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The Impact of the Global Financial Crisis on Rural and Microfinance in Asia

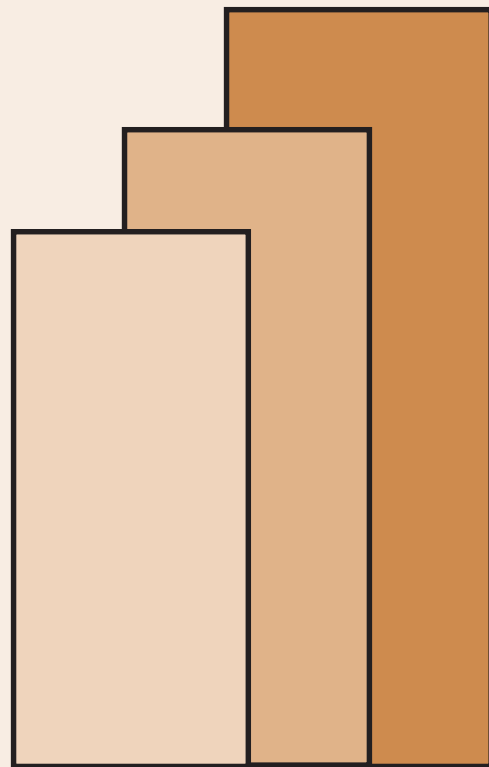
Gilberto M. Llanto and Jocelyn Alma R. Badiola

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The Impact of the Global Financial Crisis on Rural and Microfinance in Asia¹

**Gilberto M. Llanto
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Summary

Using data from a quick survey of various rural (RFIs) and microfinance institutions (MFIs) in East Asia, the paper tries to find out those institutions and their clientele have been affected by the global financial crisis, how they have coped with the on-going crisis and what they plan to do in the future to ensure the stability of the rural financial system and the continuing access of clients to financial services. The microfinance sector in Asia continues to evolve with emphasis on efficiency and strong growth in outreach. The limited data from the quick survey validate the growth in loan portfolios and increase in the number of clients, with growth varying significantly by country depending on internal and external factors during the period before the global financial crisis. Impacts vary depending on external and internal factors faced by RFIs and MFIs. However, they continue to maintain a positive attitude and expect that business will pick up as a result of an increase in demand for loans to finance livelihood projects and various micro-enterprises. They are aware of the threats and opportunities brought about by the global financial crisis. The analysis leads to some lessons for policy makers, bank regulators, rural financial institutions and microfinance institutions that are committed to provide inclusive financial services to member clients.

Key words: global financial crisis, credit crunch, loan portfolio quality, regulatory framework, inclusive financial service

I. Introduction

The current global financial crisis has hit both the real and financial sectors with unexpected severity and uncharacteristic speed, not ever witnessed since the Great Depression of the twentieth century. A World Bank update for East Asia in the wake of the global financial crisis likened the coping being taken by countries that have been impacted by the crisis to “navigating the perfect storm” (World Bank, 2008)².

During the pre-crisis situation, the rise and subsequent drop of food and fuel prices have strained the resources and policymaking skills of developing countries. The global financial crisis, which emanated from failing sub-prime mortgage markets in the U.S, caught policymakers off-balance as liquidity in the financial markets rapidly started to dry up followed by sharp rises in short-term interest rates, a fall in equity markets and great volatility in foreign exchange rates. The speed of economic reversal caught even the most experienced observers by surprise. The East Asian economy went into sharp reverse everywhere (Drysdale, 2009). Growth projections were revised as countries in East Asia realize that the global financial crisis would have longer and lasting effects than previous crises, which had the developing countries as source. This global financial crisis is different from prior crises in developing countries as it is generated from North to South and it has happened in a much more integrated global setting. Because the world economy has substantially integrated, few countries will be spared the pain (Magnoni and Powers, 2009).

Indeed, the current crisis is quite unlike the Asian financial crisis that buffeted the region in 1997-1998 because it is global in scope and deeper in its impact. It

² The World Bank economic update for the East Asia and Pacific Region on the impact of the global financial crisis is a report with the title “East Asia: navigating the perfect storm.”

works its way through the interconnected and wired global economy, which partly explains the speed, coverage and depth of the transmission of impacts. Wellen and Mulder (2008) observe that microfinance institutions and their clients have proven to be fairly stable during previous Asian, ruble and peso crises at the end of the last millennium. Stauffenberg and associates (2009) comment that the accepted wisdom is that microfinance is impervious to the global markets, but also quickly claim, “the data so far do not support or refute this claim” (page xi). It is likely that the current financial turmoil will have a greater influence on the rural and micro finance sector, first because it impacts on the global economy, which will diminish remittances, tourism and demand for commodities from developing countries and second because many microfinance institutions are more linked to the global financial markets than previously³. Fitch Ratings (2009) contends that contrary to some industry views that microfinance is resilient to wider economic shocks, it will be difficult for the sector to remain immune from the global financial crisis. There will be (a) a funding or liquidity impact, which increases refinancing risks for MFIs and (b) an economic impact, with financial performance affected by lower lending volumes, increased costs of funding, tighter net interest margins, higher impairment charges and higher volatility in foreign exchange losses/gains. This is the downside of the convergence risk of greater integration of microfinance with the banking sector (Fitch Ratings, 2009). Magnoni and Powers (2009) paint a rather bleak scenario: tightening credit, falling export revenues and declining remittances, which will lead to unemployment and currency weakness and inflation in some countries. Since mid-2008 the credit crunch has reduced the available commercial capital for microfinance institutions, which will restrain the growth of loan portfolios. They estimate that over 2009-2010, the sector wide microfinance portfolio will grow by some US\$28 billion less than anticipated before the crisis. Microfinance institutions will find their profit margins eroded by higher borrowing costs. The challenge for rural financial institutions and microfinance institutions will be finding a better equity vs. debt funding mix as well as securing access to local deposits and local bank loans.

