to respond to criticism that the BRI microbanking unit was diverging away from its mission of helping to alleviate poverty for the poor, it is important to suggest that there are different goals for different types of microfinance institutions. The chapter shows that two types of microfinance institutions can work cooperatively to provide financial services to different groups of low income people. P4K’s clients, for example, can rely on their financial record and performance in the P4K program to be eligible for KUPEDES. Ultimately, the second part of this chapter will argue that the key to collaboration between charitable microfinance institutions and financially sustainable microfinance institutions is a credit information sharing system. A charitable microfinance institution can act as a school where the poor with less creditworthiness can learn to manage their money and collect the necessary financial history. This creditworthiness record, if properly shared between microfinance institutions, will act, as BRI uses it, as collateral, a guarantee that a person has a good credit history and financial habits. This will help low income people to achieve sustainable financial inclusion if they are willing to.
The conclusion will suggest that the thesis will revisit the question: If microfinance wants to help the poor, how indeed can microfinance help them? The thesis suggests that charitable microfinance institutions and financially sustainable microfinance institutions have to work together collaboratively, and with the government, so that microfinance is well-equipped with the tools necessary to provide the services that will best respond to the poor’s needs.
Chapter One

1.1 Identifying “The Poor”

If we want to help “the poor,” how can we find them? What differentiates the poor from the other socio-economic classes? Are we able to tell that people are poor by how they look, dress, eat, or work? Why do poor people become poor? Are they lazy? Is it because they have less ability or intelligence than richer people?

According to the 2010 World Development Report from the World Bank, the extremely poor are people who live on an average daily consumption of $1.25 or less; people whose means force them to live on the edge of subsistence.\(^4\) From these data, we can try to imagine what the lives of the poor are like, if we examine what they have to spend to keep their bodies and souls together each day. Still, this information tells us only what their purchasing power is, and suggests nothing about how the poor actually live. In this thesis, “the poor” also refer to individuals who live under the upper poverty line at $4 per person a day.

If the extremely poor earn approximately $1.25 a day, where does their income come from? Do they earn their money from work, or government welfare programs? If their money comes from work, what do the poor actually do for a living? In addition, how are they spending their money? The next parts of this chapter will try to answer these questions.

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1.2 How the Poor Earn Their Money?

Abhijit Banerjee and Esther Duflo, two well-known development economists, helped to further our understanding of how the poor earn their money. They conducted household surveys on the lives of the extremely poor in thirteen countries: Côte d’Ivoire, Guatemala, India, Indonesia, Mexico, Nicaragua, Pakistan, Panama, Papua New Guinea, Peru, South Africa, Tanzania, and Timor-Leste. Their research suggests that “all over the world, a substantial fraction of the poor act as entrepreneurs in the sense of raising capital, carrying out investments, and being the full residual claimants for the resulting earnings.”

Similar to De Soto’s findings from his research on Peruvian urban poor in his famous book *The Other Path*, he asserts that the poor are not too lazy to make a living, Benerjee and Duflo (2007) add that many poor households have multiple occupations, or get their incomes from more than one source. Their studies suggest that the percentage of the rural extremely poor households that report that they conduct more than one type of activity to earn a living is 50 percent in Indonesia, 72 percent in Côte d’Ivoire, 84 percent in Guatemala, and 94 percent in India.

Now that we know they conduct more than multiple types of economic activities, the next question is what types of activities do the poor most often engage

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6 Ibid., 151
8 For India, Banerjee and Duflo only focus on Udaipur or Rajastani. Hence, the use of “India” in this chapter refers to Udaipur. – Banerjee and Duflo. "The Economic Lives of the Poor," 152.
in? Interestingly, most of the poor’s income comes from the non-agricultural sector, either from work as laborers or from self-employment.9

Why can’t the poor rely on the agricultural sector for their earnings? The answer is because they do not own land, or do not have property rights to claim ownership of the land. And if they possess some arable land, the land that the poor own is often quite small, with an area ranging between one and three hectares.10

While Banerjee and Duflo (2007) argue that the poor seem to have land, this does not seem to be the case when we look specifically at gender.11 Throughout many parts of the world, specifically in Africa and South-Asia, women have not traditionally been able to access, own, control, or inherit land.12 For example, in Ghana, land is traditionally owned by and passed down to men. In the case that her husband dies, a wife would not automatically inherit his land.13 Instead, the son or the husband’s male relatives would be the inheritors.

In developing countries, land records are often incomplete and many people do not have titles to their lands.14 For example, Olivia Kwapong (2009) argues in “The Poor and Land: A Situational Analysis of Access to Land by the Poor Land

9 Banerjee and Duflo (2007) reports that in Guatemala, 65 percent of the poor’s employments are in agriculture, 86 percent works as laborer outside of agriculture, and 36 percent earn their income from self-employment outside of agriculture. In Indonesia, 37 percent of the poor earn their income from self-employment outside of agriculture, and 34 percent work as laborers. In Pakistan 51 earn their income from self-employment outside of agricultural sector, and 35 percent earn their income from self-employment outside of agricultural sector. Ibid., 153.
10 Ibid., 154
11 Ibid., 158.
Users in Ghana” that, in theory, there are no barriers to access to land. Indigenous people have access to family lands, while migrant farmers can also access land through the sharecropping or hiring system. However, due to their poverty, the poor may prefer to sell or hire out greater portions of their land and use only small portions of it for farming food crops. Landowners who sell their land out of poverty may also become sharecroppers for the buyers. This implies that landowners may not have adequate capital resources to utilize their land for commercial farming.

In addition, Goldstein and Udry (2008) argue that, in some parts of Ghana, because land belongs to family lineages or to a village, only cultivators have rights to use the land. The acquisition of land is highly influenced by people with political power, and not by the poor. To prevent having their land taken away, the poor have to continuously be cultivators. As a result, in practice, they do not leave their land fallow long enough because this act increases the risk that someone in the village will seize the land. If they had clear documents of who owned what part of the land, the poor in Ghana would be able to leave their land fallow long enough. This in turn would help increase their agricultural productivity.

Obtaining legal title to land is sometimes very costly in developing countries. In “The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else,” Hernando De Soto argues that in country after country in the

15 Kwapong, “The Poor and Land: A Situational Analysis of Access To Land By Poor Land Users in Ghana,” 54.
16 Ibid., 54.
17 Ibid., 54.
18 Ibid., 54.
20 Ibid., 984.
developing world, squatters' rights prevail because the obstacles to obtaining legal
titles defeat most of the poor.

In Egypt, the person who wants to acquire and legally register a lot on state-owned desert land
must wend his way through at least 77 bureaucratic procedures at 31 public and private
agencies.... This explains why 4.7 million Egyptians have chosen to build their dwellings
illegally. If, after building his home, a settler decides he would now like to be a law-abiding
citizen and purchase the rights to his dwelling, he risks having it demolished, paying a steep
fine and serving up to 10 years in prison.21

This example suggests that the poor are subject to limitations on their usage of
land due to cultural and legal structures that are specific to their countries.22

Furthermore, in the situation where the poor have legal rights to land, the
piece of land that a poor person owns tends to be very small and inadequate for his or
her subsistent needs of his or her household. Banerjee and Duflo (2007) suggest that
on average the poor own approximately one to three hectares of land in the countries
they studied.23 Following Banerjee and Duflo’s approximation, the World Bank data
suggests that the low income group (a group of people who make $1005 or less
annually) yield 1708.48 kilogram of cereal per hectare.24 With the average cereal
price from 1990 to 2009 at $241 per ton (as of February 2009), the average income of
the low income group from their agricultural production is approximately $411.75 per
hectare per year.25 For low income people who are considered poor in Banerjee and

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22 Some economists argue that the poor lack incentives to make the best use of the land they are cultivating because they are agents rather than owners. Banerjee et al. (2002) add to this discussion that that a reform of tenancy that forced landlords to raise the share of output going to the sharecroppers and also gave them a secure right to the land raised productivity by about 50 percent.
23 In India, Indonesia, Guatemala, and Timor-Leste, for example, the median land holding among the poor who own land is only one hectare or less. - Banerjee and Duflo. "The Economic Lives of the Poor," 148.; The calculation is based on the World Bank data on Yield of Cereal (Kg/Ha) from 1990 to 2009. - http://data.worldbank.org/
24 Income group: Economies are divided according to 2010 GNI per capita, calculated using the World Bank Atlas method. The groups are: low income, $1,005 or less; lower middle income, $1,006 - $3,975; upper middle income, $3,976 - $12,275; and high income, $12,276 or more. - http://wdronline.worldbank.org/worldbank/a/incomelevel
25 Cereals Price Index: This index is compiled using the grain and rice price indices weighted by their average trade share for 2002-2004. The Grains Price Index consists of International Grains Council (IGC)’s wheat price
Duflo’s study (2007), they may own only one hectare of land. As a result, they may earn only $411.75 from their agricultural activities per household per year. The graph shows that if the low income and lower middle income groups were to rely on the amount their land produces alone, they would not be able to make ends meet for their households. Note that this does not take into account the impact of natural disasters, such as flooding, and the impact of plant diseases that can turn agricultural production to zero units per hectare.

With the limitations on their access to land, difficulty obtaining legal rights, and land size, the poor face problems in their agricultural production. Because the income that the poor are able to generate from the agricultural sector is not enough for their subsistence needs, the poor have had to find other income sources outside of the agricultural sector. But what work can the poor find outside of the agriculture sector in rural areas, where there are fewer opportunities for employment? The poor either migrate to do labor work elsewhere, or become self-employed in a non-agricultural sector.

Banerjee and Duflo (2008) suggest a major difference between the poor and the higher middle income person is that the middle income person work longer hours, at more stable higher-paying jobs.

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index, itself an average of 9 different wheat price quotations, and 1 maize export quotation; after expressing the maize price its index form and converting the base of the IGC index to 2002-2004. The Rice Price Index consists of 3 components containing average prices of 16 rice quotations: the components are Indica, Japonica and Aromatic rice varieties and the weights for combining the three components are assumed (fixed) trade shares of the three varieties. - "FAO Food Price Index." World Food Situation: http://www.fao.org/worldfoodsituation/wfs-home/foodpricesindex/en/.
The graph shows that higher middle class incomes (PPP$6-10/day) come from regular salaries, rather than casual payment. As shown in Figure 1, the higher the income, the less the percentage of income that comes from casual pay. This graph suggests the different nature of the types of employment that the middle class and the poor engage in. Unlike the upper middleclass, low income people (PPP below $4/day) often hold labor-intensive casual employment, a form of employment in which workers do not have access to annual leave, paid sick leave, required notice of dismissal, and lump-sum payments. A casual employee usually works on an irregular basis and may or may not be offered work on a given day, or continuation. Hence, the income from casual employment is not stable.

28 Ibid., 19.
Largely depending on casual employment as their source of income, the poor constantly have to face the risk of having employment one day and being unemployed the next day. Furthermore, because casual employment often does not offer health benefits, the poor become very vulnerable when they get sick. If they are sick, they cannot work to earn their income and they do not have insurance or other types of security to pay for healthcare. In addition, casual employment usually does not contribute to skill development for poor employees. This is because the nature of their type of employment is usually labor intensive or does not require additional skills.

Due to the nature of casual employment, the poor are more vulnerable to being exploited by their employers. Because the employment contract might not be in writing, if an employee gets injured at work, the employers may not take responsibility and take care of his or her health expenses. Furthermore, an employer can fire workers before the end of the employment period, without having to show cause. Since the workers might not have work contracts, they do not have the power to appeal their employers’ arbitrary decisions. The nature of casual employment also suggests that the poor’s income is not stable. Most importantly, while the World Bank’s poverty line suggests that the extremely poor operate on $1.25 a day, the poor who live on the poverty line might not earn even $1.25 a day. Instead, they might earn $2.50 today, $0 tomorrow, and $1.25 the next day, depending whether they have a job day by day. They might be weeding a garden one day and making bricks the next. Changing jobs frequently does not help the poor to become specialized or
highly skilled. In sum, the poor are exposed to higher risk and job instability if they depend on income from casual employment.

The risks that the poor face in casual employment also affect their households’ well-being and family structures, especially when they have to migrate to find work elsewhere. For example, Banerjee and Duflo (2007) report that, in India, the median length of a migration for casual employment is one month, and only ten percent of job holdings exceed three months. In developing countries, men are usually the breadwinners and the ones who have to migrate to find income for their families, leaving their wives and children behind in the rural villages. In some developing countries, both father and mother have to temporarily migrate to work in the cities, leaving the grandparents to raise their children. As Joyanti Haldar, a rural Bangladesh woman, puts it, “He [my husband] migrates because if he stays at home life does not go along well…we do no more than fill our stomachs…but one needs to save some money…that is why he migrates.” Her remark suggests that the poor migrate for work because of the necessity to finding employment to support their households beyond subsistence.

As the middle class holds more stable employment with weekly or monthly salary, there is less inclination to take risks and become self-employed. With less stable jobs, less pay, and less hourly work, the poor have to find other sources of income, and other ways to occupy their time. As a result, they often start small.

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30 Ibid., 153-4.
31 Ibid., 152.
businesses. The poor have less opportunity cost than the middle class to run their own businesses because they receive relatively lower wages than the middle classes, and they sometimes cannot find jobs. The opportunity cost of becoming self-employed is relatively less for the poor than for the middle class. For the unemployed poor, work outside the agriculture sphere is actually a way for them to make productive use of their time in off seasons. For these reasons, the poor should naturally more often choose to take risks, choosing to be self-employed over, or in addition to, seeking temporary casual employment.

The poor’s businesses are mostly the extension of what they do in their daily lives. Apart from land, extremely poor households in rural areas tend to own very few durable goods, including productive assets. Banerjee and Duflo (2007) report that 34 percent own a bicycle in Côte d'Ivoire, but less than 14 percent own bicycles percent in India, Nicaragua, Panama, Papua New Guinea, Peru, and East Timor. In Udaipur, for example, most extremely poor households have a bed or a cot, but only about 10 percent have a chair or a stool and 5 percent have a table. About 50 percent have a clock or a watch and less than 1 percent of the people have an electric fan, a sewing machine, a bullock cart, a motorized cycle of any kind, or a tractor. The poorer they are, the more they need to operate a business, even with almost no productive assets.

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33 Banerjee and Duflo. "The Economic Lives of the Poor," 148
34 Ibid., 148.
35 Ibid., 149.
36 Ibid., 149.
Because the poor do not usually own durable goods, their income-generating activities are often limited to just the extension of what they do in their daily lives.\(^{37}\) The types of activities that the poor do are described by Banerjee and Duflo (2007) as follow:

If you have few skills and little capital, and especially if you are a woman, being an entrepreneur is often easier than finding an employer with a job to offer. You buy some fruits and vegetables or some plastic toys at the wholesalers and start selling them on the street; you make some extra *dosa* mix and sell the *dosas* in front of your house; you collect cow dung and dry it to sell it as a fuel; you attend to one cow and collect the milk.\(^{38}\)

In addition to these activities, the poor might be collecting cow dung to be used as fuel, collecting bottles and cans for sale, raising chickens for eggs and meat, making fishing nets, or other activities. Looking at the situation more closely, the poor are not entrepreneurs because they want to be or because they know that they have a special gift for doing business. Instead, the poor have to be entrepreneurs out of necessity in order to keep their bodies and souls together. Some business attempts are successful and some are not.

Thando, 39, lived with his wife, Maduna, three children, and a niece. They received state-provided child support grants every month for two of the children. They tried to supplement this income: with a shop that quickly failed; by Maduna making mud bricks; by Thando working as a day laborer. The low value/high irregularity of their income did not allow them to manage credit needed for large-scale, formal investments. A refrigerator for the shop that they bought on informal credit was repossessed because they missed payments. But they did manage to keep up with contributions of $29 (in 1993 PPP dollars) every month to an informal saving club.\(^{39}\)

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\(^{37}\) Ownership of *durable goods* provides the owners with the means of production for a series of possible income-generating activities. More durable goods increase the possibility to expand the range of income-generating activities. For example a poor woman may use two stoves that she has to make rice crepes and she can only produce up to 30 rice crepes per day. If she owns more stove, she will be able to produce more rice crepes and earn more income from selling them.

\(^{38}\) Banerjee and Duflo. "The Economic Lives of the Poor," 162.

Such businesses are mostly run by one person, though 25 percent of the businesses have two or three household members working. With full-time casual employment, the average time part-time business owners spend on their businesses is three hours per day on average. The other household members usually work only an hour or two each day.  

Similar to the problem of the small scale of land holdings the poor face in the agricultural sector, the poor lack both initial capital and access to credit to start their own businesses. If Joyanti Halder’s husband owned a rickshaw and he could become a rickshaw puller in his village, he would not need to migrate to work in the city. In Joyanti Haldar’s case, she suggests that she would prefer her husband to be home. She thinks that doing “rickshaw van pulling” at home is “much better” than for him to work far away from his family. Yet, her family has neither enough income to buy the rickshaw, nor either formal or informal access to capital. Thus the only choice for them is to have her husband migrate to find work outside of the village. In the case of Thando, he managed to get capital from an informal moneylender to buy a shop, but then did not have enough funding to operate it. If he knew of another channel to access capital, his shop might have been able to continue to operate. Thando’s story of success might have been similar to that of Parbati Karki, a poor rural woman in Nepal.

Parbati Karki, 27, had purchased a Jersey cow five years ago by obtaining a small loan of Rs. 5,000 ($98) from a microcredit provider. She now sells 18 litres of milk daily from her two

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40 Banerjee and Duflo, "What Is Middle Class about the Middle Classes around the World?,” 16.
cows and earns about Rs. 400 ($8) per day. She has been able to erect a new house by putting together her income from the milk business and her husband's earnings.\(^{42}\)

The role of capital in helping low income people is to help them generate more income. Thando could use this small capital infusion to provide his shop the necessary liquidity to operate or his capital could be put into buying more land, in the agricultural sector. They could use it to buy more cows or goats if they were selling milk to their neighbors.

1.3 How the Poor Spend Their Money?

Despite holding multiple jobs and running their own businesses, the poor often do not make enough to fully support their lives, especially when unanticipated events occur. These events include getting sick, natural disasters, etc. In part, this vulnerability to shocks is due to the fact that the poor do not make enough money to spend and to save. Their spending is not limited to subsistence consumption, such as food, but also includes extra consumption, such as entertainment. According to Banerjee and Duflo (2011), the poor spend a surprisingly large amount on televisions, weddings, and festivals.\(^{43}\) All of these activities involve spending a large amount of money at one time. This implies that, in fact, the poor have some money to spare. According to Banerjee and Duflo (2007), “many poor people save money that they could have eaten today to spend more on entertainment in the future.”\(^{44}\) This can imply that low income people have self-control; they are not spending their excess income day to day. But if this is so, why do the poor save for entertainment and not

\(^{42}\) Collins, Daryl, *Portfolios of the Poor: How the World’s Poor Live on $2 a Day*, Appendix 1.