Providing the channel for impacting the balance sheets of rural microfinance institutions is the tighter integration of rural and microfinance into the financial sector

³ Lukas Wellen and Marnix Mulder, “Influences of the financial turmoil on MFIs”, unpublished notes, October 2008

today compared to several years ago (Magnoni and Powers, 2009; Stauffenberg and associates (2009)) and the fact that ‘microcredit’ now includes forms of lending to the poor not previously considered as microfinance, e.g., small business lending. Small businesses often operating with fixed assets appear to be highly vulnerable when the economy contracts (Stauffenberg and associates, 2009).

Because of the rural and microfinance sector’s contribution to uplifting the economic status of many poor client households and to providing an avenue for financial inclusion, it is important to examine the impact of the crisis on the sector. This paper investigates the impact of the global financial crisis on the rural and microfinance sector in East, South and Central Asia, more specifically, on APRACA⁴ member institutions, that is, (a) rural financial institutions (RFIs), (b) microfinance institutions (MFIs), and (c) bank regulators. It also takes a look at the impact on clients based on information reported by those RFIs and MFIs.

The paper tries to find out how rural and microfinance institutions and their clientele have been affected by the global financial crisis, how they have coped with the on-going crisis and what they plan to do in the future to ensure the stability of the rural financial system and the continuing access of clients to financial services. The analysis of the impact of the global financial crisis on the rural and agriculture financial markets leads to some lessons for policy makers, bank regulators, rural financial institutions and microfinance institutions that are committed to provide inclusive financial services to member clients.

It is organized into four sections. After a brief introduction, Section II describes the current macroeconomic and financial environment with focus on East and South Asia to set the stage for a discussion of the impact of the global financial crisis on the rural and micro finance sector. It draws liberally from existing literature on the region, especially those coming from the World Bank and the Asian Development Bank. Other secondary sources supplement the discussion. Section III examines the impact of the global financial crisis on microfinance institutions, rural finance institutions, regulators and clients, using information and data provided by the

⁴ Asia Pacific Rural and Agricultural Credit Association (APRACA).

country papers, secondary sources such as the Microbanking Bulletin and other sources. The main sources of information are the country papers submitted by APRACA member institutions⁵.

Many poor households, small farmers and microenterprises have benefited from access to financial services provided by microfinance institutions and rural finance institutions. Access to financial services has improved the level of welfare of poor households and has expanded the array of feasible options for production, processing, marketing and distribution for small farmers, microenterprises and rural economic agents in general. The global financial crisis has impacted both the assets and liabilities side of the balance sheets of rural finance institutions and microfinance institutions, creating problems and challenges about future funding and clients' access to financial services. The final section gives concluding observations and some recommendations.

⁵ This integrative paper is based on the findings of the country papers on the Philippines, Indonesia, Thailand, Myanmar, Cambodia, India, Pakistan, and Korea as well as on available secondary data gathered by the country authors from previous studies and reports of Central Banks and other financial institutions. The quality of data and analysis done by the country papers is uneven. Some country papers also suffer from lack of good data and information. This is a principal limitation of this paper, which relies on the information and data provided by the country papers.

II. An Overview of the Current Macroeconomic and Financial Environment

The economic storm had its epicenter in the developed countries but its fury has quickly spread to developing countries (World Bank, 2008) that are connected to the U.S. and Europe through investment, trade and financial links. The global financial crisis is impacting the balance sheets of financial institutions in terms of low asset growth, inadequate levels of capital, volatility in deposits, high default rates and curtailed funding by investors and lenders. The World Bank Global Monitoring Report (2009) notes the following immediate impacts of the crisis on financial markets:

- The failure of important financial institutions in the major financial systems froze inter-bank and credit markets around the world and revised the price of risk upward, triggering a global liquidity shortage.
- The ensuing search for liquidity worldwide prompted the sale of equity and debt securities and the withdrawal of capital from emerging markets, destabilizing banking systems.
- Boosts to liquidity and injections of capital in financial institutions by developed country authorities may avert a systemic meltdown of financial markets, but heightened risk aversion and an ongoing deleveraging across the world is causing capital to retreat from developing countries and the cost of financing to rise.
- The countries of the region have found the cost of capital in international markets to skyrocket, threatening their ability to finance development programs and hurting their poverty reduction efforts

The financial turmoil has created significant challenges to both developing economies and developed countries such as Japan and South Korea in East and South

Asia. The real economy is experiencing a severe drop in manufacturing activities, falling demand, job losses, lower remittances, shrinking export markets, weakening of commodity prices for the net commodity exporting countries and declining tourism arrivals. The interconnectedness of the global economy has allowed the easier and faster transmission of the negative effects of a liquidity and credit crunch and currency dislocations that followed in the wake of failing American sub-prime mortgage markets. Some countries are already in recession as output drops and job losses mount.

In 2008, the World Bank observed that Japan and Europe were already in recession and the United States was expected to follow soon. All three were expected to contract further in 2009, which would dampen import demand and result in the first decline in world trade volumes in a quarter century. The World Bank (2008)⁶ noted that global trade was forecast to shrink in 2009 for the first time since 1982 while foreign investment and short-term credit were drying up. Developing country exports fell; large amounts of capital have been withdrawn. Many developing countries faced sharply tighter credit and higher interest rates. GDP growth in 2009 in developing countries was expected to fall to 4.5 percent from 7.9 percent in 2007. Private capital flows were expected to drop from \$1 trillion in 2007 to \$530 billion in 2009. Remittances that workers send to home countries that provide a lifeline to poverty-stricken areas were projected to decline.

In 2009, the World Bank reports that during the second half of 2008, the global economy came to a halt: on an annualized basis, global GDP growth slowed to 2 percent after an average growth rate of 5 percent over 2003–07. International trade flows collapsed in the last quarter of 2008, with world exports projected to decline in 2009 for the first time since 1982 (World Bank, 2009). The IMF in its World Economic Outlook projects a 3.2 percent global growth for 2009 down from its projection of 4.6 percent for 2008. The global crisis has taken its toll in terms of falling demand, drop in output, rising unemployment and worsening of the poverty situation.

⁶ <http://www.worldbank.org/html/extdr/financialcrisis>

ILO Director General Juan Somavia graphically characterizes the current phenomenon as “not simply a crisis on Wall Street, this is a crisis on all streets.”⁷ Estimates of the unemployment spawned by the global financial crisis are staggering. Mr. Somavia was quoted as saying that “the ILO’s preliminary estimates indicated that the “number of unemployed could rise from 190 million in 2007 to 210 million in late 2009” and that “the number of working poor living on less than a dollar a day could rise by some 40 million, and those at 2 dollars a day by more than 100 million”. The scenario is a frightening harbinger of a worsening poverty situation especially in developing countries. The current crisis would hit hardest such sectors as construction, automotive, tourism, finance, services and real estate. Somavia also noted that the new projections “could prove to be underestimates if the effects of the current economic contraction and looming recession are not quickly confronted”⁸.

Anecdotal evidence on the impact on households suggests that the rise in food prices (a condition that preceded the financial crisis) and the economic slowdown brought about by the financial crisis are leading to a squeeze in household income and thus, low income people have been struggling to adjust to the situation (Littlefield and Kneiding, 2009). The global situation is grim and could intensify unless the global community adopts coordinated policy measures and consultations to revitalize the financial sector and spark economic recovery. In East Asia, the World Bank (2008) points out that regional organizations such as the ASEAN, including its expanded forms, ASEAN +3 and ASEAN +6, can complement such global initiatives on policy dialogs and coordination. The possibility of multilateralizing the ASEAN +3 Chiang Mai initiative—an arrangement of bilateral swap arrangements currently totaling US\$824 billion- is already being pursued.

The World Bank (2009) summarized the current global situation and the action immediately required of the global community as follows⁹:

⁷ http://www.ilo.org/global/About_the_ILO/Media_and_public_information/Press_releases/lang--en/WCMS_099529/index.htm (date accessed, June 2, 2009)

⁸ *ibid.*

⁹ World Bank, Global Monitoring Report 2009 (<http://web.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTGLOBALMONITOR/EXTGLOMONREP2009/0,,contentMDK:22149019~enableDHL:True~menuPK:5924427~pagePK:64168445~piPK:64168309~theSitePK:5924405,00.html>) date accessed June 2, 2009

- The world faces the severest credit crunch and recession since the Great Depression. Developing countries' growth prospects and access to external financing are subject to unusually large downside risks.
- Though originating in advanced countries, the crisis is hitting developing countries hard.
- While transmission channels may differ, both emerging market and low-income countries will be severely impacted.
- Economic policy responses should be adapted to country circumstances: countries with strong fundamentals may have room for monetary and fiscal stimulus, while those in weaker macroeconomic positions and with limited access to external financing will have less room for interventionist policies; some may need to undertake fiscal consolidation.
- Advanced emerging, and developing countries should take a comprehensive action to resolve liquidity and solvency problems in the banking system and strengthen prudential supervision.
- Development aid must be increased to help countries cope with the crisis.
- It is crucial to maintain an open trade and exchange system.

What of the immediate future? The World Bank (2009) avers that huge uncertainties about the expected length and severity of the recession in the developed countries remain. Reflecting this uncertainty, stock markets have remained volatile, credit markets have yet to return to normality, the US housing sector has continued to deteriorate, private investment is in a tailspin, and consumer confidence is on a decline.

Policy makers and the multilateral donor community have joined forces to develop large fiscal stimulus packages to prop an ailing world economy. In East Asian countries, the fiscal stimulus packages were designed to offset the impact of failing export markets. Central banks have cut policy rates to ensure sufficient liquidity in the financial system. The World Bank (2009) has suggested that such countercyclical fiscal packages could focus on spending for infrastructure and social safety nets.

The World Bank has argued that while most Asian economies are generally

better prepared than ever to deal with the changes in the global economy, they should not be seen as invulnerable to developments elsewhere. The Asian region's increased integration to global trading and financial systems makes it sensitive to global economic conditions. The "decoupling theory" that appears to be popular in some quarters in East Asia cannot be substantiated empirically and carries with it an inherent danger of inducing a sense of complacency (World Bank, 2009).

The global financial crisis has started to impact both growth and poverty reduction goals of developing countries in East Asia as the fury of the economic storm manifested through steep output contraction, rising unemployment and collapsing financial institutions, takes its course across the globe. While the full impact of the crisis on the region has yet to unfold, its effects are "likely to be more complex, deeper and more difficult to predict than in the past (Littlefield and Kneiding, 2009, page 1).¹⁰"

While the full impact of the global financial crisis on Asian rural and microfinance markets has not yet fully played out, it is uncertain what will happen when it does. Initial indications point to the possibility of a combination of the following phenomena: more stringent lending policies, tighter filtering of clients, liquidity shortages and increasing costs of funds amidst declining economies.

Many countries in the region are experiencing economic contraction and rising unemployment. The prospect of a sharper slowdown in economic growth, which will impact more severely on poorer households and vulnerable groups, looms in the horizon unless the global community exerts a concerted and coordinated effort to avert the "full fury of the economic storm" (World Bank 2008, page 7).