\(^{44}\) Banerjee and Duflo. "The Economic Lives of the Poor," 162.
for investment in good nutrition, education, health care, or their self-owned businesses? While conventional views would suggest that the poor are more vulnerable to shocks because they do not have excess income to save, Banerjee and Duflo (2007) show that the poor do, in fact, have excess income. They just do not spend their limited excess income on what is commonly viewed as productive investments. From Banerjee and Duflo’s studies, the question then shifts to the normative one of how to make people behave differently. If the poor can save money, can they save for productive causes?

It is essential to understand why the poor appear not to have “self-control” over spending on non-productive causes. First, it can be argued that this is a problem of information. The poor might not be aware that saving is good for them in the future. However, this seems quite unlikely as Banerjee and Duflo’s research (2007) suggests that the poor are somewhat aware of what economic choices are good for them. In their Hyderabad survey, the respondents were asked to name whether they would like to cut particular expenses, and 28 percent of the poor named at least one item. Nevertheless, while the poor have this understanding, it seems they cannot resist the temptation to spend money on these goods.

The second argument is that while the poor are aware that they should save, they might not have access to available infrastructures or institutions that will help

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45 Ibid., 164.
46 The top item that households would like to cut is alcohol and tobacco (mentioned by 44 percent of the households that want to cut on items). After that the poor households would like to cut on sugar, tea, and snacks (9 percent), festivals (7 percent), and entertainment (7 percent). - Ibid., 164.
47 Note that the study did not specify how gender plays a role in the outcome. Further research to break down this data by gender would be very interesting.
them to save successfully. For example, the poor in rural areas might not have banks in their villages and the closest bank to their villages might require a half-day walk to get to.\textsuperscript{48} The withdrawal fees and access to withdrawing money may be too expensive. In addition, they might not trust the banks or have false information that they might not get their money back if they put their money in the bank.\textsuperscript{49} Shawn Cole, Thomas Sampson, and Bilal Zia (2009) combined a household survey from Indonesia and India with a field experiment to test what causes low demand for financial services in emerging markets.\textsuperscript{50} They found that low demand for financial services correlates with the poor’s low level of financial literacy.\textsuperscript{51} Due to these reasons, the poor save their money at home or at the homes of people within their community, instead of putting their money in other financial institutions.

However, by saving at home, i.e. putting money under the pillow, the poor make access to their money too easy.\textsuperscript{52} Money kept in the house is not secure. Anyone, including thieves, can access the money. Giving the possibility that their money might be stolen, the poor might rationalize that they should spend their money, instead of waiting for it to be taken away by theft. The thief here does not

\textsuperscript{49} Dupas (2011) suggests that this mistrust of the banks might occur in countries with weak financial institutions that have a number of banking scandals. The most notorious is the Goldenberg scandal that occurred in early 1990s. This led to an estimate of $600 to $850 million of false investment in non-existing company called Goldenberg International, a goal and jewelry firm. The impact of the scheme caused many banks to be closed down and saving losses. In addition, regulation plays a major role. For example, in Kenya, that Village Bank are not insured by the central government lead to the concern that depositors might not be able to get the money in the case that scandals happen again. The lack of trust of the bank became a major barrier to bringing financial services to underserved areas. Even though the number of scandals has been decreasing in the past ten years, Dupas (2011) argues that it is difficult to change the mistrust mindset of the depositors to the banks. - Dupas, Pascaline, and Jonathan Robinson, Savings constraints and microenterprise development: Evidence from a field experiment in Kenya, NBER Working paper no. 14693, 3-4.
\textsuperscript{51} Ibid, 7.
\textsuperscript{52} Banerjee and Duflo (2007) suggest that access to the poor’s money is easy to steal, especially in a house that cannot be locked.
have to be a professional who steals money, but can simply be a family member. For example, if a husband wants some money to buy alcohol and he knows that his wife hides her money under her pillow, he might just take his wife’s money.

In addition, the poor have to constantly resist spending money on things that the higher economic classes might take for granted, such as helping relatives or friends when they have money issues, giving their children a treat, buying a television, etc. When saving money at home and having access to their savings almost instantly, they might not have time for second thoughts when these temptations for optional spending arise.

Sometimes the poor intentionally cut down their food consumption to save for entertainment. “The world’s poor typically spend about 2 percent of their income educating their children, and often larger percentages on alcohol and tobacco….The indigent also spend significant sums on soft drinks, prostitution and extravagant festivals.” 53 Why do they have these consumption patterns of low savings, and choosing to spend on these non-productive goods, rather than for good nutrition, education, or other investment? Why do the poor neglect long-term investment in businesses, health, and education? In this case, are they poor because of their seemingly “irrational” behavior? If one wants to help the poor, would it simply be impossible because the poor are “undeserving?”

Much of economics literature tries to explain the persistence of poverty. Most of the literature assumes that individuals are rational and that the poor, like any other individuals, care about their own and their children’s futures. As a result, it is often assumed that the poor, like members of any other economic class, are willing to give up part of their present consumption for the future. However, because of their environment and their circumstances, the poor might have different calculations on discounting income in the future. The poor might think differently not because they are irrational or stupid, but because what contributes to maximizing their utilities differs qualitatively from other, richer people.

Many economists ask whether the poor continue to be in poverty because they are poor. Mounting evidence and research suggest that the very fact of being poor hinders people’s ability to make good decisions. The first research was as early as 1959 when anthropologist Oscar Lewis argues that the poor develop a “culture of poverty.” This culture of poverty adapts to “cope with feelings of hopelessness and despair which develop from the realization of the impossibility of achieving success in terms of the values and goals of the larger society.” For Lewis, the culture of poverty has several key features. Among the most important is the lack of effective participation and integration of the poor into the major institutions of the larger society. To put this in the context of the small businesses that the poor operate: They have to organize their businesses without access to formal financial institutions.

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56 Ibid, 191.
57 Ibid, 177.
This limits the type of businesses the poor can operate to free-entry, free-exit activities. The unreliable sources of capital discourage and hinder business improvement in terms of efficiency and scale, and even the day-to-day operation of the businesses. Having no access to formal financial institutions is one of the causes of the culture of poverty.

Many psychological studies find that, compared to wealthier people, poorer people feel powerless and discouraged because they believe that they have less control, power, and choice.\(^58\) For example, some poor people are not willing to spend on health because they do not expect to live a long life. Or it might be possible that their lives are so miserable that they do not want to live for a long time. In addition, the poor might spend on entertainment and alcohol to relieve the stress of their miserable lives. The poor enjoy such products as much as affluent people do, and maybe even more so, given their rather miserable lives.\(^59\)

In addition, many studies suggest that the poor always have to face difficult choices, and that they cannot afford temptation. Abhijit Banerjee and Sendhil Mullainathan (2009) argue that the relationship between temptation and the level of consumption plays a key role in explaining the observed behavior or the poor.\(^60\) This is to assume that the individuals know that they will be just as tempted in the future by these items as they are today. If a cigarette costs twenty-five cents, for example,

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then that twenty-five cents will be far more expensive to the person living on $1.25 a day than to the person living on $25 a day. In other words, while the person with higher income and the person with lower income might face the same self-control problem, the consequence of the decision to buy the cigarette is more costly for the poor person. Twenty-five-cent coffee accounts for twenty percent of the daily income of a person who make $1.25 a day, whereas it only accounts for one percent for a person who makes $25 a day. The poor person would rather spend the money on coffee today than spend on coffee tomorrow, as they know that they will need to buy cigarettes in the future anyway. Considering their unstable and unpredictable income, they might be making $1.00 tomorrow and coffee will account for twenty-five percent of their daily income, rather than twenty percent. The coffee might be more expensive tomorrow than today because the poor may earn less income and thus the coffee would capture an even larger percentage of their income. Banerjee and Mullainathan’s research help to explain why the poor often behave as if they were myopic: Borrowing at a very high interest rate, failing to organize what appear to be high return divisible investments or accumulating enough to buy non-divisible investments. This is because the poor value a dollar of consumption today at least as much as, or more than, X dollars of consumption tomorrow.

In 2010, Dean Spears of Princeton University conducted a randomized experiment which shows similar result to Banerjee and Mullainathan’s study (2009). Spears (2009) found that economic decision-making had negative effects on
performance or behavior when participants were poorer.\textsuperscript{61} This may be because for poorer participants, decisions required more difficult trade-offs, and were more depleting of cognitive resources. For the people who make $25 a day, deciding whether to buy toilet paper only requires considering whether you want it, not what you might have to give up to get it. Many of the trade-off decisions that the poor have to make every day are difficult and depressing: whether to pay rent or buy food; to buy medicine or winter clothes; to pay for school materials or loan money to a relative. Making these choices in everyday life is stressful, and just thinking about them seems to have a mental cost. This might lead the poor to make bad economic decisions, such as trying to lower their stress by using alcohol or drugs.

While it is not difficult to rationalize the consumption choices of the poor, it is problematic that the poor do not spend enough on their own nutrition, health and education. They do not think about the future in a way that is more likely to take them out of poverty, instead doing things like spending on alcohol rather than saving for investment or their children’s education. In this sense, the poor are poor because they behave like poor people. They will continue to be poor because they live and spend like the poor. They have a low saving rate, low investment in education, low income, little or no healthcare, etc. Regardless, they do not have the will to change these conditions to improve their lives.

This raises the question that if we want to help the poor escape poverty, what should we be focusing on? On the one hand, part of the problem of poverty can be

solved if we can eliminate some causes of poverty, for example lack of access to resources and infrastructures. But on the other hand, solving other parts of the problem of poverty might require that the poor undertake some behavioral changes.

If the poor were to have access to resources they typically lack, would that change their behavior in a productive way? Specifically, if the poor have access to low-cost capital or have access to savings accounts through microfinance institutions, will they spend money on education or other long-term investments, or will they save more? Before moving on to Chapter Two where I will answer these questions elaborately, I will briefly respond that the lives of the poor can improve if they are granted access to low-interest-rate credit and other financial services that microfinance has to offer. Nevertheless, the magnitude of success depends on how much the poor can utilize their economic opportunities and how they can appropriately make use of the financial services.
Chapter Two

2.1 Who Is Microfinance For?

As of December 31, 2010, 3,652 microfinance institutions reported reaching 205,314,502 clients, 137,547,441 of whom were among the poorest when they took their first loan. Of these poorest clients, 82.3 percent, or 113,138,652, are women.

- Microcredit Summit Campaign Report 2012

In most settings, however, microfinance does not reach the people at the very bottom of the socioeconomic scale—the “poorest.”

- Syed Hashemi, and Richard Rosenberg
  “Graduating the Poorest into Microfinance”

These two statements contradict one another. The first statement claims that microfinance institutions reach the poorest of the poor, accounting for 67 percent of all microcredit services. However, the second statement suggests that, in most settings, microfinance does not reach the poorest of the poor. Who exactly are the target group of microfinance?

To clarify this confusion, it might be useful to separate the group of low income people into three groups (Group A, Group B, and Group C) based on discussions of poverty and World Bank data. This analysis will shed light on how financial services, namely access to capital and savings accounts provided by microfinance institutions, can or cannot help different groups of low income people.

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The above graph shows the percentage of people in the world with different income levels. If we group people according to their level of income, it is possible to roughly estimate the number of potential clients for microfinance institutions. The first grouping of low income people, Group A (the bottom fifty percent of people living below the poverty line) accounts for 4.07 percent of the world population. The second group, Group B, people with PPP between $0.63 and $1.25, accounts for 18.37 percent of the world population. The third group, Group C, people with PPP between $1.25 and $4, accounts for 46.12 percent of the population. In Stanford Social Innovation Review, Ignacio Mas and John Stanley estimated that less than thirty percent of people in developing countries have access to formal

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64 ‘PovcalNet: the on-line tool for poverty measurement developed by the Development Research Group of the World Bank’ and provide the URL to PovcalNet. Add description
financial services. In addition, the other 70 percent are not getting help from banks and other formal financial institutions to manage the small resources that they have or to invest to improve their livelihood options.

How can access to financial services help the poor? In the past three decades, one of the most prominent development ideas seeking to provide financial services for the poor has been microfinance. The basic idea of a microfinance institution is that it provides access to low cost capital to a group of individuals. This group of individuals will use the capital they are granted to start or invest in their self-employed businesses. Eventually, their businesses grow and help them generate more income—enough increase in income so that they no longer have to face constant risks of falling back into poverty.

However, microfinance is not for all low income people, and it is not suitable for the first group of the poor, Group A, who constitute the bottom fifty percent of households living below the poverty line. These are the poor whose problems of poverty are complex and are not limited to being denied access to financial resources. This group of people does not have any assets and they live in exceedingly miserable conditions. They are mainly disabled and/or mentally ill people, child laborers, and displaced persons. Having no security that they can cover basic needs, particularly for food, they suffer from extreme malnutrition and are consequently at risk of disease. This group of people might have a chronic problem that prevents them from

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66 Ibid.
working. They might be addicted to drugs or alcohol to the point that they cannot work at all. They have to manage on a regular basis with half-empty stomachs and frequently skipping meals.\textsuperscript{67} The consequent malnutrition leads to frequent morbidity, and general ill health. These illnesses or disabilities keep them from any kind of work, including running their own businesses. They might have irreversible mental illness, in addition to physical illnesses. Due to their health condition, their income may come from government welfare programs or from charitable aid. Their households might be located farthest from roads, markets, schools, and health services.\textsuperscript{68} They do not know where education can take them, or how to receive appropriate healthcares. This group of people is less likely to be literate. Their children may not attend school. Without education, there is the potential that these children’s lives will be a distressing echo of their parents’. Group A might constitute people from ethnic minorities in the countries.\textsuperscript{69} These may be people who migrate illegally from other countries, and/or are children of illegal migrants. They do not have citizenship and are deprived of the basic needs that a country has to offer to its citizens. A child of illegal migrant Burmese to Thailand, for example, cannot enroll in Thai schools even though he was born in Thailand because he does not have


\textsuperscript{69} According to the International Food Policy Research (IFPRI), ethnic minorities have consistently higher prevalence of poverty and hunger, especially in Asia. In Laos and Vietnam, ethnic minorities in upland areas experience a higher probability of being poor. In Sri Lanka, the incidence of poverty is highest among Tamils, and in India, disadvantaged castes and tribes consistently experience deprivation in a number of dimensions. For example, tribal people in India are 2.5 times more likely to live in extreme poverty than others. In Latin America, indigenous peoples are overrepresented among the poor. - http://www.ifpri.org/sites/default/files/pubs/2020/dp/vp43/vp43execsum.pdf
citizenship. They are poor but they are not eligible to participate in any form of legal
and formal institutions.

What Group A needs is not access to capital. An example of Group A can be seen in the poorest people in Sub-Saharan Africa. They operate day to day with little to eat and suffer from malnutrition and malaria. Those who are addicted to drug or alcohol need not credit, but rehabilitation and healthcare. Furthermore, for the poorest of the poor who live in very remote areas without access to schooling, electricity, and healthcare, government programs that offer them relocation might be necessary. An example of this is people who live in the rural desert area in Northern China where there is no water because of climate change. If they have access to credit, but do not have access to water, what can they do with the money? They can buy seeds but cannot grow any crops because there is no water.

Giving this group of people access to capital will not solve the problem. We must conclude that what this first group of people needs is not access to capital, but access to resources to fulfill their basic needs, such as food, healthcare, and electricity, etc. This work should be done by governments or charities. This is not because low income people are not deserving of capital, but because they need more help outside the scope of services microfinance institutions can provide.

Microfinance, however, works for Group B, namely people with PPP between $0.63 and $1.25—the top fifty percent of the people who live below the poverty line. Unlike Group A, Group B may not have to worry about basic necessities like food, water, shelter, and clothing every day and all year round. In addition, they are
economically active: they are either employed or actively seeking employment: They may be able to generate income for one day and able to buy food for that day, but they might not generate income the next. They are still highly vulnerable to adverse effects that interrupt their income, such as ill health, lack of education, natural disasters, and irrational spending.

Group B is a group of low income people whose lives would improve if they were granted access to credit. However, in order to help them to get out of poverty, the financial institutions might be obligated to provide the borrowers more than just credit. While they do not require as much additional help as the first group, they still require additional training and skills. With access to credit, they could become more like the middle class and change their spending and consumption patterns. However, this process would very costly for the financial institutions and they cannot be independent from donors and be financially sustainable only with profits generated by their operations.

Lastly, the third group, Group C, are low income people whose lives would be improved if they have granted access to credit and formal savings, a perfect fit for microfinance institutions. They are people who live above the poverty line and they account for nearly 50 percent of the world’s population live between $1.25 and $4 a day. Having access to credit is one of the few missing ingredients that they need to rise of poverty and decrease their vulnerability.

Credits can be a very efficient means of helping Group C, who already have a somewhat reliable (but too small) source of income. With some source of reliable
income, they do not have to use the loan for consumption smoothing as much as the second group. They can channel the credit they take and use it more fully as working capital or investment capital. Access to capital can be very effective for those who already have experience in running their own small enterprises. A loan allows a small-business owner to buy machines or tools or inventory space, or to start buying supplies up-front in large scale. In addition, it also allows some breathing room they need to manage their cash flow or other payments.

While Group B needs additional assistance, individuals in Group C demand different types of services. They prefer low interest rates that do not have additional limitations, such as the group lending method. Thus, it is important to separate the types of services of these two groups of low income people.

The idea of microfinance institutions helping Groups B and C is very attractive to donors: The idea of helping the poor to help themselves, instead of spoon-feeding them. It was believed that microfinance institutions would be able to help the poor to be financially independent. Low income people would learn how to lift themselves up from impoverished conditions by their own abilities and this skill would remain with them for the rest of their lives. This might continue to the next generation and would finally help to end poverty. It is a beautiful idea that has been promoted by many success stories in real lives, although not all attempts have been successful.

While there are many success stories, there are also many failures. Within this group of people who are the target group of charitable microfinance institutions,
there may be a number of clients who choose to spend “irrationally.” If granted microcredit, they may spend it on weddings, festivals, and entertainment, rather than investing the money they are offered. For such people to be able to take loans out easily is rather dangerous and harmful—they can easily become over-indebted. Close monitoring and financial management training are essential for this group of poor people.

The change in rational behavior is largely necessary for Group A and some individuals in Group B. While changing the poor’s behavior might be the key to ending poverty, it is beyond the scope of this thesis, which focuses on the operation of sustainable microfinance institutions. Changing the poor’s thinking or behavior requires long-term programs such as education and welfare policy, something that should be conducted by governments because they have more suitable tools and resources. Although it is difficult to measure how effective governmental policies have an indirect impact on the poor’s behavior, Chapter Four will try to propose how the government can create a friendly macroeconomic and political environment to fight poverty.