As the financial deleveraging process continues and capital flows to emerging economies in the East Asia region reverse, the increase in the cost of financing, a sharp fall in equity prices and an overall decline in demand will result to a general economic slowdown. Forecasts for 2009 indicate the negative impact of the global financial crisis (Table 1). While the World Bank and Asian Development Bank may

¹⁰ Elizabeth Littlefield and Christoph Kneiding (2009), "The global financial crisis and its impact on microfinance," CGAP Focus Note No. 52, February.

differ in their estimation of the economic impact of the global financial crisis on East Asian countries, the undeniable fact is that all those countries are experiencing negative impacts in varying degrees of depth and severity.

Table 1. Economic growth forecasts, 2009-2010

Country	2009	2010
China	6.0**	6.5
Japan	-6.4	-
Hong Kong	-5.9	8.6
Korea	-10.1	4.0
Singapore	-7.5	3.5
Taiwan	-9.3	2.4
Indonesia	1.9	5.0
Malaysia	-3.0	4.4
Philippines	-1.9	3.5
Thailand	-4.4	3.0

Sources: Asian Development Bank, March 31, 2009 [Economist.com/country briefings](http://Economist.com/country_briefings), April 19, 2009

However, the economic fundamentals of Asian countries considered in this paper are generally sound primarily because of lessons learned from the Asian financial crisis of 1997. East Asian banks have begun to raise more capital and exercised prudence in lending. They have limited direct exposures to derivative products¹¹ and other assets, which have caused the closure or large losses of international banks in OECD economies. Current account positions are healthier and external liabilities appear to be manageable in many East Asian economies.

¹¹ Labelled now as 'toxic assets'

Some Asian countries are affected more than others. Vulnerability factors include: current account deficits; reliance on external funding; significant foreign participation in domestic equity and bond markets; and domestic macro imbalance. Those that are more highly dependent on external demand will contract more sharply than the rest.

South Asia experienced surging inflation rates as well as current account and fiscal deficits¹². Combined with food and fuel price shocks, the inflation rate in Pakistan was as high as 25 percent at the height of the financial crisis in 2008. Gross domestic product (GDP) growth spurred by gains in the industrial and service sectors remained in the 6 percent to 8 percent range in 2004-2006 after which it slipped downwards to 5.8 percent in 2007. Pakistan faces higher inflationary pressure due to a rise in food prices, an acute power shortage and a slowdown in the manufacturing and services sector. The impact of the global financial crisis has been somewhat limited but there have been a sharp pull back in domestic asset markets, constrained investment flows and a fall in business confidence. Security concerns arising from an on-going insurgency have led to domestic instability and a decline in net inflow of foreign investment from a high US\$8.4 billion in 2007 down to US\$3.9 billion in 2008. High commodity prices and capital flight helped create a gaping trade deficit, high inflation and a crash in the exchange rate from US\$1:Rs 60 to US\$1:Rs 80 in just a few months. For the first time in many years, Pakistan may have to seek external funding for balance of payments support. Thus, security concerns and domestic instability have compounded the problems brought about by the global financial crisis.

Although India has responded well to the food and fuel price shocks and has generally maintained prudent macroeconomic management, the crisis has hit India relatively hard because of its strong link to global financial markets. Demand effects have been particularly severe in housing, construction, consumer durables and the information technology (IT) sectors while exports sharply declined. GDP growth

¹² The following paragraphs summarize the macroeconomic and financial situation in the countries included in this paper. The country papers are the sources of data and related information. Details of the macroeconomic and financial situation can be read in the submitted country papers. Another source is the World Bank (2008).

slowed down to 7 percent in 2008 from 9 percent in 2007 due to a decline in agriculture, industry and services. The growth of the Index of Industrial Production decelerated to 3.9 percent in 2008 from 9.2 percent a year ago. Inventory build-up, production cuts and temporary closure in some sectors such as automobiles indicate a huge stress on the economy. Even as India has managed to grow at an average annual growth rate of 8.8 percent driven largely by domestic consumption and investment, the crisis is likely to dent India's growth trajectory as investments and exports slow down. GDP is projected to decline to around 5 percent in 2009.

In Southeast Asia, the Philippines experienced a significant economic slowdown in 2008. GDP growth rate dropped to 4.6 percent in the first nine months of 2008 from 7.2 percent during the same period in 2007 (World Bank 2008). However, the slowdown was largely due to a sharp rise in inflation triggered by a surge in food and fuel prices and not to the global recession (Yap, 2009). Inflation rose to 9.4 percent in 2008 from 2.8 percent in 2007. The Philippines has yet to feel the full impact of the global crisis but the World Bank (2008) has noted that the global slowdown has taken a toll on export growth and has put downward pressure on foreign investment inflows.

Domestic financial markets have been relatively resilient in the face of the crisis with overall exposure to structured products estimated at around 2 percent of banking assets. However, banks are nonetheless affected through their large holdings of Philippine sovereign paper whose price has fallen substantially because of the global turmoil. Spreads on ten-year peso-denominated government bonds have climbed to 600 basis points from 200 basis points in late 2007. Equity prices have fallen by more than 40 percent in 2008 (World Bank 2008).

The Thai economy plunged by 4.3 percent in the fourth quarter of 2008, much deeper than expected as compared to a 5 percent growth in the first three quarters of the same year. This was due largely to the contraction of Thai exports and tourism arrivals brought about by the deteriorating global economic condition. The export sector contributes about 70 percent of gross domestic product. Political uncertainty and frequent changes in government have also contributed to the rapid pace of economic slowdown. Overall, the economy grew by only 2.6 percent in 2008, a

dramatic decline from an expansion of 4.9 percent and 5.2 percent in 2006 and 2007 respectively. Economic growth is expected to slow down to 0.5 percent in 2009. The World Bank (2008) sees limited scope for investment to recover and the slow growth in exports will cause GDP growth to weaken in the coming year.