Contrary to the United Nations’ hope that micro-entrepreneurs will develop thriving businesses that lead to flourishing economies, most microenterprises are small and many fail. This should not be too surprising because people not necessarily entrepreneurial by nature. Some of people do not want to take out loans, but have to do so out of necessity. To ensure that this type of loan to poor people can be successful requires great monitoring, which is very costly. So, the service that
charitable microfinance institutions try to provide this group of people is to give them the skills, vision, creativity, and persistence to be entrepreneurs. To perform these services for the poor is very costly. The microfinance institutions cannot be financially sustainable if they try to provide their services without subsidies for this necessary educational work; the loans cannot have the desired effect without these costly education supports.

Let us return to the question at the beginning of this thesis, if we want to help the poor, how can we help them? By examining the poor by degree of poverty, it is clear that giving all poor people access to low cost capital, the basic idea of microfinance, is not the silver bullet to end poverty. Microfinance does not work for Group A. Furthermore, while some microfinance institutions that target Group B might have a positive impact on poor people’s lives, the resources and costs that a microfinance institution has to invest are too much for them to be able to be financially sustainable without dependence on donors or external funds. These types of microfinance institutions thus run more like charitable business, than commercial financial institutions.

The “poorest of the poor” mentioned in both statement does not refer to Group A since they are clearly not the target for microfinance institutions. The term “the poorest of the poor” refers to the bottom half of individuals in Group B. They are the individuals who generally intersect the various definitions of extreme poverty: landlessness and limited access to basic education and healthcare. While access to capital will help the second group of the lower income improve their lives, it is not
enough to get them out of poverty. Individuals in Group B, especially the bottom half of the group, need additional programs to help them take full advantage of the microloans. A microfinance institution that seeks to be financially sustainable has to target Group C. This is because they are ready to be served, while they still lack the opportunity to invest, to gain access to formal financial institutions. Group C would demand different types of products from Group B.

Different approaches to serving these two different groups of low income people have been practiced before through agricultural development banks and informal money lending. The “charitable microfinance” approach which targets the poorer poor (Group B) has similar characteristics to the agricultural development banks initiated in the 1960s and the 1970s, while the “sustainable microfinance approach,” which targets the richer poor (Group C), is more similar to the informal moneylenders. Thus, it will be helpful for us to understand the background of the agricultural development banks and informal money lending to better understand the bases of the two approaches to microfinance.

2.2 Before Microfinance

2.2.1 Agricultural Development Banks

Microfinance institutions are not the first institutions that have tried to help the poor by providing them with access to capital. Governments have frequently attempted to use financial markets to pursue a broad range of economic development objectives. However, according to Adams, Graham, and Von Pischke (1984), their
attempts usually had disastrous financial consequences for the institutions that provided the programs.\textsuperscript{70}

Similar to microfinance institutions, state-owned agricultural development banks were created in the 1960s with the objective of supplying either the longer-term agricultural credit that the commercial banks were not prepared to grant, or the loans "needed" by risky clients. These clients were small and medium farmers who lacked access to financial services in the conventional banking sector, but were considered to be a priority of development programs by the governments of developing countries. These state-owned agricultural development banks received the largest share of their funds from international donor agencies, national or local governments, or central banks. The participants in the bank’s program were granted credit at subsidized interest rates. Similarly to charitable microfinance institutions, Gonzalez-Vega (1990) suggests that these public-sector funds were channeled to receivers who frequently were not creditworthy.\textsuperscript{71} In general, agricultural development banks have focused on providing credit rather than on accepting deposits, a practice that has undermined their viability.\textsuperscript{72}

These agricultural development banks found it difficult to remain financially viable. Most of the banks became insolvent; many of them became insolvent several times over the years. When insolvency occurs, banks need additional capitalization. In many developing countries, the process of adding capital to the banks required the institutions to change their names and managers. Despite these changes, many

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{71} Gonzalez-Vega, Claudio, “On the Viability of Agricultural Development Banks: Conceptual Framework,” Economics and Sociology Occasional Paper No. 1760, Columbus, Ohio: The Ohio State University, 1990, 3.
\end{itemize}
\end{footnotesize}
agricultural development banks became insolvent again, because the same operations were performed.

This would not have been a problem if the banks still had financial support from their donors: international donor agencies, governments, and other donors. However, during the global economic recession in the early 1980s, governments and central banks in developing countries faced economic difficulties and had to withdraw their support for money-losing development banks. Several of these banks have been dismantled (Bolivia), a few have been privatized (Gambia), a few have been allowed to go bankrupt (Banco Anglo in Costa Rica), some have benefitted from more or less successful restructuring efforts (The Dominican Republic, Nicaragua), but most have dissolved.\(^\text{73}\)

This problem of funding is similar to the charitable microfinance institutions whose objective is poverty alleviation and development, rather than creating sustainable financial institutions. Although the development programs implemented by agricultural development institutions had a positive impact that helped rural farmers, the institutions were financially unsustainable. Hence, a brief analysis of why agricultural development banks fail is helpful to explain why charitable microfinance institutions cannot operate without funds from their donors.

Many factors contributed to the shortcomings of agricultural development banks, such as repressive regulation and political intrusion. However, the main problems were information asymmetries and monitoring difficulties. Information asymmetries come from the complexity of agricultural finance. Agricultural

production is complicated by natural factors, such as the heterogeneity of soils and climate across and within regions. These conditions make it difficult to estimate the income of loan recipients and how much of a loan they can manage. Given the differences of productivity and the comparatively high incidence of location-specific factors and exogenous shocks on yields, it is very difficult to determine the extent to which negative outcomes reflect levels of effort by the recipients or simply conditions beyond their control in their operations. Monitoring how recipients actually used the subsidized credits was extremely costly and often inaccurate. It was very difficult for bank headquarters to determine if defaults in their areas of responsibility were due to fraud or hardship. The recipients might use the loan to buy a motorcycle, instead of investing in their farm, and then blame the money loss on a crop disease.

This is very similar to the problem that charitable microfinance institutions face. Similarly to agricultural development banks, they often do not have any guarantee or information on how their clients actually use their loans. Clients are unsure whether they should use the capital for consumption smoothing, for entertainment, or for investment. Costly monitoring efforts make the provision of agricultural loans very expensive for agricultural development banks.\(^{74}\) However, charitable microfinance institutions tried to solve this monitoring problem with “joint liability” in the group lending method. This will be revisited in Chapter Three.

Another reason that agricultural development banks often failed to be financially sustainable was because they did not seek, as a key objective, profitability and financial viability. What they pursued were development objectives, i.e. growth

of agricultural production, adoption of new technology, agrarian reform and regional
development. These agricultural development banks were specifically created to
promote the growth of agricultural production, regional development, and the
adoption of new technology. They were created to promote the “Green Revolution”
in developing countries.\textsuperscript{75}

The operation of state-owned agricultural development banks was focused on
borrowers’ interests. All practices and procedures were designed with the borrowers’
benefit in mind, and not for the sake of the institution's viability.\textsuperscript{76} As a result, the
rapid disbursement of funds was favored by borrowers, and the clients targeted for
subsidized credit were chosen independently of repayment capacity and without
reasonable guarantees of loan recovery.\textsuperscript{77}

For agricultural banks, the clients feel that they are entitled to get the loans as
part of the welfare that they should receive; they do not think about the credit as a
loan that must be repaid.\textsuperscript{78} The attitude of loans as welfare resulted in a high rate of
default in lending programs by the agricultural development banks. Furthermore, as
long as there were still funds from international donors or from the government,
managers of agricultural development banks were not concerned with financial self-
sustainability or profitability. They were not concerned with revenue-enhancing
pricing policies. The concern of the managers for the institution’s viability had been

\textsuperscript{75} The “green revolution” encompasses “the application of science to increasing agricultural productivity,
including the breeding of high-yield varieties of grains, the effective use of pesticides, and improved fertilization,
irrigation, mechanization, and soil conservation techniques,” according to the American Heritage Science
Dictionary.
\textsuperscript{76} Gonzalez-Vega, Claudio and Douglas H. Graham, “State-Owned Agricultural Development Banks: Lessons and
\textsuperscript{77} Ibid., 14.
\textsuperscript{78} Ibid., 6.
subordinated to the pursuit of non-financial objectives.\textsuperscript{79} Despite some success in providing knowledge and financial services to rural farmers, high default rates deterred donors and governmental supports for agricultural development banks, especially during severe economic periods. As a result, some banks ceased to exist. In order to continue providing financial services, some banks had to reform themselves into commercialized and financially sustainable institutions.

### 2.2.2 Informal Money Lending

Unlike commercial banks, informal moneylenders were able to provide loans to the poor because they had access to information that could lead them to the people who were most likely to pay back their loans. Informal moneylenders are local landlords and traders, small businessmen, village shop owners, and relatives. Unlike commercial banks that cannot easily determine which borrowers are likely to pay back loans, informal moneylenders are often the people in a community who have certain types of relationships with the borrowers. These relationships between the borrowers and lenders outside the scope of just lending or borrowing money have an impact on the trust that the lenders have in the borrowers and vice versa. Informal moneylenders might be as close as a relative would be to the borrowers; they might be respected people in the borrower’s community or they might share the same race or ethnicity.

One way to have access to capital is to borrow from neighbors and friends by forming a Rotating Savings and Credit Association (ROSCA). ROSCAs can be

\textsuperscript{79} Ibid., 15.
formed spontaneously by groups of individuals who agree to regularly contribute money to a common “pot” that will be allocated to one member of the group during each period. The money can be collected weekly, bimonthly, or once every month, for an agreed period of time. In addition, the member who wins the bid is free spends this money on anything he or she wants. For example, a group of twelve people may agree to put $10 every month into the pot of $120. If they decide to collect the money monthly, then the members of the group will bid on the pot every month. Once that member takes the money, the member has gotten to wait until everyone in the group gets to take the money in subsequent rounds, to bid on the money again. During this waiting time, every member has to continue paying their share of $10 every month.

Note that this process allows individuals to have access to large sums of money, but the cost of accessing to the capital might differ depending on how much the member wants the loan. The last person who takes the loan would have a free bid, because no one would be available to compete in bidding, whereas the first person who wants to take the loan in the earlier rounds might have to compete with other members in the group and bid at higher cost to get the sum of money.

For example, if both A and B want to take the sum of money in the first bid, A might decide to bid with $2 and B might choose to bid with $5. This means that B wins the sum of money in this first bid, and A has to wait for two months to bid on the pot again. After taking the sum of money, B will have to wait for the other eleven

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81 Unlike group lending in microfinance, members of ROSCA are not expected to be or to become entrepreneurs. However, many microfinance organizations use modified-ROSCA in microfinance. An example of this is the “Self Help Group.” This will be discussed with P4K credit program in the case study in Chapter Four.
members in the group to take their share for another 11 months. The $5 that B bid may be distributed equally to each member within the group. Hence, B will receive $235 of the sum of money. Usually the money from bidding is used to stimulate social bonding within the group. The member might decide to use this money to go to restaurants and celebrate the member who wins the bid. The last person who takes the sum of money has an advantage of not having to bid against the other member. Hence, the last person who waits to take the sum of money receives the full amount of the agreed sum of money at $120.

Nevertheless, because there is no contract between the members participating, the risk that a ROSCA will fall apart is quite high. For example, the member who collects the money from every member in the group might run away with the sum of money. To limit this risk, the members must be able to access information about other members in the group. ROSCA members meet frequently to keep track of one another. In addition, while the monetary cost of accessing a lump-sum of capital might be lower in ROSCAs when compared to other types of informal moneylenders, the social consequences to the borrower of not repaying the credit is relatively high. People who break the group agreement may face social sanctions. For example, members who renege may lose their credit and good image within the community. They may be excluded from social and religious events. Anderson, Baland, and

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Moene (2010) argue that in some cases there might be a use of force to obtain good from members who fall behind in their obligations to be resold.  

In addition, informal moneylenders can easily obtain information at a relatively low cost. Because moneylenders often live and work in the area of their borrowers’ financial operations, they can follow up on their outstanding loans. Further, moneylenders may observe whether their potential borrowers are spending their money on gambling, alcohol, or other frivolous consumption of goods. They might choose not to provide loans for these groups of potential borrowers.

However, there is another type of informal moneylender who performs predatory lending. Unscrupulous moneylenders do not expect loan repayment, but borrower default, the moneylenders can target groups of potential borrowers who have frivolous patterns of consumption and who are less likely to be able to pay back. The moneylenders are aware that these groups of borrowers are likely to default on their loan, and therefore may create contracts that allow them to gain the borrower’s land, labor, or other services at a cheaper price than the market value of these assets. This kind of predatory lending is what “loan sharks” do. Unlike informal money lending from close relatives where they may charge zero interest rate, predatory moneylenders may impose outrageous interest rates on the borrowers to ensure that their borrowers will not be able to pay back the loans.

Furthermore, lenders can minimize risk through connections that they have with people who have a direct relationship with their borrowers. For example, in

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Thailand, moneylenders might target people who are low-ranking officers in the local government. They might ask that borrowers give them their identity card or passport to prevent them from defaulting. If borrowers fail to repay their loans, the moneylenders may report to their office chief and the borrowers could lose their jobs.

An example of the outside relationship can be seen in the informal moneylenders in Southeast Asian and other East Asian countries. In the Philippines, moneylenders are often referred to as “Bombays,” after the Indian city Bombay.87 These informal moneylenders are of Indian ethnicity, living in the Philippines. “Bombays” operate in cities, and they provide small 5/6 loans to other people of Indian ethnicity in the Philippines.88 The 5/6 loans mean the loan charges an interest rate of 20 percent; meaning for every five pesos borrowed in the morning, six pesos must be repaid by the evening.89 Interest rates on loans provided by informal moneylenders can range widely. The interest rate can be zero, such as close relatives lending to one another. Or, as shown in the example of Bombays, an interest rate of 5/6 accounts for an effective monthly interest rate of 23,638 percent. A moneylender can also choose to charge different rates of interest to different groups of borrowers based on their information on the borrowers and borrowers’ credit history.

The default rate on loans is quite small, despite the high interest rate that informal moneylenders charge. Timberg and Aiyar (1984) report in their study that the default rate is as low as 0.5% of working funds for informal lenders.90 In contrast,
they report default rates of up to 60% for formal lenders (state-owned commercial banks). This low default rate might be due to information about the borrowers that informal moneylenders hold. Robinson (2001) suggests that moneylenders struggle to find low-risk borrowers available to lend their money to. 91 From an interview with an Indian moneylender in the Philippines, he suggested that only 15 percent of new customers are good enough for him to continue lending to, and the other 85 percent are too risky. 92 Informal moneylenders do not only choose to lend to those borrowers that they can access to good, cheap information about the borrowers. Similar to the interviewed Bombay, informal moneylenders also use information about borrowers to calculate the chances of having their money repaid.

Information is not only important for moneylenders, but also for borrowers. Given the generally high quality of lenders’ information about their borrowers, a borrower can face high risk if they default or depart from their usual moneylenders and seek new moneylenders. New moneylenders might refuse to lend money to the borrowers because of the risk of collecting loans in another moneylender’s territory. Furthermore, the borrowers might get into trouble if their current moneylender knows of their attempt. The current moneylender might get insecure and may require immediate repayment of the loan from the borrower. Moneylenders who are also the employers of the borrowers are concerned that the borrowers might be thinking of leaving their current jobs. As a result, they might want to make sure that the borrowers repay the loan before leaving the job.

92 I owe this information to my friend who lives in the Philippines Malilay Timbancaya.
Another scenario may be that informal moneylenders become involved with gang members who also practice other malicious activities. These moneylenders operate in developing countries, where the rule of law cannot intervene or prevent the moneylenders from performing illegal activities such as harming the borrowers when they do not repay their loans. These gangs might have an agreement that they will not lend money in the territory of the other gangs. As a result, the moneylenders might refuse to give the borrowers loans because they do not want to lend outside of their networks. These moneylenders operate under a variant of monopolistic competition. Without competition, the moneylender may charge the borrowers at a usurious interest rate. In sum, borrowers are faced with limited options in terms of their access to capital, as there are a limited number of commercial lenders in the informal sector.

While governments try to impose usury laws in some countries, this often does not have an effect on informal money lending activities. This is because of the informal nature of such lending activities. For example, in the case of Bombays in the Philippines, there is no collateral and no paperwork to show the financial relationship between borrowers and lenders. Because there is no collateral or paperwork in the lending process, it can be concluded that borrowers choose to repay their loans because they want to maintain a healthy relationship with their last resort financiers.

Furthermore, informal moneylenders also have substantial flexibility and may allow the poor access to capital in desperate circumstances. While the banks close at

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midnight or may be physically far away from the borrowers’ residences, informal moneylenders may be the neighbor of the borrowers who can provide them with a $6 loan at midnight. The borrowers might choose to borrow from the moneylenders instead of the banks, because they are more flexible and provide more convenient access to credit.

Understanding how informal moneylenders operate their businesses is useful in understanding how microfinance institutions operate and how commercial banks seek to provide credit services to the poor. Unlike the informal moneylenders, regular commercial banks could not easily determine which customers are likely to be at a higher risk of default than others. As a result, they cannot provide a wide range of interest rate, for example, providing lower interest rates for low-risk borrowers. Instead, to cover the probability of default with limited information, banks have to raise interest rates for everyone.\textsuperscript{94} Unfortunately, this often drives safer borrowers out of the credit market. Hence, a major task of formal money lending institutions is to solve the problem of asymmetrical information between lenders and borrowers.

Secondly, unlike informal moneylenders, banks do not have information to prevent moral hazard which occurs when the borrowers have incentives to engage in activities that make them less likely to pay back their loans. Banks are unable to ensure that customers are making the full efforts required for their investment projects to succeed. The moral problem occurs when the receivers of the loan use the money for outside purposes. Unlike the informal moneylenders who can more easily acquire information on what their borrowers do with their money, the transaction cost for

\textsuperscript{94} Armendariz and Morduch, \textit{The Economics of Microfinance}. Cambridge, MA: MIT Press, 2010, 36.
banks to monitor their borrowers is greater. Moral hazard also arises when customers try to run away with the bank’s money. These problems are made in regions with corruption and weak judicial systems, where it is difficult to enforce contracts. These problems could be eliminated if banks had cheaper ways to gather and evaluate information on their clients and if they were to enforce contracts. Microfinance institutions that seek to be financially sustainable can learn from informal moneylenders. Particularly, the screening process of the moneylenders will be crucial for the sustainability of the microfinance institutions.

The next chapter will discuss how microfinance institutions combine the advantages of agricultural development banks and informal money lending, and how microfinance institutions try to overcome the limitations of agricultural development banks and informal money lending.

95 Ibid., p. 39.
Chapter Three

3.1 Microfinance Institution: A Hybrid Between Agricultural Development Bank and Informal Money Lending

Microfinance institutions seek to provide financial services for poor and low-income clients, and improve the lives of the poor. Initially, the financial product that microfinance institutions offered was limited to providing microcredit for the poor. However, microfinance institutions later came up with new products such as savings, housing loans, insurance, remittance transfers, and providing guidance and skill trainings. Microfinance institutions that provide microcredit services aim to fulfill the banking services that are missing for the poor. The idea is that if the poor were able to have access to financial services that would help them save their money and give them low interest loan to expand their existing businesses, their lives would be improved.

Mohammad Yunus, a Nobel Laureate and the founding father of microfinance suggests that the problem of poverty stems from a lack of inexpensive access to capital—what the poor need is low-interest-rate loans. Yunus believes that if the poor were to have enough capital to make their businesses large enough to have some efficiency or obtain some economies of scale, then they would be able to generate not only adequate income, but would gain confidence and change the way they think.

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96 Almost like a fairy tale, Muhammad Yunus started the great microfinance movement by making a loan of $27 to a group of women in Jobra, Bangladesh out of his own pocket. - Armendariz and Morduch, The Economics of Microfinance, 11.
about their lives. If poor individuals could be encouraged to expand their existing income-generating activities, or start a new line of work, their lives, and the lives of those around them, would be improved considerably. Once the poor are able to support themselves financially, have some money left for savings, and have a channel to put their money to productive use, their way out of poverty would no longer be out of reach. In sum, the poor need capital not only to solve the problem of scale in their own businesses, but also to give them hope and confidence for the future. While there are many successful stories that support Yunus’ claim, this approach does not work with all low income groups, and certainly not Group A as described in Chapter Two. In this context, the poor, and often the poorest of the poor, that Yunus seeks to serve belong to Group C and Group B.

Microfinance institutions act as a hybrid between the agricultural development banks and informal moneylender. Similarly to agricultural development banks, microfinance institutions target the poor. One of their goals is to improve the quality of life for poor clients. Similar to informal moneylenders, microfinance institutions rely on the incentive of their clients to repay their loans. And like informal moneylenders, microfinance institutions want their clients to repay their loans so that they can re-channel the money into lending more credits to the poor.

Similar to agricultural development banks that aim to improve the productivity of rural farmers, microfinance institutions seek to improve the productivity and income of the poor from their small enterprises. However, unlike

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agricultural banks, microfinance institutions do not only target farmers, and microfinance borrowers operate a wide range of businesses. Microfinance institution focuses on individuals who are financially excluded, those who lack access to appropriate and affordable financial services and products. For example, the focus of microfinance institutions that work to fight poverty, such as the Grameen Bank, is women—because women have traditionally been a disadvantaged group with limited access to land ownership, formal employment opportunities, and credit and other financial services.\textsuperscript{99} In many parts of the world, women are discriminated against in the work force. As suggested in the earlier section, in some developing countries, specifically in North Africa, women do not have an opportunity to inherit land. Women are also more likely to “invest” earnings in their families’ wellbeing.

According to the United Nations Economic and Social Commission for Asia and the Pacific, the restriction on women’s labor market participation and access to schooling costs up to $80 billion annually. Costa and Silva (2008) show in a study of selected Latin American countries that removing gender-based barriers to the labor market would lead to a significant reduction in the poverty rate.\textsuperscript{100} The graph of employment population ratios suggests that female participation in the work force is lower than male in every specified region. Particularly, female participation in the workforce is significantly less than that of males in North Africa, the Middle East, and South Asia.

\textsuperscript{99} Yunus, Muhammad, and Alan Jolis. \textit{Banker to the Poor: Micro-lending and the Battle against World Poverty}. New York: PublicAffairs, 42, 46, 73-78.
Of the poorest clients reported at the Microcredit Summit 2012, 82.3 percent, or 113,138,652, are women. Therefore, targeting female borrowers makes sense from a poverty alleviation standpoint. It would allow women, who have been blocked from formal employment, to have jobs and earn an income. Microfinance institutions help to strengthen women’s financial base and their economic contribution to their families, and increase their self-esteem. Women also contribute larger portions of their income to household consumption than their male counterparts. Although microfinance institutions do not have this impact on every woman that they serve, the majority of women who participated in microfinance institutions have benefited from the programs. Serving women fulfills the purpose of microfinance institutions in providing financial services to a group faced with the problem of financial exclusion.

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According to Lewis (1969), providing access to institutions, in this case financial inclusion, contributes to fighting the “culture of poverty.”

Similar to ROSCA, microfinance institutions make use of social ties. This is translated into the “Group Lending” method. In a ROSCA, participants do not need to have collateral to confirm that they will contribute their share to the group. Similarly, microfinance institutions often do not require collateral from their borrowers. Most importantly, ROSCAs are based on trust and the relationships of members to monitor and make sure that other members in the group will not break the agreement. Because members of the group know that there is a risk a the member of the group will take the money and stop following the agreement, the incentive in forming the group is that those who are likely to abuse the agreement will not be invited to join. They use social ties as liabilities and guarantees for their agreements.

Similarly, group lending in microfinance institutions works by giving the members of the group the requisite incentives to solve information problems. Like ROSCAs, the group lending method requires members of the group to share their responsibilities. This is called “joint liability.”

This “joint liability” condition is the most celebrated feature of the Grameen contract, and it is why microfinance is so closely associated with the idea of group lending. The group lending method requires individuals to form groups voluntarily and take credit out as a group. Grameen Bank groups consist of five borrowers each, and the loan go first to two members, then to another

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102 See Chapter One.
two, and then to the fifth. The rule is that as long as loans are being repaid, the cycle of lending continues. This is similar to a ROSCA where as long as every member of the groups continues to pay their share, the ROSCA continues to operate. For microfinance institutions including the Grameen Bank, if one member defaults on a loan and fellow group members do not pay off the debt, every member in the group is denied subsequent loans. This feature gives customers powerful incentives to repay promptly, to monitor their neighbors, and to select responsible partners when forming groups. Moreover, the five-member group is part of a “center” composed of eight groups. Repayments are made in public before the forty members of the center in weekly installments. Similar to ROSCA, Grameen Bank’s group lending method takes advantage of local information, peer support, and, most importantly, peer pressure. The mechanism relies on informal relationships between neighbors that facilitate borrowing for poor households that lack collateral. The program thus combines the scale advantages of a standard bank with mechanisms used in traditional modes of informal finance.

107 Armendariz and Morduch, The Economics of Microfinance, 28.
“Joint liability” mitigates the information problem by helping to distinguish different types of borrowers: risky and safe borrowers.108 Because the groups are encouraged to form their own partners, potential borrowers can use information gained through informal relationships between neighbors to recruit the best partners for their groups. The incentive is the joint responsibility for loans. Safe borrowers are better off grouping with other safe borrowers because grouping with risky borrowers would create a higher chance that they will have to cover the loan defaults. According to Jonathan Morduch, this leads to a segregated outcome or “assortative matching.”109

As microfinance institutions are able to differentiate between safe and risky types of borrowers, they can charge different interest rates based on the risk that the banks have to bear. This method helps transfer the bank’s risk onto the risky borrower. Furthermore, with this method, safe borrowers pay lower interest rates than risky ones because they no longer have to cross-subsidize risky borrowers. Group lending methods help to solve the adverse selection problem by ascertaining the potential credit risk of the borrowers during the lending process. It is important to note that in group lending methods, the responsibility of discovering information and mitigating risk of the borrowers is pushed on the group members, instead of on the microfinance institutions. Like informal moneylenders who select borrowers whose credit riskiness the moneylenders have some information about, group members utilize local information that borrowers have about each other’s projects through the self-selection of group members in the group formation stage.

109 Armendariz and Morduch, The Economics of Microfinance, 89-93.
However, similar to the problem of enforcement that ROSCAs may face, the members of a group lending programs might abuse their agreement and stop their contributions to the groups. According to Grameen Bank, this is not uncommon.\footnote{Loan default rates increase after unprecedented flood in 1998. This is one of many reasons the Grameen Bank shift to the Grameen II model, which provides individual loans. - Dowla, Asif, and Dipal Barua. The Poor Always Pay Back: The Grameen II Story. Bloomfield, CT: Kumarian Press, 2006, 5-8, 141.} It can deter safe and risk-averse borrowers from joining the program. This is because they do not want to share the responsibility with other members in the group and they want to have full control of their credit. Similar to ROSCAs, the group lending method has little flexibility. In a ROSCA, a member can only take the pot during the agreed period. However, if they need money during the time when they cannot take the pot out, for example, in the case of an accident, they may have to find other ways to acquire a large sum of money. In the group lending method, a member can have access to new loans, sometimes a larger amount, only if the loans they have taken as a group are repaid fully and on time.

Charitable microfinance institutions are similar to agricultural development banks in that they focus on helping their borrowers, regardless of the borrowers’ ability to repay their loan. In addition, like agricultural development banks, charitable microfinance institutions also provide additional programs that prepare the poorest of the poor to be able to take advantage of the loans.

Similarly to informal moneylenders, microfinance institutions want their clients to repay their loans. They target women because women tend to have a smaller default rate on loans. In addition, microfinance institutions use incentive schemes, in addition to group lending, to make sure that their clients repay their loans. The first incentive is called a dynamic incentive—borrowers can have access
to additional loans if they pay back the initial loan. However, unlike informal
moneylenders, microfinance institutions have less flexibility. Some informal
moneylenders may allow their borrowers to make late repayments in case of
emergency, whereas microfinance institutions strictly require their borrowers to repay
their loans on time.

While moneylenders might allow their borrowers to repay a loan late, and do
so without imposing any penalties, some microfinance institutions may forbid their
borrowers to access new loans totally, if they do not pay the money back fully and on
time. This is one way that microfinance uses to screen individuals in Group B, if they
are not certain of their creditworthiness. Unlike informal moneylenders,
microfinance institutions do not have enough information on whether borrowers will
be able to repay loans in the future and how honest they are. To acquire this
information about the borrowers, microfinance may lend out small loans to this group
of individuals to see if they will in fact pay back. Compared to microfinance
institutions, informal moneylenders offer more convenience and flexibility to their
borrowers. This is because informal money lending is run at a much smaller scale
and they can access information about their borrowers more cheaply. According to
Siamwalla (2001) and his study of informal moneylenders in Thailand, commercial
informal moneylenders lend money to 45 borrowers on average.111 Note that small
scale is not a problem for lenders, but it limits the financial access available to
potential borrowers and cannot meet the borrowers’ credit demands. However, unlike

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111 Siamwalla, Ammar, Chirmsak Pinthong, Mipon Poapongsakorn, Ploenpit Satsanguan, Prayong Nettauarak,
Wanrak Mingmaneenakin, and Yuavares Tubpun. 1998. “The Thai Rural Credit System and Elements of a Theory:
Public Subsidies, Private Information, and Segmented Markets.” In K. Hoff, A. Braverman, and J.E. Stiglitz ed., The
Economics of Rural Organization: Theory, Practice, and Policy, New York, Oxford University Press, 278.
informal moneylenders, microfinance institutions lend to the poor at a much larger scale and have established a standard system for a larger group of borrowers. Most importantly, in asking their borrowers to repay loans fully and on-time, microfinance institutions seek to teach the poor financial discipline. Penalties if borrowers do not repay the loan fully and on-time signal to the borrowers that microfinance institutions are not just another free money-giving program. The borrowers from microfinance institutions see themselves less as beneficiaries, and more as clients of a financial institution.

The limitation of informal moneylenders in providing financial services for the poor is that they are only willing to lend to a small number of borrowers. This is because they would like to make sure that their clients will be able to pay back their loan or that they will be able to get something in return from the borrowers, such as labor, land, and other assets. Similarly, if a microfinance institution’s objective is to be financially sustainable, they want to make sure that their clients will pay them back. Thus, similar to informal moneylenders who use information to screen their borrowers, monitoring and screening for microcredit borrowers who are more likely to repay the loan is essential if microfinance institutions are to be financially sustainable.\(^\text{112}\) For a microfinance institution to be financially sustainable, it needs to increase its interest rate to a level that will make the institution sustainable, and able to target safe borrowers.

\(^{112}\) It is important to note that informal moneylenders do not only loan to safe borrowers; they also loan to risky borrowers who they expect will have no ability to repay their loans in monetary terms. Informal moneylenders increase interest rates for riskier borrowers. In addition, there are predators hoping to attach property and collateral from the borrowers. – See Chapter Two.
However, when microfinance institutions raise interest rates to reach financial sustainability, they are often compared to the informal moneylenders who charge excessive interest rates, so-called loan sharks. Mohammad Yunus offers a criticism of the type of microfinance that raises high interest rate for its borrowers. In a *New York Times* op-ed on January 14, 2011, Yunus wrote, “I never imagined that one day microcredit would give rise to its own breed of loan sharks.”\(^{113}\) Raising interest rates on loans is likely to improve financial performance, assuming inelastic demand. However, the social objective of improving poverty conditions for the poor is likely to diminish.\(^{114}\) Higher interest rates are seen at increasing the burden of the poor to repay loans that could lead the poor borrowers into a debt trap, that is, when most of their income has to be used to pay back loans. In addition, higher interest rate and larger loan size may attract the richer group of the poor, Group C or the top of Group B. Hence, the marginal poverty improvement may be less than when microfinance institutions lend to the bottom of Group B.

Yunus argues that this type of microfinance institutions leads the microfinance industry to “mission drift.” The institution moves away from the mission of helping


\(^{114}\) Note that there is no consensus on how the social performance of microfinance institutions can be measured. One of the simplest forms of measurement is the percentage of women among the borrowers. The measurement and impact on poverty of microfinance institutions can be costly and the program may take a long time to have impact on the poor’s lives. For example, a father of a family may take loans from microfinance to start a business and to fund his son’s education. However, his business may fail due to external reasons, such as flood. Nevertheless, his son graduates from medical school because of the credit he received from microfinance institutions. Once he starts his practice, he can improve the economic condition of his family. More research needs to be done on how the social performance of microfinance should be measured. This also helps to explain why financial performance is often discussed more explicitly than the social performance of microfinance. The social performance of microfinance institutions is still a myth. However, researchers increasingly use the Random Control Trial (RCT) method to track the social performance of microfinance in increasing income for the participants. Note that the limitation of this method is its internal validity. This means that while the experiment and result might be valid in the controlled location, it may not work elsewhere. For example, if an RCT on microfinance’s social performance is conducted in India and discovers that microfinance help reduce poverty, this result may not be true in Vietnam because of different time, location, experimental groups, etc.
the poor to improve their lives and instead puts the poor into more debt. Mission drift occurs when microfinance institutions reach out to wealthier clients because they are able to repay, and neglect the poorest of the poor. Specifically, as Cull et al. (2008) argue, “mission drift” occurs when loan size increases for the purpose of minimizing transaction cost and to increase profit. Nevertheless, Armendariz (2011) argues that it is difficult to differentiate between the mission drift and cross-subsidization. Cross-subsidization occurs when microfinance institutions target Group C and the top of Group B in order to fund a larger number of individuals at the bottom of Group B. As long as microfinance institutions do not crowd out the poorest of the poor, the bottom of Group B, Yunus argues that it is not mission drift. However, with this description, there is a very thin line between mission drift and cross-subsidization and the distinction between cross-subsidization and mission drift requires further research.

Another point of view, held by the founder of the Swayam Krishi Sangam (SKS) Microfinance Limited, Vikram Akula, is that increasing interest rates is not mission drift. Poor clients voluntarily take loans because they need them. Clearly, the poorest of the poor, individuals at the bottom of Group B in Chapter Two, is not the only group of people that need access to credit. The richer poor, the top half of Group B and individuals in Group C, also face difficulties in having access to capital.

116 In their study, Armendariz et al. (2011) suggest that existing empirical studies cannot differentiate between mission drift and cross-subsidization. They further argue that these studies can potentially mislead donors and socially responsible investors pertaining to resource allocation across institutions offering financial services to the poor. - Armendariz, Beatriz, and Marc Labie. The Handbook of Microfinance. Singapore: World Scientific, 2011, 341.
Hence, increasing interest rates is not mission drift. The microfinance institutions still serve low income people, but are able to expand their financial services to Group C who may be excluded if microfinance institutions only target the bottom of Group B. By targeting the richer poor, microfinance institutions can be financially sustainable and be independent of donors or subsidized credit. In sum, raising interest rates in order for microfinance institutions to be financially sustainable is not mission drift but accomplishes a different goal – it allows the institution to serve the richer group within the lower income group. To support Akula’s argument, it might be helpful to separate the type of microfinance institutions into two types: charitable microfinance institutions and financially sustainable microfinance institutions.

3.2 Two Types of Microfinance Institutions: Charitable Microfinance Institutions vs. Financially Sustainable Microfinance Institutions

Charitable microfinance institutions are those microfinance institutions that put their social performance ahead of their financial performance. Their target group is Group B, and mainly the bottom of Group B. One of the most renowned examples of charitable microfinance institutions is the Grameen Bank. Its mission statement is:

Grameen Foundation's mission is to enable the poor, especially the poorest, to create a world without poverty. In all our work, we embrace and draw inspiration from our rich Grameen Bank Heritage. Our core values are:

- We seek to empower the world’s poor, especially the poorest women;
- We hold ourselves and our partners accountable for transparency and measurable results, including social and financial performance;
- We champion innovation that makes a difference in the lives of the poor;

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118 The idea of two types of microfinance institutions in this thesis stems from the Welfarist vs. Institutionalist debate in microfinance. In the context of this thesis, the welfarists believe that what the poor need is cheap loans, whereas the institutionalists believe that what the poor need is continuation of access to credits. See Morduch, J. "The Microfinance Schism." *World Development* 28, no. 4 (2000): 617-29. doi:10.1016/S0305-750X(99)00151-5.
• We first seek to form partnerships with those who can advance our mission before acting alone;
• We respect, invest in and promote local social entrepreneurs and local ownership; and,
• We honor the voice, professionalism and integrity of our staff and volunteers.¹¹⁹

Note that the mission statement of the Grameen Bank does not mention financial sustainability. Despite high repayment rates, the interest rate that the Grameen Bank charges its clients is too low to be financially sustainable. According to Jonathan Morduch, Grameen Bank currently charges interest rates of 15.9 percent. However, it would need to charge an interest rate of 32 percent to be sustainable.¹²⁰

The mission of charitable microfinance institutions is similar to the mission of agricultural development banks, as they are more concerned about poverty alleviation and other development objectives than financial return. On the other hand, financially sustainable microfinance institutions are more similar to the service provided by informal moneylenders. Financially sustainable microfinance institutions are the microfinance institutions that seek to provide financial services to the third group of lower income in Chapter One. Their approach to lending to the poor is to use the financial system to make their services for the poor sustainable and independent from donors. An example of this type of microfinance institution is SKS Microfinance Limited:

SKS aims to make microfinance financially self-sustainable. We use systematic processes, technology and training to help ensure we offer quality service to our borrowers.¹²¹

This is not to compare whether charitable microfinance institutions are better or worse than financially sustainable microfinance institutions. The goal is to emphasize that there are mainly two types of microfinance institutions that are

serving different types of low income people. This is not to choose between types of microfinance institutions to serve the poor, but to emphasize the different target groups and different goals of the two types of microfinance institutions. While the financially sustainable microfinance institutions are most concerned with reaching break-even point in their operations, the charitable microfinance institutions work to reach the poorer clients and explore the demographic and socio-economic characteristics of potential clients.