Thailand's inflation rate jumped to a high 9.2 percent in 2008 from 5 percent in 2007 due to surging oil and food prices. Fuel prices in Thailand rose by about 47 percent also in 2008. Household consumption decreased by 2.2 percent during the same year. Economic and political uncertainty and rising risk premiums have forced banks to exercise caution in lending. The World Bank (2008) indicates that the impact of the crisis on Thai commercial banks has been limited so far because of the absence of exposure to toxic assets. Banks are becoming more cautious and will likely curb credit growth in 2009.

Indonesia has remained in relatively good shape because it is the only major economy in East Asia that did not experience a growth slowdown during the first half of 2008. After reaching rock bottom during the Asian financial crisis of 1997 when it experienced a negative 13 percent economic growth rate, the Indonesian economy grew steadily during the period 2002-2007. In 2007, Indonesia posted a growth rate of 6.3 percent. In the next three quarters of 2008, the growth was steady and robust, i.e., 6.3 percent in the first quarter; 6.4 percent in the 2nd quarter which slightly declined to 6.1 percent in the third quarter of 2008. According to the World Bank (2008) the main growth drivers were private investments and net exports. The main concern is inflation brought about by rising fuel and food prices earlier in 2008. Food accounts for 40 percent of Indonesia's consumer price basket. A decline in inflation and a perceptible slowdown in economic activity have prompted the central bank to cut its policy rates. The global financial crisis has affected Indonesian financial institutions because of a relatively open capital account, significant foreign holdings of equities and debt, the relatively large foreign ownership of Indonesian banks, and the lingering memories of the 1997 Asian financial crisis that has made investors wary of exchange rate volatility (World Bank 2008).

The global financial crisis did not spare transition economies like Cambodia, Vietnam and Myanmar. The Cambodian economy, which is largely driven by the

export markets and foreign direct investment in the garment industry, tourism and the construction sectors, experienced a sharp decline in economic growth from 10.2 percent in 2007 to 7 percent in 2008. The World Bank (2008) observes that shocks have increased uncertainties over the economic outlook. Real GDP is projected to slide further to 4.9 percent in 2009. The government has to address substantial challenges to the following growth drivers: (a) rice, (b) garments, (c) construction and (d) tourism. A surge in food prices has contributed to inflationary pressure but the subsequent fall in fuel and food prices will slowdown the rise in consumer price inflation.

Vietnam's gross domestic product growth rate dropped from 8.5 percent in 2007 to 6.2 percent in 2008. The global financial crisis struck at a time when Vietnam was trying to address its double-digit inflation of 12.7 percent at the end of 2007. In September 2008, inflation in Vietnam almost doubled to 21.5 percent following sharp increases in the world energy and food prices. The government confirmed significant losses in the stock market and closure of business enterprises especially those in exports, which eventually had an adverse impact on production and consumption, employment as well as household incomes. Nonetheless, the World Bank (2008) reports that Vietnam's performance in 2008 demonstrated the resilience of the economy. After three years of real GDP growth above 8 percent, economic growth slowed down in 2008 chiefly because of the stabilization package implemented by the government to temper surging inflation and overheating pressures.

Myanmar's financial system and economy are largely cut off from the outside world but it is not invulnerable to the crisis. According to a reporter of the Wall Street Journal, credit has dried up, remittance income is falling, and thousands of workers returning from abroad discover that jobs are scarce. The local banking system has yet to fully recover following its collapse in 2003, with 20 or more private banks closing shop after a run on deposits. However, the country is holding up given the declining prices of the country's prime commodities which helped ease inflation and the weaker demand for imported goods which has improved the country's trade balance, boosting the local currency, the kyat. The government's finances are also in relatively good shape. With the help of natural-gas revenue—including \$2 billion in annual supplies

to Thailand—the government has more than \$3 billion in foreign-exchange reserves, and it has significantly improved tax collection according to the Asian Development Bank (2008).

South Korea is one of the wealthiest countries in the world with a gross domestic product (GDP) measured on purchasing power parity basis at \$1.2 trillion (World Bank, 2007). The nation has one of the highest GDP per capita in Asia, more than \$20,000, according to the International Monetary Fund. However, because of the global financial meltdown, GDP growth significantly declined from 5.1 percent in 2007 to 2.4 percent in 2008. The crisis is expected to significantly affect an export-led economy like South Korea because shrinking American and European markets. However, North America and the European Union constitute only 13.3 and 15.1 percent of the Korean export market, respectively. In contrast, China, ASEAN, Japan and other countries constitute 22.1, 10.4, 7.1, and 19.1 percent of the Korean export market, respectively. The crisis, therefore, has propelled Korea to concentrate more on intra-regional trade and explore new export destinations. Korea has around \$420 billion of external debt but \$152 billion of it is deemed risk-free. Similarly, the Korean banking sector has had moderate loan growth in 2008 with a continued low level of delinquencies.

The Asian financial environment

Transition countries like Cambodia, Vietnam and Myanmar have underdeveloped formal rural financial markets with the majority of their population still lacking access to formal financial services and dependent on informal credit markets. However, Cambodia and Vietnam have begun establishing a market-oriented policy environment. The main driver is the need to attract foreign capital to boost a growing economy. The State Bank of Vietnam has liberalized interest rates since 2002 but still allows the Vietnam Bank for Social Policies to provide subsidized credit to poor households. Myanmar has initiated financial reforms with banking laws in 1990 including: The Central Bank of Myanmar Law; The Financial Institutions of Myanmar Law and The Myanmar Agricultural Development Bank Law. These laws specify the functions, duties and powers of financial institutions, as well as the regulatory framework for these institutions. The country still lacks the policy

framework, the legal and administrative structure to effectively implement microfinance or rural finance nationwide.