Charitable microfinance institutions are funded by fundraising and donations. To get a clearer picture of how a charitable microfinance institution is funded, the example of Wokai(我开), a charitable microfinance institution in China is helpful. Wokai operates in a P2P lending method and all interest rates charged on their loans are absorbed by its Field Partners, namely NGOs that help them distribute the loans to borrowers. As a charitable microfinance institutions, Wokai suggests that their “costs are covered by donations by our generous supporters from around the globe…online donations…raise funds from corporate sponsors, foundations and individual grants…members of our Founders Circle.” 122 Other charitable microfinance institutions are funded based on donations in similar fashion to Wokai.

The divergence of these two forms of microfinance institutions can be complementary in helping the poor. For example, low income people who graduate from the government development program may be eligible for credit from charitable microfinance institutions. Charitable microfinance borrowers whose businesses started to expand and needed larger sum of loans than charitable microfinance

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institutions can provide, may shift to receive services from financially sustainable microfinance institutions. Both types of microfinance institutions provide assistance for low income people, although through different approaches.

**Figure 4 Charitable Microfinance Institutions vs. Financially Sustainable Microfinance Institutions**

![Figure 4 Charitable Microfinance Institutions vs. Financially Sustainable Microfinance Institutions](image)

3.3 Shifting from Charitable Microfinance Institutions to Financially Sustainable Microfinance Institutions

While the microfinance movement may have started with a charitable microfinance institution, recent developments in the movement are beginning to move towards financially sustainable microfinance institutions. Why?

One of the most prominent reasons is the limited numbers of donors to support charitable microfinance institutions to reach a larger number of the poor. The

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data from the Microcredit Summit 2012 suggest that microfinance institutions reported reaching 205,314,502 clients. If we compare this number with World Bank data on the number of people who live with PPP below $4 per day in Chapter Two, microfinance institutions’ clients only account for 5.21 percent of this group of people. When compared to the total world population, the number of microfinance institutions’ clients accounts for only 3.57 percent of the world population. The scope of service outreach is so small that it is hard to believe that the goal of poverty alleviation can be achieved through microfinance institutions if they continue to provide services on this scale. Thus, outreach has become very important for microfinance institutions. However, the problem is funding limitations. Charitable microfinance institutions need subsidies to be able to operate, but they cannot find an unlimited amount of subsidies. Thus, they have to limit the amount of credit that they loan out to their potential customers.

In addition, like many agricultural development banks, the irregularity of funding due to outside circumstances such as economic crises may drive small microfinance institutions to insolvency. While charitable microfinance institutions can continue providing services for the lower income as long as they receive funds from donors, they face the risk of going out of business if the funds that they receive from donors decrease, especially during an on-going financial crisis. Reporter Laura McInnis of Reuters observes that “charitable giving and foreign aid flows are likely to

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125 According to PovcalNet of the World Bank, the total world population was based in 2008 at 5,745.42 million. The microcredit summit report suggests that there are 205,314,502 microfinance clients all over the world. This accounts for 3.57 percent of the world’s population.
dry up as the global economy sours.” In addition, Steve Radelet, a senior fellow at the Center of Global Development suggests, “Washington in particular would be under severe pressure to pare its international aid spending after agreeing to a $700 billion financial rescue package.” To continue serving the poor and to expand their services to the poor, microfinance institutions have to change their operations to become financially sustainable institutions. With these obstacles, the financial service approach was put into practice, and microfinance institutions started to move away from their traditional form. To continue providing services to the poor, microfinance institutions must first be able to operate. Hence, moving towards financial sustainability by changing the operation of the institutions may be the solution for many charitable microfinance institutions that seek to mitigate the risk of insolvency and to provide service for a larger number of the poor.

However, working on becoming financially sustainable microfinance institutions requires some operational shifts. Simple ways to become financially sustainable are to increase revenues and/or to cut costs. Financial sustainability can be attained by reaching economies of scale to cut cost. Furthermore, similar to informal moneylenders, a microfinance institution that wants to have financial sustainability might have to “cherry-pick” the borrowers that are more likely to pay back, the richer poor, instead of the poorest of the poor.

Cutting costs can be achieved by lowering the transaction and operating costs. The transaction cost for providing microcredit is very high because the loans that charitable microfinance institutions give out are usually very small. One way to

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127 Ibid.
decrease the transaction cost is to increase the loan size. Another way to decrease average transaction costs is to place microcredit operations within payments infrastructure that has been developed, for example using post office networks or mobile phone services. In addition, a microfinance institution can cut out additional poverty alleviation programs such as skills training.

To become financially sustainable, the target group of clients and the services that microfinance institutions provide has to change. In this sense, a microfinance institution has to choose either to be a charitable microfinance institution or to be a financially sustainable microfinance institution. How a charitable microfinance institution undergoes the process of becoming a financially sustainable microfinance institution varies. For example, a microfinance institution may decide to emphasize outreach to reach economies of scale, and cut down the institutions monitoring process by incorporating the group lending method, pushing the responsibility of monitoring to the borrowers. Or, a microfinance institution may choose to raise interest rates, while focusing on providing services to specific groups of people that the institution think are more likely to be able to repay loans at higher interest rates.

It is important to note that the differentiation between the two types of microfinance institutions has to be very clear for the success of the microcredit program. Try to imagine what would happen if financially sustainable microfinance institutions try to lend to the second type of low income people who have no business skills and want to use their credit for a wedding, for example. The story might end up as follow:

Lalitha’s family ran up $1460 in debts from five MFIs and other informal moneylenders to pay for the wedding of their elder daughter. Unable to meet a payment, they went away to
seek help from the new in-laws. An MFI officer arrived, along with the village head and the four other members of her mother’s “joint liability group” – fellow villagers who had taken collective responsibility for the debt. After their harangue, Lalitha drank pesticide. Her mother treasures a tattered suicide note. It advises her not to take out anymore loans, except for her young son’s education.  

Without close monitoring due to an attempt to reach as large number of the lower income as possible, financially sustainable microfinance institutions that aim for growth in outreach might harm the poor. They may not have close enough screening to know that Lalitha’s family was already in debt with other microfinance institutions. In addition, while the microfinance institutions are not affected financially in this case because the loans got paid back by the other members of the joint liability group, the suicide due to access to credit from microfinance institutions is far from the objective of microfinance institutions in helping the poor to improve their lives through access to credit. 

Recently, such events have not been uncommon, especially in Andhra Pradesh. According to the Society for Elimination of Rural Poverty, Andhra Pradesh’s local government agency that compiled data on microfinance-related deaths from police and press reports, more than 70 people committed suicide in Andhra Pradesh from March 1, 2010 to November 19, 2010. The article implies an increasing hostility on the part of the government to microfinance institutions. It also suggests that competitions among microfinance institutions to reach a larger number of poor people caused such a devastating outcome. While there might be other

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129 This is not unlike the subprime crisis in the U.S. and the solution is to build credit information sharing and educate customer. This will be discussed in the concluding chapter.

factors that influence these disastrous outcomes, the suicides underscore microfinance institutions’ goal of providing appropriate services for low income people. Hence, focusing on the target group of microfinance is essential. If financially sustainable microfinance institutions target the low income group that is more ready to take the loans, those who know how to manage the credit they receive, the end result should be business success, rather than suicide.

Microfinance institutions must focus on their target groups for improving the quality of their operations for the poor. For example, if a financially sustainable microfinance institution wants to be financially sustainable by ending subsidized interest rates and targeting richer clients (Group C) who might have some forms of assets, the institution might require that their borrowers provide some form of collateral before taking a loan, or show that they have employment. A clear target group of borrower will thus provide a win-win situation for borrowers and lenders.

The next chapter will emphasize why financial sustainability is crucial for microfinance institutions, and provide an example of one of the best models for financially sustainable microfinance in the industry. This model is a microfinance institution in Indonesia, Bank Rakyat Indonesia (BRI). The case study of BRI can further illustrate how a charitable microfinance institution can become financially sustainable by using appropriate methods to screen potential borrower, and focusing on new financial products, specifically microsavings. In addition, the BRI case study shows how a microfinance industry can solve the problem of servicing the wrong
group by providing clear distinctions between charitable microfinance services and financially sustainable microfinance services.
Chapter Four

Case Study: Bank Rakyat Indonesia (BRI)

The Indonesian experience in microfinance is worth examining not only because of its impressive growth rate, but also because BRI is one of the most successful and sustainable commercialized microfinance institutions in the world. To shed light on this discussion, it is worth looking at why and how banks develop their products for microfinance industry. Most importantly, the example of BRI is important because it focuses both on being sustainable and on outreach to poor clients, without focusing on the poorest of the poor. The success of the BRI microbanking units in being financially sustainable supports the argument that providing access to credit to lower income clients should focus on Group C, instead of Group B.

In addition, the BRI case study also suggests important elements that are rather missing in the microfinance industry, and that is credit information linkage. What is particularly interesting about this case study is how BRI works collaboratively with the Indonesian government to provide credit and saving services to Group B in Pembinaan Peningkatan Pendapatan Petani Kecil (P4K). While the BRI microbanking unit (KUPEDES-SIMPEDES) and P4K operate separately under BRI, the model that microfinance institutions should adopt is the credit information linkage between a charitable microfinance program P4K and a financially sustainable microfinance program (KUPEDES-SIMPEDES).
Hence, this chapter will be divided into two parts. The first part will focus on BRI reform and how BRI became a sustainable microfinance institution. The second part of this chapter will focus on credit information linkage between a charitable microfinance program, P4K, and a sustainable microfinance program, the BRI microbanking unit.

Part I: How BRI Became a Financially Sustainable Microfinance Institution

4.1 The Birth of Bank Rakyat Indonesia

Bank Rakyat Indonesia (BRI) is one of the oldest microfinance institutions in the world. The bank was founded in 1895, during the Dutch colonial period. As the first rural bank in Indonesia, it established a three-tiered system, comprising national, district, and village institutions. In 1968, BRI became an agricultural development bank. This was classical agricultural development as described in Chapter Two. BRI was a state-owned commercial bank tasked with financing the production of improved crop varieties promoted by the “green revolution.” During this period, BRI was responsible for serving agricultural estates and small rural enterprises and microenterprises, as well as supervising close to 6,000 local financial institutions.

The birth of microfinance initiatives from BRI started when this state-owned bank created the BRI village unit system or Unit Desa System (UDES) in the early

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1970s, to encourage rice production by rural farmers. The Unit Desa System was a nationwide network of small village banks. In order to intensify rice production in the country, the Indonesian government integrated development through the Bimbingan Masjarakat (BIMAS) (Social Guidance) program of subsidized credit to farmers’ groups. The mission of UDES was to provide BIMAS credits in rice-growing areas. The Indonesian government sponsored and subsidized loans for the program and gave funds for the expansion of the BRI unit desas (village bank units). By 1983, BRI unit desas had expanded to 3,600 units all over the country.

Interest rates were fixed by the government at approximately 12 percent per year, at a rate that was well below the inflation rate of 32 percent at that time. Thus, it is not surprising that the BIMAS credit program suffered losses and could only be sustained by subsidies from the government. The program was not successful and the portfolio quality of the program deteriorated rapidly. The default rate exceeded 22 percent by 1976. By 1981, the default rate had reached 60 percent.

The problems faced by BRI in implementing the BIMAS program were similar to the problem that agricultural development banks faced as described in Chapter Two. Severe losses were the result of BRI’s inability to enforce loan repayments. The government’s implicit guarantees of these loans gave farmers little

137 Ibid., 74.
139 See Appendix 2.
incentive to repay. Furthermore, Patten and Rosengard (1991) suggest that the BRI at that time had no financial autonomy nor was they responsible for their own operations and they, therefore, lacked the means and incentives to successfully encourage credit repayments. One of the former BRI unit desa managers said in an interview:

For political reasons, there is no chasing of borrowers when they do not pay back in time. Also, no penalty interest….interest just continues at 1 percent per month. Only disadvantage: the farmer cannot get a new loan.

The losses of the program would not have been a problem if the Indonesian government could continue funding the program. However, when the oil prices dropped in the early 1980s and with the decrease in oil-related revenue, the government could no longer afford to provide massive support for poorly performing BIMAS.

Note that similarly to charitable microfinance institutions, the BIMAS program contributed to increasing the income of the farmers who joined the program. Despite high default rates, Tabor (1992) argues that BIMAS famers were reported to have received higher income than non-participant farmers, and the program contributed to poverty reduction in rural areas. However, like the problem that charitable microfinance institutions which rely on funds from donors have, BRI’s BIMAS program was dependent on funding to be sustainable. With a lack of stable

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140 This is, of course, unless the government acted against the delinquent farmers. However, it was unlikely that the government would do so.
Cash flow, some of these microfinance institutions could no longer provide financial services to the poor and had to go out of business. Lessons learned from BRI reform necessitated by lack of funding may provide a good example of how reform can be achieved so that a microfinance institutions to become financially sustainable.

4.2 BRI Unit Desa System Reform

In response to the government opting out of its support for BIMAS, BRI decided to reform and commercialize the Unit Desa System, which had been established to channel BIMAS credit to farmers all over the country.144 Sponsored by USAID, BRI worked closely with the Harvard Institute of International Development (HIID). In 1987 and 1988, a new operating system called the “one stop service method” was introduced.145 With this method, a teller at a unit handled various transactions including money transfers, check clearing, bill payment and other noncash transactions in one stop. In addition to changing their operations in established UDES, BRI also introduced training and retraining of unit staff.146 Most important, BRI no longer provided a subsidized credit program at the UDES village units, and they raised interest rates.147 BRI also stopped limiting its target group to farmers. Instead, BRI expanded, providing credit to any creditworthy person who would use the loan for any income-generating activity such as petty trading, agriculture and agricultural input trades, industry, services, operation of small

146 ibid., 3.
147 The reform was possible because the governmental deregulation on interest rate in June 1983. This allows BRI to fix its own interest rates on most loans and deficits. Maurer, Klaus. “Bank Rakyat Indonesia (BRI)” Eschborn: CGAP, 1999, 10.
plantations and livestock-related activity, and consumer credits. Anyone who was able to save and repay a loan was a potential UDES customer.

Unlike when the UDES was used to channel BIMAS, where UDES was under the control of BRI provincial branches, the reformed UDES operates on a full commercial basis, with each unit acting as a semiautonomous entity serving micro and small customers, predominantly in rural areas. Each reformed UDES village unit is treated as a separate financial unit that constitutes a profit center with its own balance sheet and profit and loss account. In each village unit, the unit manager has authority to make independent decisions on credit and other operations. This reform increased the autonomy of the managers in the area of unit operations’ to make appropriate decisions based on their knowledge of both banking practices and the local conditions village under their responsibility. In addition, managers held full responsibility for the performance of their units.

To reform UDES, BRI realized they would need to change the work culture of the program. It took a major effort in human resource development to transform UDES from government-type loan disbursement agencies to full-service rural banks operating for financial sustainability. After the collapse of BISMA program, UDES employed more than 14,000 staff that had to be re-oriented to the new types of services UDES had to offer. Maurer (2002) suggests that this did required not only massive training for the transfer of knowledge and development of skills, but also a

150 Maurer, “Bank Rakyat Indonesia (BRI),” 15.
fundamental change in attitude.¹⁵¹ To build the new work culture in UDES, Robinson (2002) adds that BRI recruited new, young, and well-educated staff.¹⁵² BRI preferentially recruited individuals who were from the area where the unit was located, who had mastered the local language, and who were familiar with the local culture and customs.¹⁵³ In addition, these staff members were provided with financial incentives based on their unit of operations’ performance.

At the head office level, BRI initiated new positions, from President to Director. These high management levels would be responsible for the unit desa networks and were allowed independent decision-making, free from political influences.¹⁵⁴ Without political intervention, UDES here free from interest rate restrictions and provision of cheap funds based on political decisions. Having little to no political intervention was good for the consistency of implementing UDES because focus did not shift under the reform for political reasons. Unlike BIMAS, where “there was no chasing of borrowers” for political reasons, UDES were able to establish a market approach to their credit program which resulted in high repayment rates.

Under this reform, the bank abandoned BIMAS and introduced two of its own star products to the microfinance sector: Kredit Umum Pedesaan (KUPEDES) (microcredit) and Simpanan Umum Pedesaan (SIMPEDES) (microsavings).

¹⁵¹ Ibid., 15.
¹⁵⁴ Maurer, “Bank Rakyat Indonesia (BRI),” 16.
4.2.1 KUPEDES – Microcredit

In 1984, KUPEDES was offered throughout the UDES network established under BIMAS. Unlike the old BIMAS program, which targeted the rural farmer with subsidized loans, KUPEDES neither targeted any particular groups nor subsidized the loans. Unlike the group lending method that was initially practiced by the Grameen Bank in Bangladesh, BRI allowed individual lending for rural borrowers. In addition, unlike conventional microfinance institutions, they encouraged their clients to take loans for entrepreneurial purposes, including for consumption. Although BRI does not technically allow KUPEDES loans for the purposes such as ceremonies, health care, education, housing, consumer durables, and basic household needs, BRI is aware that some KUPEDES loans are often used by borrowers for other cited economic activities and for consumption.\(^{155}\)

BRI offered two types of loans according to the purpose stated in the loan application: working capital and investing capital. According to Robinson (2002), the most frequently stated loan purpose in 1995 was trade (44 percent of loans).\(^{156}\) These traders use their KUPEDES loans to fund trading in agriculture, livestock, poultry, dairying, fishing, and food processing. For BRI, the most important concerns are that the borrower can profitably use and repay the loan, and that the repayments are made on time.

Furthermore, unlike conventional ideas of microfinance from the Microfinance Summit 2005, which aim to provide credit to the bottom half of Group


\(^{156}\) Unit desa borrowers also operate small and microenterprises in services (transportation, restaurants, gas stations, repair services); and in manufacturing (textiles, garments, leather goods, furniture, crafts, bricks, tiles, jewelry, herbal medicines, and others). Ibid. 240.
B, BRI attempted to provide credit through KUPEDES to the poor who live near or just above the poverty line and to the lower middle class with some form of collateral.\textsuperscript{157} BRI managers explain that the borrower’s willingness and ability to pledge collateral is taken as evidence of purpose and determination, rather than as a source of repayment.\textsuperscript{158} According to Robinson (2002), except in unusual cases of fraud or borrower deception, the units rarely take legal steps to collect collateral from defaulters.\textsuperscript{159}

Based on Hartungi’s (2007) interview conducted with BRI managers, managers know that low income people might have difficulty pledging collateral.\textsuperscript{160} However, they argue that borrowers usually have assets that BRI can ask for as collateral, such as land titles, bikes, motorbikes, cars, or salary if they are regularly employed. In addition, Hartungi (2007) also shows that asking the borrower to pledge collateral has other positive effects.\textsuperscript{161} For example, it motivates such potential borrowers to start acquiring assets and processing their land titles if they inherit land from their elders.

Unlike most charitable microfinance institutions that aim to teach entrepreneurial skills to the poor as they offer them credit, KUPEDES targets those who already have established enterprises. Villagers who do not own an enterprise – for example those who live entirely from wage labor, pensions, or remittances from relatives who live outside the village – do not qualify.\textsuperscript{162} The nominal interest on

\textsuperscript{157} BRI is internationally recognized for its innovative ideas in demanding collateral.
\textsuperscript{158} Maurer, “Bank Rakyat Indonesia (BRI),” 18.
\textsuperscript{159} Robinson, The Microfinance Revolution: Volume 2 : Lessons from Indonesia, 244.
\textsuperscript{160} Hartungi, “Understanding the success factors of micro-finance institutions in a developing country,” 395.
\textsuperscript{161} Ibid., 397.
loans was set at a flat rate of 1.5 percent per month on the original loan balance, which is equivalent to about a 32 percent annual effective interest rate for a one-year loan with 12 monthly installments, if all payments are made on time.\textsuperscript{163} Loan terms are up to 24 months for working capital and up to 36 months for investment capital.\textsuperscript{164}

Unlike the BIMAS program where there was no chasing borrowers, KUPEDES has invested in following up on loan repayment. As soon as a borrower misses a payment, the credit officer is expected to visit him; many overdue payments are collected on such visits. If the loan payment has not been made after several visits, the unit manager will also visit the borrower. If this fails, the unit development officer from the branch will work with the credit officer and unit manager to collect the loan. Most overdue repayments are collected through this process.\textsuperscript{165} However, if a unit's collection rate falls below 95 percent in a particular month, the unit manager's loan authority can be withdrawn. All loans must then be approved by the branch until the unit's collection rate goes up to 95 percent and its manager's loan authority is restored.\textsuperscript{166}

Because KUPEDES borrowers must provide sufficient collateral to cover the value of their loan, the program would not be effective for those who are debt-averse and those who would be afraid to pledge collateral. Hence, it is important to note that BRI's collateral requirements for KUPEDES loans do not help to attract low-risk borrowers or increase the riskiness of the loans, because BRI microbanking units

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\textsuperscript{164} Ibid., 212.
\textsuperscript{165} Ibid., 245.
\textsuperscript{166} Ibid., 245.
\end{flushright}
usually do not foreclose on loan defaults except in extraordinary circumstances.\textsuperscript{167} What BRI wants in borrowers is to screen out those who do not have incentive to utilize the loan in such a way that they can pay it back. In the case of Joyanti Halder, the woman in Chapter One who wanted to invest in a rickshaw so her husband could love and work at home, this would be possible under KUPEDES. But it can only happen if Halder shows her willingness and her ability to pledge collateral to demonstrate that she is determined to use KUPEDES credit to buy rickshaw for her husband so that he can earn more income and thus be able to repay the loan. For a BRI microbanking unit, pledging collateral is a tool for the bank to gain information on the borrowers’ ability to repay, and their seriousness about utilizing the credit. The case of KUPEDES shows that careful screening processes, including but not limited to asking for a collateral pledge, are essential to limiting losses and ensuring the financial viability of microfinance institutions.\textsuperscript{168}

4.2.2 SIMPEDES - Microsavings

SIMPEDES was launched along with KUPEDES in 1984. This is a deposit instrument that allows an unlimited number of transactions. The money can be withdrawn at any time with no cost, those favoring the low-income household’s need for liquidity. To join SIMPEDES, there are no fees to open an account. The only requirement is to open the account with a minimum balance of approximately $10.\textsuperscript{169} Unlike microfinance institutions, which only or mainly collect savings from members

\textsuperscript{167} Note that the probability of foreclosing loan default is mitigated by frequently scheduled repayments and visits from BRI staff. – Robinson, \textit{The Microfinance Revolution: Sustainable Microfinance for the Poor,}” 165.
\textsuperscript{168} Because BRI uses public deposits from SIMPEDES to fund KUPEDES, requiring collateral is one way to mitigate risks for their savers.
who take loans, BRI allows the poor to save without having to borrow. To increase the incentive for customers to save, SIMPEDES also has a lottery program with an organized prize drawing every six months.\footnote{Maurer, “Bank Rakyat Indonesia (BRI),” 12.} This serves as a deadline and enticement for lottery bonuses, since the account’s amount determines the issuing of lottery coupons. The more savings one has with the bank, the higher the chances or odds of winning the prize. Collecting public savings enables widespread services to poor savers, makes more funds available for small loans, and helps attain institutional profitability.\footnote{Robinson, The Microfinance Revolution, 256.}

It is important to note that before the program was launched nationwide, BRI ran many research projects with HIID, including 12 pilot programs to test preliminary SIMPEDES.\footnote{Robinson, Marguerite. “Bank Rakyat Indonesia (BRI) – Why It Became a Leader.” Microfinance Podcast. January 10, 2010} This is important, because before SIMPEDES was launched, many bankers believed that the poor were incapable of saving in banks. However, research by HIID and BRI suggested that the poor are willing to save in banks if the banks give them what they need: security and convenience, and liquidity.\footnote{Ibid.} This conclusion was based on survey that asked the poor what they like and do not like about savings. Like the discussion of poverty in Chapter One, Robinson (2002) found that the poor faced security problems when they kept their money in their houses.\footnote{Robinson, The Microfinance Revolution: Volume 2 : Lessons from Indonesia, 264.} Through their research on how the poor in Indonesia save, Robinson (2002) suggests that the poor also save by investing in animals and other property.\footnote{Ibid., 264.} But these assets do not provide liquidity for the poor and they are risky. For example,
an animal or the whole herd might get sick and die. This research on what the poor actually want in saving services was used as a baseline for designing SIMPEDES: security, convenience, and liquidity.\textsuperscript{176}

After designing savings products to meet these needs, BRI ran twelve pilot projects to test customer satisfaction and to find appropriate pricing for their product. The result was that the customers liked the products. BRI also discovered through these pilot projects that it was more difficult to manage savings than credit.\textsuperscript{177} This is because the growth in savings is uncontrollable, while BRI can control how many borrowers they have. Unlike credit management, where rejecting a loan would not harm the reputation of BRI, there is a reputational risk if BRI does not manage to mobilize savings deposits well.\textsuperscript{178}

By mobilizing local savings successfully, SIMPEDES provided the banks with a stable source of funds for KUPEDES, and kept savings local. Within four years after the BRI microbanking unit reform, all KUPEDES are financed by SIMPEDES, which has been a lower-cost source of funds than commercial debt. And SIMPEDES is a more stable source of funding in a financial crisis.\textsuperscript{179}

There are two major lessons from the UDES reform. First, it is possible to create a financially-sustaining and profitable microlending program that serves the poor. But to succeed, bank units will need to lend at market rates, use their income (public deposits, in this case) to finance their operations, and devise appropriate

\textsuperscript{178} The reputational risk occurs when savers go to withdraw money and they cannot get their money. Robinson (2002) suggests that savers go to check with the bank whether they can withdraw their money after depositing their savings.
\textsuperscript{179} This will be discussed in detail later in the chapter.
savings instruments to attract depositors.\textsuperscript{180} Second, developing a savings instrument for the poor is at least as important as providing them with loans. In Indonesia, SIMPEDES attracted thousands of depositors.\textsuperscript{181} By mobilizing rural savings, SIMPEDES provided the BRI microbanking units with a stable source of funds and kept the financial savings the rural areas to maintain development in the countryside.\textsuperscript{182}

To relate this back to Chapter One, where the poor do not save in banks because they do not trust the banks—maintaining a good reputation and relationship with savers was the key element in BRI’s success. One of the most important lessons that a microfinance institution that seeks to provide microsavings services for the poor can learn from this case study is how BRI developed a relationship with its customers.

4.3 From 1984 to 1989, Moving Towards Financial Sustainability

When BRI started to reform UDES subsidized units to financially sustainable units, BRI received funds for the reform from two major sources, the Indonesian Government and the World Bank.\textsuperscript{183} The government injected $200 million into UDES in 1984 as start-up liquidity for loans and initial administrative costs, while the World Bank lent $5 million in 1984 for technical assistance and $97 million in 1989 for liquidity support.\textsuperscript{184} However, with the success of SIMPEDES and KUPEDES,

\begin{footnotesize}
\begin{enumerate}
\item [181] ibid.
\item [184] ibid., 4.
\end{enumerate}
\end{footnotesize}
UDES became financially sustainable in 1989, where the programs generated surplus liquidity for the first time at $62.8 million.\textsuperscript{185}

Measuring the success, SIMPEDES’ accounts grew from 2,655 savings accounts in 1984 to 6,261,988 savings accounts in 1989, while KUPEDES’s borrowers increased from 640,746 borrowers to 1,643,980 borrowers in 1989.\textsuperscript{186} Total savings increased by 1,361 percent from $39.3 million in 1984 to $534.9 million in 1989, while total loans rose by 456 percent from $103.4 million in 1984 to $472.1 million in 1989.\textsuperscript{187}

Perhaps most impressive was the growth in savings during this same period. Before the transformation of the village units from 1973–1983, savings mobilized through the national savings system totaled $30 million.\textsuperscript{188} Note that the savings-to-loans ratio increased from 38 percent in 1984 to 113 percent in 1989.\textsuperscript{189} SIMPEDES played a crucial role in helping BRI microbanking unit become sustainable. By 1987, the BRI microbanking unit was able to use SIMPEDES to fund all KUPEDES loans. Within seven years after the reform, the BRI microbanking unit was able to repay its loans from the Indonesian government and the World Bank.\textsuperscript{190}

As of the end of 1996, total unit desa savings approached $3.0 billion, or nearly $800,000 per unit desa, in 16.2 million savings accounts.\textsuperscript{191} Equally

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\textsuperscript{185} See Appendix 2.
\textsuperscript{186} See Appendix 2.
\textsuperscript{187} See Appendix 2.
\textsuperscript{189} See Appendix 2.
\textsuperscript{191} See Appendix 2.
impressive is the fact that the average size of these deposits in the primary savings products was US$184. This represented some 30% of the total number of savings accounts in Indonesia, serving 10% of Indonesia’s population. Since 1989, UDES have been generating surplus liquidity for BRI and the programs have been completely financially self-reliant in mobilizing their own resources, covering their operational costs, and earning profits.

4.4 The 1997-98 Asian Financial Crisis

One of the biggest tests for the UDES was the Asian Financial Crisis that hit Indonesia in 1997-98. The Indonesian economy plunged into recession, with a sharp fall in the international value of the Rupiah. The inflation rate was 77 percent in 1998 and export industries contracted by nearly 40 percent during the same period. Unemployment reached 15 percent at the end of 1998, rising by 220 percent from the pre-crisis period. The increasing unemployment rate and high inflation rate resulted in a severe decline in real income.

Interestingly, the financial performance of the BRI microbanking unit was the opposite. During the crisis year, from September 1997 to August 1998, total savings deposits in UDES increased by 89.6 percent, well above the inflation rate of that period. During the three-month period June-August 1998, after Indonesia had been hit by both a drought and an economic crisis, 1.29 million new savings deposit

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194 See Appendix 2.
196 Ibid.
197 See Appendix 2.
accounts were opened in BRI units (bringing the total up to 20.93 million); and an additional Rp2.84 trillion (US$284 million at the October 1998 exchange rate) were deposited.¹⁹⁸

Unlike the expectation that loan accounts would increase during times of economic hardship, the number of KUPEDES borrowers, which had steadily increased from 640,746 in December 1984 to 2,615,679 in December 1997, stagnated.¹⁹⁹ There was only a slight nominal increase in credit portfolios in 1997, from 2,488,135 million loan accounts in December 1996 to 2,615,679 million loan accounts in December 1997.²⁰⁰ Furthermore, the number of loan accounts even decreased by 6.04 percent from December 1997 to December 1998, and loan size dropped by 41.91 percent during this period.²⁰¹

High savings and low loan rates during the crisis year reinforce the idea that low income people demand microsavings more than microcredit, especially during times of uncertainty. To relate this back to the discussion of poverty in Chapter One, the case study supports Banerjee and Duflo’s finding (2007) that the poor are aware that savings are good for them. The striking ratio between savings and loans at the BRI microbanking unit suggests that the poor may be risk-averse and debt-averse, especially during crisis years. Regardless of the poor’s poverty level, they wanted to increase their financial security by saving more.

The financial crisis and the performance of the BRI microbanking unit reveal the priorities in the rationale of low income people. Their priority is security, rather

¹⁹⁹ See Appendix 2.
²⁰⁰ See Appendix 2.
²⁰¹ See Appendix 2.
than poverty alleviation. This priority is reflected in the behavior of BRI customers. They saved so that they would have financial security if the crisis got worse. They rushed to repay loans so that they maintained a good relationship with the BRI, which would allow them to continue to have access to KUPEDES in the uncertain future. The financial crisis suggested that what those with low incomes want is to save and to have “access” to credit all the time, for security purposes. If they had a choice, they would demand actual credit after their security needs were fulfilled. Unlike the conventional belief of most microfinance institutions that the poor need credit all the time to improve their impoverished living conditions, the case study of BRI rejects this belief by answering that the poor may need “access” to credit more than the credit itself.\textsuperscript{202} This insight is important for microfinance institutions to respond to what the poor prioritize and to properly provide financial services in order to suitably assist them.

The financial crisis reinforced the importance of savings as a stable source of funding for microfinance institutions. This relates to a larger theme of where microfinance institutions find their funds: from donations, commercial loans, initial public offerings, or, in this case, from public deposits. The case of BRI shows that utilizing funds from public deposits is a very safe way for microfinance institutions to fund credit programs during times of inevitable economic crisis.

\textsuperscript{202} Unfortunately, most microfinance institutions cannot meet this demand for microsavings. This issue will be discussed later in this Chapter.
4.5 Lesson Learned from BRI Unit Desa System: Becoming a Financially Sustainable Microfinance Institution

Many lessons can be learned from the BRI Unit Desa experience. Some of its key principles have been replicated and adopted by the international microfinance industry as best practices. Some of the features are unique to the specific context of rural Indonesia and/or to BRI as an institution, but others can be generalized and applied in other countries.

1) Relationship with the Government and Organizational Structure

The Unit Desa reform was implemented at an appropriate time, because of financial sector deregulation in June 1983. This allowed UDES to set their own interest rates, instead of the government imposing interest rate caps as they used to do under the BIMAS program. In addition, BRI received strong support from the government, which was the sole shareholder of the bank. In the initial reform stage, the Indonesian government helped BRI refinance its non-profit loans and inject $200 billion to help the BRI unit start its lending and expand its branches.

Although BRI microbanking unit received financial support from the government in the initial stage of its reform, there was little or no interference in unit operations. In addition, the strong leadership of the BRI’s President Director was essential for the development of the unit banking system as a highly decentralized and autonomous unit operation. The individual unit desa was purposely kept small, with limited staff and operational focuses. The organization of the Unit Desa program was also simple for both customers and the unit staffs. There was only one loan product under KUPEDES, with flat interest. On the savings side, the Unit Desa focused only on SIMPEDES, and mobilized local public deposits from SIMPEDES to all their
KUPEDES loans. The BRI case study suggests that microfinance products should be kept simple so that the borrowers can learn about the products, as well as for management purposes.

The lesson from the BRI microbanking unit also suggests that government support, but not intervention in the autonomy of microfinance, is essential for the development of a financially sustainable microfinance institution. This, however, may be unique to BRI, because of the time when it was reformed. Due to growing criticism of financially sustainable microfinance institutions, such as the high suicide rate attributed to exorbitant interest rates in Andhra Pradesh, India, governments may attempt to intervene in the microfinance industry, for example, imposing interest rate caps.

Recently, in Andhra Pradesh, the Indian state with the most microfinance borrowers and the base for the biggest for-profit microfinance institutions, the local government imposed an interest rate cap at 26 percent for microfinance institutions. In Bangladesh, the government has capped the annual interest rate that microfinance can charge at 27 percent. While the governments argue that the interest rate cap stems from their desire to defend the poor from getting stuck in debt, the case of Bank Rakyat Indonesia shows that interest rate caps may not be the optimal solution for over-indebtedness. Interest rate caps could potentially harm the poor by pushing some microfinance institutions into insolvency and limiting the poor’s credit options.

205 The solution will be proposed in Part II of this chapter.
Based on the analysis of microfinance institutions in Chapter Three, the main reason microcredit interest rates are higher in microfinance in comparison with other credit markets is because of the high operating cost of covering small loans. Making 4,000 loans of $50 for each loan requires more staff than making a single loan of $200,000. Thus, the interest rate cap will disproportionately affect the microfinance institutions that provide a smaller loan size to their borrowers. These institutions are often charitable microfinance institutions that seek to serve the poorest of the poor. Similarly to BIMAS, if these charitable microfinance institutions continue to receive funds from donors, they might be able to maintain their operations. However, these microfinance institutions may not be sustainable and may have to fail if they do not have adequate funding. The case study of the BRI microbanking unit supports this argument, as the microbanking unit was able to maintain its operations because it was free to set its own interest rate. In addition, interest rate caps may decrease competition and prevent new financial institutions from coming into the microfinance industry. Thus, interest rate caps could potentially harm the poor by limiting the variety of services and microfinance institutions available to them. The bottom line from this case study is that the government should not impose an interest rate cap on microfinance institutions.

2) Savings Mobilization

One of the reasons the BRI microbanking unit became financially sustainable was the bank’s ability to mobilize savings. The success of BRI rejects three common beliefs that prevent microfinance institutions from providing savings services. The first belief is that interest rates need to be high to encourage the poor to save with the
microfinance institutions. However, the case study of BRI proves that if the financial institution is trustworthy enough and if it provides savings services that respond to the actual demands of the low income people, they do not require high interest rates for savings to encourage them to save with the bank.

The significance of this finding is not limited to Indonesian low income savers, but also holds in other regions. According to the discussion of the savings habits of the poor in Chapter One, poor people often save at home. As a result, they face the risk of having their money stolen, or they cannot resist the temptation to spend the money that is too easy to reach. The example of the Kenyan banks in Chapter One suggests that a bank’s bad reputation stays in the savers’ minds for more than a decade after the scandals.

The second belief is that the poor have small accounts which are expensive for the microfinance institutions to administer their savings. The financial institutions cannot use savings to fund large loan portfolios. This problem can be solved, as BRI did, when savings are collected from the public and the institution attains economies of scale. Savers with higher account balances can cross-subsidize borrowers with small account balances. The BRI microbanking unit was fortunate to have infrastructures in place and established reputation decades before the program was launched. While this is unique to BRI, it could be a guideline for either state-owned development banks, or large and established microfinance institutions to offer savings services for the poor.