A common characteristic of the rural financial markets of these countries is that dominant role of specialized banks and non-governmental organizations (NGOs) as formal credit providers. Cambodia has established the ACLEDA Bank while Myanmar Agricultural Development Bank (MADB), a state-owned bank is virtually the only major source of institutional credit in the rural areas of Myanmar. The Vietnam Bank for Agriculture and Rural Development (VBARD) has been the major source of credit and savings in rural Vietnam since its establishment in 1988. Vietnam also has the Vietnam Bank for Social Policies, Vietnam Postal Saving Company and the People's Credit Fund including 57 international non-government organizations and 4 government-recognized micro-finance organizations. In transition countries government-owned banks exist side by side with private commercial banks, providing directed credit to a motley group of small clientele consisting of farmers, shopkeepers, microenterprises and other small clientele.

The Philippines, Indonesia and Thailand have relatively more developed rural financial markets. These three countries have successfully developed innovative finance schemes and strengthened rural financial institutions that have served them well in providing small farmers, poor households and microenterprises with access to finance services.

In the Philippines, lessons learned from the failure of directed (subsidized) credit programs in providing small borrowers with access to credit led to the adoption of a market-based policy environment. The Philippines developed a national strategy for microfinance, which envisions a viable and sustainable private microfinance market with the main objective of providing low-income households and microenterprises with access to financial services. Anchored on this national strategy, several laws and regulations were passed to promote greater involvement of the private sector, the non-participation of government line agencies in credit programs and the adoption of market oriented financial and credit policies¹³. The regulatory

¹³ These laws and issuances are the Social Reform and Poverty Alleviation Act, Agriculture and Fisheries Modernization Act, Executive Order 138, which rationalized government directed credit

forbearance adopted by the Bangko Sentral ng Pilipinas (Central Bank of the Philippines) shows an understanding of the challenges in the emerging microfinance market and the willingness of the regulator to issue market-enhancing regulations while at the same time providing consumer protection. The regulatory framework focuses on the key areas of transparency, portfolio quality, efficiency and outreach.

In Indonesia the nationwide banking network provides sustainable financing for poor rural communities. During the last two decades, Bank Rakyat Indonesia (BRI), a large state-owned commercial bank, has shown via its world-famous "unit desa" or local banking system that the demand for rural and microfinance can be a large-scale and sustainable operation. Bank Rakyat Indonesia -Unit Desas are the foremost formal lenders in the rural areas. The Bank for Agriculture and Agricultural Cooperatives (BAAC) of Thailand has also successfully expanded the access of farmers to financial services. The lending approach includes features that aim to (a) reduce risk (non-collateral lending through joint liability groups and peer monitoring); (b) reduce borrower transaction cost (simple and quick procedure in loan disbursement; flexible repayment schedule); and (c) improve creditworthiness (progressive lending based on repayment performance).

The rural financial markets of India and Pakistan is composed of a diverse and extensive institutional structure that includes banks, cooperatives, self-help groups and other similar schemes that provide the rural poor with access to financial services. In India the National Bank for Agriculture and Rural Development has linked self-help groups with banks to provide credit and savings services to the rural areas. The linkage program with almost 2 million self-help groups as of 2007 has become one of the world's biggest microfinance programs in terms of outreach. In Pakistan a specialized agricultural bank named Zarai Taraqati Bank, Ltd., several commercial banks, microfinance banks as well as NGO-MFIs and cooperatives are addressing the credit requirements of farmers and other small borrowers. Only 35 to 40 percent of said requirements are provided by the banking system and thus, the government of Pakistan has encouraged more bank lending to the rural poor and the

programs, the Amended General Banking Law of 2000 and the Barangay Micro Business Enterprise Act.

commercialization of microfinance institutions to expand microfinance outreach to 3 million borrowers by 2010.

South Korean agricultural cooperatives dominate the rural financial markets with a three-tiered federal system consisting of village-level cooperatives, city and country-level cooperatives and the National Agricultural Cooperative Federation (NACF) at the national level. For more than four decades, agricultural cooperatives have provided access to the financing and marketing requirements of farmers.

III. Impact of the global financial crisis on rural and microfinance institutions

An analytical framework

Given the significant growth of rural and microfinance institutions in Asia in recent years to what extent have these institutions been affected by the global financial crisis?¹⁴

The integration of rural and microfinance into the mainstream financial system provides a convenient pathway for the negative impacts of the crisis. A survey by CGAP (2009) summarizes the situation: credit crunch, inflation, currency dislocations and global recession are hitting microfinance in very different ways, depending on location, funding structure, financial state and economic health of clients. There is little doubt that that there will be impact and integration into the mainstream does have costs.¹⁵

¹⁴ This section first looks at the rural and microfinance environment in East, South and Central Asia prior to the global financial crisis based on the findings of the MIX/Intellect Survey of 244 microfinance institutions covering 16 countries across South Asia and East Asia and the Pacific and the Microfinance Analysis and Benchmarking Report of 2008 supplemented by information gathered by the author from other sources. The second part of this section reports the experience of rural and microfinance institutions in selected countries of the region. Data and related information are drawn from the country papers submitted by APRACA member institutions.

¹⁵ CGAP Virtual Conference: Microfinance and the Financial Crisis November 18-20, 2008

A convenient starting point to understand the impact of the crisis is the MFI's balance sheet¹⁶. Examination of the liability side will provide insights on access to funding (e.g., deposits), cost of funding, financial risk. Analysis of the asset side will give an understanding of the loan portfolio growth, portfolio at risk, and quality of the loan portfolio. The crisis will impact both sides of the balance sheet in varying degrees depending on internal (MFIs' financial strength and preparedness for such phenomenon) and external (domestic macroeconomic and financial environment, regulators' response, client behavior) factors. The impact of the crisis will be much more felt in financial sectors that are more integrated into the global financial markets. RFIs and MFIs that are integrated into mainstream financial systems are likely to experience the burden of liquidity and credit shortage that follows the compression of financial markets in developed countries. Institutional investors may review their portfolios, re-assess their investment strategies and become more discriminating over investment destinations. If institutional investors lose appetite for microfinance investments, the resulting slowdown in fund flows to the rural and microfinance sector will drive up the cost of funds as RFIs and MFIs compete for whatever funds are available in the market.