The third common belief is that the poor demand high liquidity, which will raise the transaction costs for microfinance institutions and make collection of small
savings mobilization expensive. The case of BRI suggests that the poor want the option to withdraw whenever they want, but most of them do not withdraw frequently. In addition, the case of the BRI microbanking unit suggests that when savings are mobilized, they attain economies of scale, the types of borrower diversify, and borrowers withdraw money at different times.

The number of clients in SIMPEDES and KUPEDES suggests a very interesting demand for financial products among low income people. While most microfinance institutions focus mainly on the credit side, the BRI microbanking unit suggests that low income people actually like to save more than to borrow. The savings-to-loans ratio of the UDES program has been more than 113 percent since 1989. The peak of this was during the economic crisis, where the savings-to-loans ratio reached 344 percent, contrary to all expectations and assumptions. The demand for the product offered to UDES’ clients leads us to question whether most microfinance institutions have been focusing on the wrong financial services to meeting demands of the poor they focus on providing credit instead of providing savings services.

To examine this issue, I obtained data for 537 microfinance institutions from the Microfinance Information Exchange (MIX) in 2009, created dummy variables for microfinance institutions in the following categories: savings introduced before loans, loans introduced before savings, more outstanding savings than loans, and more outstanding loans than savings. The result suggests that 0 percent of observed microfinance institutions introduce savings before loans and only 6 percent of

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206 See Appendix 2.
observed microfinance institutions have more outstanding savings than loans.\textsuperscript{207} Interestingly, these microfinance institutions that have higher savings than loans are, similarly to BRI, large microfinance institutions.\textsuperscript{208}

One potential explanation of this result is that providing savings services is harder than providing credit services. Microsavings services are expensive. Similar to microcredit, microsavings faces high operational costs to deal with many, small value accounts. Although it can be argued that microfinance institutions can cut some costs because microsavings does not require client evaluation, the frequency of transactions can be higher than the microcredit transactions. According to the Inter-American Development Bank (IADB), the average operating cost of microsavings accounts with less-than-$100 balance ranged between 200 and 250 percent of the account value.\textsuperscript{209}

The challenge of microfinance institutions seeking to provide microsavings is savings mobilization. As shown in the case of the BRI microbanking unit, this requires large infrastructure to be in place before microsavings can operate. The structure of liquidity transfers between different units within microfinance institutions is crucial for savings mobilization. In addition, the flexibility and accountability of services is particularly important for providing savings services, and this partly explains why most of the existing microfinance institutions only provide credit to their customers – how many people would dare to put their hard-earned money into unrecognized, unregulated, and/or new start-up financial institutions? Unlike

\textsuperscript{207} See Appendix 3.

\textsuperscript{208} These microfinance institutions are Akiba, BRI, CFE, CPECG Yete Mali, Caja Popular Mexicana, CamCCUL, Centenary Bank, Coop Universitaria, Equity Bank, FMFB-Pakistan, Interfisa, OIBM, OMB, and PMDF. Also see Appendix 3.

microcredit, which requires microfinance institutions to trust their clients, microsavings requires clients to trust the institutions. The reputation of the microfinance institutions thus plays a crucial role in encouraging clients to save with the microfinance institutions.

While the case of BRI suggests that a strong reputation is difficult to attain and that this takes time, building a good relationship with clients is not unattainable. However, this may require a characteristic that a small-scale charitable microfinance institution may not have, that is, the sustainability of the financial institutions. Not surprisingly, people will not save in a financial institution they fear might not exist in the near future. Thus, financial sustainability is a preliminary requirement for any microfinance institution that wants to provide microsavings services for the poor.

3) Sustainability of Microfinance Institutions in Financial Crisis

The economic uncertainty during the 1997 financial crisis shows that people wanted to have their financial security in savings and were cautious about taking up new loans. Furthermore, the financial crisis had no negative effect on repayment. The 12-month loan loss ratio was at 2.2 percent in 1997 and decreased to 1.9 percent in 1998. During this time period, BRI even experienced an unprecedented negative one-month loss-ratio in August 1998, which suggested that loans were repaid even before they were due. The BRI microbanking unit outperformed the loans made to corporate clients by other parts of the bank. This was because the poor do not move their money abroad during a crisis to save in dollars as the currency depreciates. They wanted to continue saving in Indonesian Rupiah. In addition, it

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210 See Appendix 2.
211 Morduch, J. (1999): The microfinance promise, in: Journal of Economic Literature, Vol. 37, No. 4, p. 1578
shows that the poor are concerned about the future, and they choose to save more in the middle of a financial crisis because they want security. In addition, despite the financial services that largely affected the Indonesian financial sector, BRI unit savers continued to save with the banks. This shows their trust in the bank. Part of this is because BRI was backed by the government, and it had established a strong reputation with borrowers for over two decades. In an interview with Microfinance Podcast, Robinson suggests that had the financial crisis hit BRI ten years earlier, the outcome might have been different, because the bank had not yet established a strong relationship with their clients.\footnote{Robinson, Marguerite. “Bank Rakyat Indonesia (BRI) – Why It Became a Leader.” Microfinance Podcast. January 10, 2010}

BRI microbanking unit’s survival in 1997 can be instructive in the current situation, where many microfinance institutions are faced with the subprime crisis. The case study suggests that large and financially sustainable microfinance institutions are more likely to survive financial crisis, when compared to small and/or donor-dependent microfinance institutions. This is not because smaller banks cannot establish a good reputation, but because savings with small banks are riskier than savings with big banks since small banks may not survive a financial crisis. Large microfinance institutions have the advantage of economies of scale and can undersell both moneylenders and small microfinance institutions by a larger margin. In addition, large financial institutions can diversify risk better than small microfinance institutions both in terms of geographical risk and financial risk.
4) Macroeconomic Conditions Matter for the Development of Microfinance Institutions

Macroeconomic conditions during the development of the BRI microbanking unit played a crucial role in the success of BRI. Indonesia is the fourth most populous country in the world. Major economic “big bang reforms” started in 1983, when the drastic decline in oil prices forced the country to restructure and diversify its economy, and allowed BRI microbanking to set its own interest rates. For more than a decade - from the mid-1980s until 1996 - the gross domestic product (GDP) expanded at annual rates of 6 to 8%, and Indonesia joined the ranks of the fastest-growing economies in Southeast Asia. In 1995, per capita income (GDP) had surpassed the mark of US$1,000. The manufacturing sector accounts for the main share of GDP with 33%, followed by services (28%), agriculture (17%), with commerce and others accounting for the remaining share. These high uninterrupted growth decades of the Indonesian economy ran parallel to the growth of the UDES, so UDES benefited from this period of stable and strong economic growth. The relationship of BRI microbanking success and Indonesia economic conditions leads to the question: What proportion of an MFI’s success is determined by the macroeconomic environment in which it is situated? Much empirical literature that examines this issue agrees with the case studies of BRI, that macroeconomic conditions contribute to the performance of microfinance institutions. For

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213 Indonesia is a very diverse nation with approximately 300 ethnic groups, and more than 500 languages and dialects. Her more than 200 million people are spread over an archipelago of almost 14,000 islands. The World Factbook: Indonesia. Central Intelligence Agency. (1998). Retrieved from http://www.umsl.edu/services/govdocs/wofact99/166.htm#econ
example, the empirical results from Ahlin et al. (2010) suggest that general GDP
growth helps reduce default rates for microfinance institutions, and economics and
political stability have significant positive impacts on microfinance institutions. In
Marconi and Mosley’s study (2005), they show empirically that microfinance can
only be put in place once a country’s hyperinflation was controlled. This research,
as well as the case study of BRI, hints that microfinance institutions cannot rely
solely on their operations and management to be successful; macroeconomics factors,
which are country-specific, also count toward the success of providing microfinance
services to the poor.

Part II: How a Charitable Microfinance Institution Can Work
Collaboratively With a Sustainable Microfinance Institution

4.6 Pembinaan Peningkatan Pendapatan Petani-nelayan Kecil
(P4K)

After the UDES reform, BRI faced criticisms of “mission drift.” As a state-
owned commercial bank, BRI was asked by the government to provide financial
services for individuals who are poorer than their KUPEDES’ clients. To expand the
financial services to the poorer poor, BRI developed a charitable microfinance
program called Pembinaan Peningkatan Pendapatan Petani-nelayan Kecil (P4K)
(income generating project for small landless and farmers). P4K is a group-based
microenterprise lending and promotion program targeting the rural poor. In addition

doi:10.1002/jid.1218
217 It is important to note that agriculture is a crucial activity in Indonesia, employing 57% of the labor force in
1990 and contributing 17% of GDP in 1994 (as compared to average 10% and 3% respectively in industrial
countries).
to providing subsidized credit to the poor, the program also provides training in microenterprise skills, and acts as a “pre-school” before its target group can become KUPEDES borrowers.

P4K is jointly operated by both BRI and the Ministry of Agriculture and receives significant financial and management support from the International Fund for Agricultural Development (IFAD), the United Nations Development Program (UNDP), and the Asian Development Bank (ADB). In this study, the focus will be on phase II of the project, which was launched between 1988 and 1997, and phase III of the project initiated in 1998.

The principal implementers of the program are agents from the Ministry of Agriculture. These agents identify communities with the potential to participate in the program based on the community’s income level and opportunity for microenterprise development. Within the targeted communities, these agents from the Ministry of Agriculture identify poor households interested in participating in the program. The household income is determined by a detailed questionnaire that these ministry agents filled out based on information they obtained from the households. Eligible households are those with annual per capita incomes below the monetary equivalent of the price of 320 kilograms of rice. The purpose of the eligibility requirements is to reach very poor households in rural Indonesia. This is in line with the objective of the program, which targets the very poor and the non-creditworthy,

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the poorer group with lower incomes when compared with the UDES program, as the mission of P4K was:

1) to improve the skills of small farmers so that they will be able to improve their livelihoods
2) to empower small farmers so that they can increase their income and improve their welfare
3) to create conditions and develop services conducive to supporting the productive activities of poor farmers
4) to institutionalize poor farmers’ groups so as to increase their capacity to work together, improve their bargaining power and improve their productivity. The project's objectives were directed toward the development of a sustainable and participatory system to help poor rural households improve their livelihoods and standards of living through the creation of community-based self-help groups (SHGs).219

Eligible households are encouraged to form self-help groups (SHGs) of 8 to 16 families.220 In order to receive the first loan, the group must save a minimum of $22 and participate in two mandatory training sessions provided by the agents. In the last training sessions, the agents help the eligible groups to complete their business plans.221 The business plan is then sent to the district office of the Ministry of Agriculture for approval. If approval is granted, the business plan will proceed to the appropriate BRI branch for a second approval.222 Although BRI staffs are required to visit the group in theory, this may not always occur in practice. The group may receive a loan from BRI without any previous contact with BRI agents. The average processing time, from the time the agents from the Ministry of Agriculture fill out the questionnaires to the time the group receives the loan, is six months.223

220 Note that self-help group is similar to ROSCA. Unlike ROSCA where the group choose the members spontaneously, outside agents pick the member to participate in each self-help group based on their qualifications. Because the set-up of the group is planned and controlled by the third party, self-help group is often called modified ROSCA. Ibid., 29.
221 Group members selected about 200 different types of investment activities, including livestock raising, small-scale trade, food processing, handicrafts and microenterprises. Robinson Indo, 347-8
223 Ibid.
After receiving the first loan, the group is eligible to receive up to 4 subsidized loans. These four subsidized P4K loans have maturities of 12-18 months each. The interest on the loans is 12 percent per year, flat rate. However, the actual interest is higher, because the group is required to save at BRI as a condition of receiving a loan. As the first loan required the group to save $22, the group needs to save up to 10 percent of the total loan amount in order to take the second loan, and 20 percent to take the third and fourth loans. The group cannot use the mandatory savings during the loan period, although the savings of the group members are deposited in a BRI microbanking unit SIMPEDES account that pays interest on the minimum monthly balance.

The difference between commercial and subsidized microcredit is symbolized in the fact that the BRI microbanking unit call their KUPEDES customers “clients,” indicating a business association. The P4K program calls its customers “beneficiaries,” implying a form of charitable microfinance program. Ravicz (1998) calculates an estimate for the 1995 P4K Subsidy Dependence Index (SDI) of 262 percent, indicating that instead of its 27 percent average annual effective interest rate, the P4K program would have to charge 98 percent to operate sustainably.

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224 Robinson Indo, 348
225 Ibid., 348.
226 Ibid., 348.
227 The author notes that the SDI model has been fleshed out by previous scholars such as J. Yaron and others in a series of papers. The comparison of total subsidy and income from loans (in the forms of SDI) yields two results: 1) The indication of the percentage by which the average yield obtained on the MFIs loan portfolio would have to increase in order to make it subsidy dependent. 2) The cost to society of subsidizing the MFI, relative to the interest plus fees paid by the target clientele to the MFI.
P4K (Phrase II) was funded by the Indonesian Government, the IFAD, and BRI. The government paid for the agents and other screening-related processes, such as forming the self-help groups. In terms of the cost of funds, 80 percent of the funds BRI lends under the project were from IFAD, and BRI used its resources to fund 20 percent of the loans.229

4.7 Comparing P4K and KUPEDES

In Phase II, P4K promoted the formation of 48,000 self-help groups and helped group members obtain loans once they had developed solid savings habits and prepared a group business plan.230 Out of 48,000 self-help groups, approximately 38,000 were able to receive at least one loan from BRI.231 Since the number of group members is between 8 and 16 families (12 families on average), estimated outreach of the program is approximately 576,000 household from 1988 to 1997. However, when comparing this number with KUPEDES, the outreach that P4K attained seems quite small. Assuming that a household can only take one loan from KUPEDES and that the number of loan accounts represents the number of households served by KUPEDES, this means that by 1997, KUPEDES loans were able to reach 2,615,679 households and achieve significantly greater outreach when compared to P4K.232

However, unlike KUPEDES program, P4K was also targeted at empowering individuals. About 37 percent of the self-help groups were made up exclusively of

231 Ibid.
232 Note that this might be an over-estimation, because many members of the household might be eligible for and take loans from KUPEDES. See Appendix 2.
women and 25 percent were mixed.\textsuperscript{233} Total savings stood at $3.3 million and total borrowing amounted to US$47.0 million, with a loan repayment rate of 86 percent.\textsuperscript{234} The incomes of participating families rose by between 41 and 54 percent on average.\textsuperscript{235} Based on the discussion of charitable microfinance institutions in Chapter Three, P4K is a successful charitable microfinance institution. The main target of the program is Group B and women. According to IFAD, the utmost benefit of the program is not financial benefit, but the self-determination of the participants.\textsuperscript{236} Participants have learned not only to save and invest their earnings but also how to manage their own affairs, build self-confidence and become self-reliant. P4K also helps participants to accumulate by introducing SIMPEDES to them as they take their loans. The savings requirement is one way that P4K tries to teach financial literacy and discipline for poor people who have not yet met the criteria of creditworthiness.

To recall the example of agricultural development banks, which failed because their beneficiaries felt they were entitled to the loans that the banks lent out and ended up not repaying them, P4K’s repayment rate is much higher than the agricultural development banks, even though it also operates as a form of charitable organization. This is because the program correctly identified what could help the participants make productive use of the loans they received, specifically a business plan and financial literacy. In addition, unlike other charitable microfinance institutions that claim that their goal is to serve the poorest of the poor (the bottom

\textsuperscript{233} “Income-Generating Project for Marginal Farmers and Landless - Phase III (P4K - Phase III).” (n.d.), IFAD, http://operations.ifad.org/web/ifad/operations/country/project/tags/indonesia/1024/project%20overview
\textsuperscript{235} Ibid.
\textsuperscript{236} Ibid.
half of Group B), BRI does not lend their money out to every self-help group, only lending out to groups that receive approval from both the Ministry of Agriculture and BRI branch directors. The biggest difference is that before the groups receive their loans, they already have three things that they did not have before joining the program. First is $22 in savings. Second is peers who agree to share their responsibility and help them carry out their business projects. Third are the business skills training and business plans. This screening process helps to ensure, to a certain degree, that the group entering the program will focus their efforts on following the business plan they have worked out with the agents from the Ministry of Agriculture. Having a business plan and directions on how they can use their loans helps mitigate the potential for misuse of the loans, which was the major problem in BIMAS.

The case study of BRI suggests that there is a market segment to providing microfinance services to low income people. In this case, BRI provided two types of microfinance services in its different units of operations. Unit Desa is operated under the financially sustainable microfinance model, whereas P4K launched under the charitable microfinance model. Once BRI identified the target group of the program, they designed and adapted the product in response to the needs of their target customers. KUPEDES targets the richer poor who have some forms of collateral, and who would prefer individual loans over group lending. The program targets those who already run some forms of business and already have knowledge of running their own enterprises. At the same time, BRI collaborates with the P4K program with the government to serve not-so-creditworthy individuals. The product is designed to empower the individuals, encourage them to save, and teach them entrepreneurial
skills and how to conduct a business plan. The goal of BRI for KUPEDES is loan repayment, so that the program can attain financial sustainability, whereas the goal of P4K is to prepare potential borrowers who can be served by KUPEDES in the future. Although operating as separate units within the same financial institutions, UDES and P4K can work well collaboratively (as long as P4K receives enough funds from the government, IFAD, and BRI for its operations). P4K then acts as a school and training institution for the poorer poor, and their diploma from this school is eligibility to participate in KUPEDES.

Targeting specific groups of low income people also contributes to the success of the program —by sending a clear message to the clients, and informing them of how they should respond to the program. While UDES calls their customers clients, P4K call their customers beneficiaries, implying the formal characteristic of UDES, and suggesting that P4K operates as a form of charitable programs. Further, BRI was able to send a clear message to its potential customers by separating the two operations units completely: UDES operates through unit desas, P4K through BRI branches. This is to emphasize that UDES and P4K are totally different financial programs, even though both are run under BRI.

The lesson from KUPEDES and P4K is important for the future of the microfinance industry, because there are growing numbers of financially sustainable microfinance institutions, but few collaborative efforts between the two types of microfinance institutions. That P4K serves as a school and training institution for the poorer poor, with the certificate of eligibility being participation in KUPEDES, is essential. It suggests that, equally important as helping the poor to acquire knowledge
and accumulate capital, one of the most important roles of a microfinance institution is to help the poor to build credit history within the formal financial system. Solving the asymmetrical information problem is not a new challenge to microfinance institutions, and there have been many efforts to acquire information from microfinance clients. However, the missing element is the linking of information-sharing between different types of microfinance programs. Linking borrowers’ credit history and information which was collected in P4K and passed on to KUPEDES provides an example of how credit-information sharing can be achieved between different types of microfinance programs.

4.8 Credit Information Linkage: Lesson from KUPEDES and P4K

The lessons from the discussion on poverty suggest that the poor face many difficulties, and one of the most important of these is that they do not have access to formal financial services when they need them. In order to help the poor, the first microfinance institution was initiated to provide the poor access to low-cost capital. However, after charitable microfinance institutions proved that it is possible to lend to the poor, more players, including conventional banks, stepped into the microfinance industry. In recent years, the role of charitable microfinance institutions has declined, and the role of financially sustainable microfinance institutions (some are for-profit institutions) increased.
The microfinance industry is at a crossroads, in moving away from a charitable approach toward a financially sustainable approach. Thus, it is important that microfinance institutions educate their customers, whether they are a charitable microfinance institution or a financially sustainable microfinance institution, and whether their goals are poverty alleviation, or financial sustainability. It is also essential that government regulators understand that different types of microfinance institutions operate with different rules and goals for their clients. With this understanding, the government can advocate for the development of microfinance institutions in proper directions. For example, instead of capping the interest rate for all types of microfinance institutions like the local government did in Andhra Pradesh, the government can implement the policy only with some outrageous profit-making microfinance institutions, as it deems proper.
The crossroads of microfinance institutions also presents the microfinance industry with overlapping problems. Like informal moneylenders, taking loans from a microfinance institution does not require any documentary collateral, the microcredit borrowers can take multiple loans within the same repayment period from different microcredit institutions, and even different lending points or providers from the same organizations, if the borrower is able to hide information about previously-taken loans. At the same time, microfinance institutions do not have an effective credit system to track the information about the borrowers and their credit histories. Rozycki (2006) suggests that this information problem does not only occur across different microfinance institutions, but also within different programs in the same microfinance institution. Hitherto, there has been no effective credit information system for microfinance providers to keep records of the borrowers’ performance across institutions.

According to Robinson (2002), overlapping is not a major problem for informal moneylenders because they follow and keep track of borrower information. In addition, the informal information system that they operate with is limited to the specific geographic areas they operate in. According to this, informal moneylenders can mitigate the moral hazards of borrowers who hide or lie about their credit information. However, unlike informal moneylenders who mitigate this problem by lending to borrowers they know well, microfinance institutions aim to reach a large number of low income people and make it difficult for them to capture information about borrowers as effectively as informal moneylenders.

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The performance of microfinance institutions is measured by their loan repayment rates and the number of borrowers they are able to reach. Many microfinance institutions constantly advertise their high repayment rate in their microcredit programs. While this might show that low income people are bankable and they are very good borrowers, it does not necessarily translate into poverty reduction. Recently, the industry has overemphasized on finding more capital, and left improving the credit information system in the industry underdeveloped. If poverty alleviation requires people who were not creditworthy to become creditworthy, an important element is to build their financial record and use that as base information to evaluate the borrowers’ creditworthiness.

The case study of BRI supports the argument that charitable microfinance institutions and financially sustainable microfinance institutions can work collaboratively to help the low income who do not have financial access. However, in order to do so, they need a credit information system that allows financially sustainable microfinance institutions to access specific information about borrowers of charitable microfinance institutions.
For Group B, BRI works with the government organization to monitor the safer type of low income people coming into the program. The government agents work closely with potential borrowers to make sure that they have business plans before receiving loans. In addition, P4K encourages low income people to save to build their credit history with SIMPEDES. As P4K borrowers graduate from the programs, they may take KUPEDES if they wish to continue borrowing. This is because P4K not only focuses on helping the poor start or operate a business, but also helps the poor to build their assets in savings and establish their credit history with formal financial institutions. The information on how P4K borrowers save is recorded in the P4K, and this information is taken into consideration when borrowers want to join KUPEDES.
To fund their charitable microfinance institutions program, BRI still relies on funds from the government and from IFAD. BRI only contributes 20 percent of P4K loans. That the government, international development organization, and BRI work collaboratively on P4K presents a win-win situation for each party. For the government, they can use P4K to implement their welfare policies. For IFAD, P4K helps fulfill their development goals. For BRI, P4K increases SIMPEDES’ accounts and helps screen and recommend potential KUPEDES borrowers. For the participants in the program, receiving training and learning how to build a business plan helps them improve their lives.

To put this successful collaboration into the context of the microfinance industry, the information-sharing at the borrower level is missing between different financial institutions:

**Figure 7 Credit Information Linkage Model**

There are many limitations to creating an information-sharing system between microfinance institutions. Further research needs to be done to address the problem
of information asymmetry in different microfinance sectors and to create other models that offer win-win situations like the BRI example. There are many challenges to achieving BRI’s win-win outcomes. For example, while BRI might be able to address the issue within between its own different units of operation (UDES and P4K), sharing borrower-level data across the industry might not be in for-profit financial institutions’ best interests, because they might not want their competitors to know potential borrowers information and compete to provide services to the borrowers. In addition, a charitable microfinance institution might be skeptical of a financially sustainable microfinance institution’s underlying motives for acquiring information about borrowers, questioning whether it is genuinely to help the poor with financial inclusion, or to make a bigger profit. It is also important to note that BRI is not just a profit-making commercial bank. BRI is also a state-owned bank with entitled responsibility on welfare, in addition to earning profit.

Regardless how difficult this win-win scenario may seem, it shows that the goal of microfinance institutions helping the poor and low income is an achievable goal. Before accomplishing poverty alleviation, this model provides financial inclusion as well as building creditworthiness for the poor and low income. This creditworthiness record will act, as BRI uses it, as collateral—a guarantee that a person has a good credit history and financial habits. The key to building sustainable financial inclusion for the poor is to access borrower-level data and share that information across microfinance institutions. This requires microfinance institutions to work collaboratively to attain the goal of financial inclusion.
4.9 Recommendation: The Concept of a Credit Information Sharing System

A simple web-based database where microfinance institutions can share information about borrowers may be helpful. This simple database may contain a borrower’s name, national identification number, loan providing organization, loan repayment record, and, if available, savings records. This borrower record can prevent borrowers from lying about their credit information, i.e. lying that they are not currently in debt with other microfinance institutions. At the same time, it helps borrowers to keep their credit record ready in the system, for loan disbursement, if they would like to take loans from other microfinance institutions. In addition, the information system helps microfinance providers to acquire credit information on their potential borrowers more cheaply. In sum, this information sharing system would minimize information asymmetry, lower the cost of information acquisition, and help microcredit providers to evaluate their borrowers’ creditworthiness in the process of making disbursement decisions. While this is a simple suggestion of how an information-sharing program can be built, the execution of the credit-sharing system needs further research.

Note that it is still possible to lie about their credit situations with informal moneylenders. But this information sharing system can help mitigate the problem within the sphere of participating financial institutions.
Concluding Remarks

This thesis suggests that there are two types of microfinance institutions serving different groups of low income people. A charitable microfinance institution should serve Group B, and a financially sustainable microfinance institution should supply Group C. Microfinance should not only seek to provide services to the poorest of the poor, but also take into account individuals without access to financial service in Group C, who accounted for almost fifty percent of the world’s population. By increasingly serving Group C, microfinance can achieve the primary goal of financial inclusion, rather than poverty alleviation.

The case study of BRI suggests that as the industry moves forward to achieve financial inclusions; it should increase its focus on two elements. First, the microfinance industry should pay more attention to microsavings. One way that a charitable microfinance institution can become financially sustainable is through offering public deposits. Second, in order to attain the goal of microfinance, which is financial inclusion, credit information linkage is essential.

My prediction for the future of microfinance industry is that it will change to become more like BRI model, as it moves toward offering microsavings and creating credit information sharing systems. However, there are many challenges that the microfinance industry will have to overcome. These challenges range from macroeconomic conditions of the country where the microfinance institution is located, to politics.

Government, government will play an important role in enhancing or limiting the impact of microfinance institutions on financial inclusion, as happening in the
case of BRI. However, depending on the political conditions of a specific country, how the government executes this task is set up differently. The limitation of this thesis is that it only examines the case study of BRI and its relationship with the Indonesian government. Because BRI is a state-owned bank, there was no tension between the government and BRI microfinance operations. In contrast, there are countries where the government has become increasingly hostile to microfinance operations, such as the local Indian government in Andhra Pradesh, which imposed interest rate cap for microfinance institutions and closed down a number of microfinance institutions due to microfinance-related deaths. Further research needs to take into account the tension between government programs and private microfinance institutions in order to create optimal welfare outcomes for the low income people.

Furthermore, in order to achieve financial inclusion for low income people, charitable microfinance institutions and financially sustainable microfinance institutions have to work collaboratively with one another and with the government. Unlike BRI which is a regulated financial institution, most microfinance institutions, especially the large numbers of charitable microfinance institutions, are not regulated. In many countries, such institutions are not allowed to take public deposits. One way that a non-regulated microfinance institution can provide microsavings services is to work with a regulated microfinance institution, such as a microfinance banks or commercial bank.

While microfinance institutions were started as informal and small scale, with $27 from the pocket of Mohammad Yunus, the future of the microfinance industry
will be large microfinance institutions with more for-profit institutions coming into the industry. On the bright side, commercial banks coming into the microfinance industry can increase competition and drive interest rates down. However, by lowering costs, large and financially sustainable microfinance institutions may crowd out small and donor-dependent microfinance institutions. The challenge for the industry is how to preserve the goal of financial inclusion for Group B, and especially the bottom of Group B, when most for-profits will be more interested in Group C.

How then can we continue helping Group B? One possible answer is that, emulating the case of BRI, government and NGOs need to be involved in collaboratively implementing microfinance programs with large financial institutions. Unlike BRI which is a state-owned commercial bank, privately-owned commercial banks may have a different relationship with the government or NGOs. Thus, the task for the government and for NGOs is to create incentives for these large scale financial institutions to create services for Group B. For example, government can implement policies that will protect charitable microfinance institutions crowding-out effect. This challenge needs to be overcome to create a win-win scheme like the BRI, but the issue needs further in-depth research.

While a credit information sharing system may be helpful for microfinance’s objective of financial inclusion, I am aware that this approach may be prone to serious abuse, especially the abusive use of credit information sharing, and particularly in developing countries. Even in the United States, the subprime crisis showed that the results of abuse of information can have disastrous impacts. In order
to establish this system in developing countries, a few key elements need to be shaped:

1) Who will establish and manage the system? Would it be the government or third party organizations? Who would this information be open to?
2) How will the system be implemented? Would this be written into law that all microfinance institutions reveal their information to one another? Would it be voluntary?
3) How do we provide safeguards against abusive use of information by lenders?

BRI proposes a simple solution to these challenges by ingeniously sharing the information within the same organization, one that provides both a charitable microfinance program and a financially sustainable microfinance program. While this might not provide optimal market outcomes, i.e., there is no competition, this is one model to overcome the tension between different microfinance institutions and to create credit information linkage for the poor. Further research needs to be done to create models of credit information sharing systems that can be adapted to other types of microfinance institutions and conditions in other countries.

The challenge of how to make profit-making contribute to the welfare goal of microfinance requires further research. As the future of the microfinance institution moves more towards the financially sustainable approach and away from the purely charitable approach, the case study of BRI will provide a great basis for the implementation of more advanced models. Two striking keys from the BRI case studies can always be used to improve microfinance industry’s ability to provide financial inclusion for low income people. First, BRI asked low income people what they actually wanted, instead of imposing the programs that BRI thought would work for them. Second, BRI emphasizes one of the most basic, and most important, elements in providing financial services, trust. As increasing numbers of
microfinance institutions race to provide services to as many people as possible, it is important not to forget these two simple key elements will make it possible to provide workable, useful, and sustainable financial services to low income people.
## Appendix

### Appendix 1 – World Population with Different Income Level

<table>
<thead>
<tr>
<th>Income Level ($PPP/day)</th>
<th>Number</th>
<th>Population</th>
<th>Percentage of People who Live Below the Income Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0.63</td>
<td>233.76</td>
<td>5,745.52</td>
<td>4.06856124</td>
</tr>
<tr>
<td>$1.25</td>
<td>1,288.99</td>
<td>5,745.52</td>
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<tr>
<td>$2</td>
<td>2,470.11</td>
<td>5,745.52</td>
<td>42.9919311</td>
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<tr>
<td>$4</td>
<td>3,938.73</td>
<td>5,745.52</td>
<td>68.553064</td>
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<tr>
<td>$6</td>
<td>4,567.72</td>
<td>5,745.52</td>
<td>79.50055</td>
</tr>
<tr>
<td>$10</td>
<td>5,166.83</td>
<td>5,745.52</td>
<td>89.9279787</td>
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</tbody>
</table>

### Appendix 2 - BIMAS Disbursement and Repayment Performance

<table>
<thead>
<tr>
<th>Column1</th>
<th>Loans outstanding (Rp Billion)</th>
<th>Default rate (Percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970/1971</td>
<td>0.3</td>
<td>3.5</td>
</tr>
<tr>
<td>1971/1972</td>
<td>0.2</td>
<td>3.0</td>
</tr>
<tr>
<td>1972/1973</td>
<td>0.7</td>
<td>5.2</td>
</tr>
<tr>
<td>1973/1974</td>
<td>2.7</td>
<td>8.5</td>
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<tr>
<td>1974/1975</td>
<td>3.7</td>
<td>9.1</td>
</tr>
<tr>
<td>1975/1976</td>
<td>7.5</td>
<td>14.0</td>
</tr>
<tr>
<td>1976/1977</td>
<td>10.7</td>
<td>22.0</td>
</tr>
<tr>
<td>1977/1978</td>
<td>12.7</td>
<td>30.1</td>
</tr>
<tr>
<td>1978/1979</td>
<td>13.9</td>
<td>33.0</td>
</tr>
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<td>1979/1980</td>
<td>11.8</td>
<td>33.0</td>
</tr>
<tr>
<td>1980/1981</td>
<td>21.3</td>
<td>60.0</td>
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</table>

Source: Bank Rakyat Indonesia
Appendix 3 - Financial Performance of BRI Microbanking Unit

<table>
<thead>
<tr>
<th>Year</th>
<th>Savings Accounts (Number)</th>
<th>Savings Accounts ($ million)</th>
<th>Loan Accounts (Number)</th>
<th>Loans ($ million)</th>
<th>Savings-to-Loans Ratio (%)</th>
<th>Surplus Liquidity ($ million)</th>
<th>12-Month Loan-Loss Ratio (%)</th>
<th>Arrears Ratio (%)</th>
<th>Return on Assets (%)</th>
<th>Exchange Rate (Rp)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>2,655</td>
<td>39.3</td>
<td>640,746</td>
<td>103.4</td>
<td>38</td>
<td>(84.1)</td>
<td>1.0</td>
<td>5.4</td>
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<td>1985</td>
<td>36,563</td>
<td>75.5</td>
<td>1,034,532</td>
<td>203.6</td>
<td>37</td>
<td>(128.1)</td>
<td>1.8</td>
<td>2.1</td>
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<td>418,945</td>
<td>107.1</td>
<td>1,231,723</td>
<td>203.7</td>
<td>53</td>
<td>(99.6)</td>
<td>2.7</td>
<td>4.5</td>
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<td>4,163,983</td>
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<td>1,214,789</td>
<td>260.4</td>
<td>67</td>
<td>(86.2)</td>
<td>3.0</td>
<td>5.8</td>
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<td>284.8</td>
<td>1,386,035</td>
<td>313.3</td>
<td>91</td>
<td>(28.5)</td>
<td>4.6</td>
<td>7.4</td>
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<td>1,643,980</td>
<td>472.1</td>
<td>113</td>
<td>(62.8)</td>
<td>2.3</td>
<td>5.4</td>
<td>n.a.</td>
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<td>4.1</td>
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<td>1,837,549</td>
<td>730.8</td>
<td>174</td>
<td>544.6</td>
<td>4.9</td>
<td>8.6</td>
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<td>2,790,192</td>
<td>949.4</td>
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<td>1,165.1</td>
<td>0.5</td>
<td>2.2</td>
<td>5.8</td>
<td>10,400</td>
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<tr>
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<td>28,262,073</td>
<td>2,626.4</td>
<td>3,056,103</td>
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<td>195</td>
<td>1,283.0</td>
<td>1.7</td>
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<td>29,089,197</td>
<td>3,538.2</td>
<td>3,100,356</td>
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<td>210</td>
<td>1,854.8</td>
<td>1.9</td>
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<td>5.7</td>
<td>8,425</td>
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<tr>
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<td>3,541.4</td>
<td>3,210,678</td>
<td>2,067.0</td>
<td>171</td>
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<td>3,742.7</td>
<td>3,213,582</td>
<td>2,317.9</td>
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<td>1,424.8</td>
<td>1.3</td>
<td>1.4</td>
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<td>30,907,566</td>
<td>4,659.7</td>
<td>3,455,528</td>
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<td>1,754.9</td>
<td>1.2</td>
<td>1.3</td>
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<td>9,393</td>
</tr>
<tr>
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<td>3,515,812</td>
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<td>163</td>
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<td>0.9</td>
<td>1.2</td>
<td>9.4</td>
<td>9,419</td>
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</table>

Source: Bank Rakyat Indonesia

Appendix 4 – Microfinance Institutions (MFI) Data Summary

The MFI data are collected from individual institutions as reported to the Microfinance Information Exchange. To investigate the service structures of MFIs, I
utilized panel data of MFIs for the year 1999-2008. I only keep MFIs that provide both microsavings and microcredit for this analysis.

1) Data Summary on 537 Microfinance Institutions

<table>
<thead>
<tr>
<th>Microfinance Institutions</th>
<th>Freq.</th>
<th>Percent</th>
<th>Cum.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Offer Microsavings</td>
<td>537</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Offer Microcredit</td>
<td>537</td>
<td>50</td>
<td>100</td>
</tr>
<tr>
<td>Total</td>
<td>1,074</td>
<td>100</td>
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</tbody>
</table>

2) Data Summary by Year (1995-2008)

<table>
<thead>
<tr>
<th>Variable</th>
<th>Observation</th>
<th>Mean</th>
<th>Std. Dev.</th>
<th>Min</th>
<th>Max</th>
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</thead>
<tbody>
<tr>
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<td>2</td>
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<td>67166</td>
<td>67166</td>
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<tr>
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<td>1.09E+07</td>
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<tr>
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<td>1.69E+08</td>
<td>168303</td>
<td>8.46E+08</td>
</tr>
<tr>
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</tr>
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<td>3.47E+09</td>
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<tr>
<td>y2008</td>
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<td>7.12E+07</td>
<td>1.45E+08</td>
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<td>7.81E+08</td>
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</table>

3) Microfinance Institutions that Introduce Savings Before Loans

<table>
<thead>
<tr>
<th>Savings Introduce</th>
<th>Frequency</th>
<th>Percent</th>
<th>Cum.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before Loans</td>
<td>1,074</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

4) Microfinance Institutions with More Outstanding Savings than Loans

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Savings than Loans</td>
<td>1,006</td>
<td>93.67</td>
<td>93.67</td>
</tr>
<tr>
<td>1</td>
<td>68</td>
<td>6.33</td>
<td>100</td>
</tr>
<tr>
<td>Total</td>
<td>1,074</td>
<td>100</td>
<td></td>
</tr>
</tbody>
</table>
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