It is often hypothesized that microfinance is a countercyclical tool and that in times of financial or economic stress, rural and microfinance institutions step up to provide liquidity and working capital to microenterprises, small borrowers mostly in the informal sector. Severe economic and financial stress may squeeze economies so hard that outputs may fall and unemployment rise, which will drive people to the informal sector. In a recent address, the Bangko Sentral ng Pilipinas avers that microfinance is an effective countercyclical tool for softening the negative effects of economic crises, particularly to the most vulnerable segment of the economy¹⁷.

During a pre-crisis situation, the asset side of the balance sheet may register growth in loan portfolio. However, an economic downturn can drastically lead to output losses and rising unemployment. If the decline in economic growth is prolonged, dwindling income, a squeeze on the profitability of small, medium and

¹⁶ The part is from Magnoni and Powers (2009) and Llanto (2009).

¹⁷ Speech delivered at the 2009 RBAP-MABS Roundtable conference, Hyatt Hotel, Manila, Philippines, February 12, 2009.

large businesses and microenterprises, and narrower margins in tradable and non-tradable alike will impact on the quality of loan portfolios of financial institutions, including those of rural and microfinance institutions. Magnoni and Powers (2009) comment that while hard data are not yet available for most MFIs' portfolios for 2008, there is anecdotal evidence of a gradual deterioration in asset quality of MFIs in some countries.

In sum, the global financial crisis can lead to severe funding constraints, higher cost of funds for on-lending, rising interest rates, tighter lending standards and a reduction of loan portfolios. Deterioration in asset quality will impact on the viability and sustainability of rural and microfinance institutions. Higher loan loss provisioning and tighter risk monitoring can be expected.

The upside pointed out by Magnoni and Powers (2009) is that in response to the global financial crisis, rural and microfinance institutions will focus on improving efficiencies (cutting down costs), diversifying sources of funds (raising more domestic deposits and searching for new equity and institutional investors), monitoring of asset quality (better risk management techniques) and improving customer service (developing innovative products, lowering transaction cost).

Rural and microfinance environment in East and South Asia

Growing at a rapid and sustained rate, microfinance in East and South Asia has been considered by policy makers as an important tool for poverty alleviation since the 1997 crisis¹⁸. Professional management of loan portfolios has enabled many MFIs to expand outreach and attain a high level of profitability and sustainability in operation. Those MFIs have also competed effectively with commercial banks in the loan markets.

¹⁸ There is an on-going debate on whether microfinance has in fact reduced or helped reduce poverty. This is not the focus of the paper and this issue will be ignored here. This is not to say that an examination of this issue should not be done. It is an important issue with far-ranging implications for governments, donors and the microfinance institutions. More research on this issue is recommended.

Outreach. MFIs in South Asia, East Asia and the Pacific have reached close to 47 million borrowers with more than US\$10 billion in loans and have sourced more than US\$7 billion in deposits in 2007 (Table 2)¹⁹

Table 2. Snapshot of Asian MFIs (2007)

Country	MFIs	Borrowers	Gross Loan Portfolio	Deposits
	(Actual Number)	(Thousands)	(US\$ Million)	
Afghanistan	14	358	106	5
Bangladesh	28	21,699	1680	374
Cambodia	15	802	469	348
China	6	32	13	-
East Timor	2	14	5	2
India	80	9,910	1,359	31
Indonesia	33	3,712	3,558	5,728
Laos	1	<1	<1	-
Nepal	34	478	81	16
Pakistan	15	1,248	143	32
Papua New Guinea	1	7	4	10
Philippines	55	1,921	365	222
Samoa	1	4	1	<1
Sri Lanka	14	943	263	189
Thailand	2	5	1	-
Vietnam	12	5,788	2,203	126
Total	313	46,921	10,250	7,083

Source: MIX Market 2007 data as of December 1, 2008.

Pakistan and India in posted the highest growth rates for active borrowers at 57 percent and 44 percent, respectively followed by Indonesia and Philippines at 36 percent, Cambodia at 32 percent and Vietnam at 20 percent.

Funding Sources. MFIs in Asia rely mainly on debt financing, either through borrowings or deposit mobilization. With debt to equity ration of 490 percent, they

¹⁹ Source: Asia Microfinance Analysis and Benchmarking Report 2008

are able to leverage equity more than MFIs in other regions; the global median is 320 percent. A typical Asian MFI is heavily in debt with capital equivalent to 15.2 percent of asset base while MFIs in Africa, Eastern Europe/Central Asia and Latin America and the Caribbean have capital corresponding to 25 percent of total assets. For every dollar lent by an average Asian MFI, about 85 cents is sourced from borrowings.

Most banks, NBFIs and NGOs source their lending funds largely from borrowings while rural banks obtain lending funds primarily from mobilization of deposits from the public. Regulatory authorities would typically only allow regulated entities such as banks to mobilize deposits unless there is a special law that permits non-bank entities such as NGOs to tap such deposits.

Deposits are a significant fund source for MFIs in Indonesia, the Philippines, Sri Lanka and Cambodia. MFIs in India, Pakistan, Nepal and Vietnam derive their on-lending funds mainly from borrowings. Indian MFIs, in particular, posted a high leverage, such that “nearly 80 percent of its debt financing is sourced from external borrowings through local bank refinancing”.

As MFIs expand their services, some borrow more in order to support expansion. Cambodian MFIs attracted large amounts of foreign borrowings in 2007 and raised their liabilities by 130 percent during the same year. The leading Indian MFIs, while highly leveraged, infused more than US\$100 million in share capital to improve capital adequacy due to the tightening policy of the Reserve Bank of India. As a result, those Indian MFIs raised their equity more than three times compared to the 2006 levels. Pakistani MFIs increased their liabilities by 31 percent relative to the growth of equity at 5 percent. Vietnamese MFIs raised their liabilities by 82 percent compared to equity growth of 66 percent. MFIs in the Philippines and Indonesia showed nearly equal growth in debt and equity for 2007 (Table 3).

Table 3. Growth in Debt and Equity (2006 – 2007)

	Country	Equity	Liabilities
Higher Growth in Debt	Afghanistan	20%	84%
	Bangladesh	21%	48%
	Cambodia	18%	130%

	Country	Equity	Liabilities
	Nepal	11%	31%
	Pakistan	5%	36%
	Vietnam	66%	82%
Higher Growth in Equity	India	216%	91%
Equal growth in Debt / Equity	Indonesia	25%	27%
	Philippines	77%	72%
	Sri Lanka	20%	28%

Financial Performance. MFIs in Cambodia, India and the Philippines registered better returns in 2007 while the median returns on assets remained the same across countries in the Asian region. Cambodian MFIs showed an improvement in operational efficiency as growth of their loan portfolios outpaced the growth in the number of borrowers while the expansion in loan balances reduced operating expenses per dollar of loan outstanding. Except for Philippine and Indonesian MFIs, which relied mostly on deposits as an important source of funds for lending, MFIs in most countries experienced rising financing costs due to significant increases in borrowings to support loan portfolio growth.

Overall, rising delinquency in some countries, particularly among some MFIs in Bangladesh, reduced returns and consequently raised the portfolio at risk (PAR) to nearly 3 percent in 2007. This increased the costs of loan loss provisioning, which reduced over-all profitability, resulting in negative returns for an average Asian MFI in 2007 from positive returns a year before.

The global financial crisis and rural and microfinance institutions

CGAP's 2009 Opinion Survey of MFIs in Asia and other parts of the world on the effects of the global financial crisis indicate that "many MFIs are finding it harder to access funding, and their microcredit portfolios are stagnant or shrinking—a significant shift after years of remarkable growth". Non-deposit-taking MFIs are concerned about the impact of global liquidity contraction on the cost and availability of funding. This could make fundraising very difficult for MFIs, which have not built up proper reserves and could neither tap additional capital from external sources

1. Southeast Asia

1.1 Philippines

Microfinance continues to show strong growth in outreach and greater efforts on achieving operational and financial self-sufficiency. Competition, the availability of a wider range of products and services, and technological innovations and applications have contributed to the recent significant growth of microfinance. Tables 4-6 show the financial performance, financing structure, and loan portfolio quality of Philippine MFIs. Key indicators indicate a room for improving the performance of Philippine MFIs whose financial performance, although positive, is below that of other Asian MFIs.

Table 4. Financial Performance of Philippine MFIs, By Type and Size, as of end 2007

Financial Performance Indicators	NGO	Rural Bank	Large	Medium	Small	All MFIs	MFIs Asia
Return on Assets	0.8%	0.5%	2.9%	0.8%	-0.4%	0.6%	0.2%
Return on Equity	4.8%	3.5%	12.1%	2.3%	-1.5%	3.3%	2.3%
Operational Self-Sufficiency	106.7%	114.3%	112.9%	109.5%	113.1%	111.3%	113.2%
Financial Self-Sufficiency	102.6%	107.7%	110.3%	102.8%	101.6%	105.7%	102.6%
Revenue Indicators							
Financial Revenue Ratio	37.2%	21.6%	38.8%	30.7%	25.0%	30.7%	20.5%
Profit Margin	2.6%	7.1%	9.3%	2.7%	1.6%	5.4%	2.6%
Yield on Gross Portfolio (nominal)	55.9%	29.6%	50.3%	38.6%	31.1%	42.9%	26.8%
Yield on Gross Portfolio (real)	51.7%	26.1%	46.2%	34.8%	27.5%	39.0%	18.1%
Expense Indicators							
Total Expense Ratio	39.2%	21.9%	33.9%	31.3%	23.5%	31.1%	22.2%
Financial Expense Ratio	4.6%	4.5%	4.7%	4.8%	4.2%	4.6%	6.9%
Loan Loss Provision Expense Ratio	2.6%	1.4%	1.3%	2.8%	2.7%	1.9%	1.3%
Operating Expense Ratio	31.1%	12.2%	29.6%	22.6%	14.8%	22.6%	11.6%
Personnel Expense Ratio	19.3%	5.6%	14.4%	12.8%	6.8%	11.8%	6.7%
Administrative Expense Ratio	11.3%	6.7%	11.8%	9.7%	7.0%	9.9%	4.7%

Adjustment Expense Ratio	0.8%	1.8%	0.5%	1.6%	1.9%	1.2%	1.8%
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Source: MIX/MCPI, 2008

Table 5. Financing Structure of MFIs, as of end 2007

Financing Structure Indicators	NGO	Rural Bank	Large	Medium	Small	All MFIs	MFIs Asia
Capital / Asset Ratio	25.5%	13.6%	18.0%	20.9%	14.7%	17.7%	15.2%
Commercial Funding Liabilities Ratio	43.4%	122.8%	64.1%	81.9%	116.5%	83.5%	80.7%
Debt / Equity Ratio	2.9	6.0	4.6	3.5	5.0	4.2	4.9
Gross Loan Portfolio / Total Assets	68.5%	66.9%	70.8%	66.4%	63.4%	66.5%	74.8%

Source: MIX/MCPI, 2008

Table 6. Portfolio Quality of Philippine MFIs, as of end 2007

Financing Structure Indicators	NGO	Rural Bank	Large	Medium	Small	All MFIs	MFIs Asia
Portfolio at Risk > 30 days	3.3%	5.5%	2.6%	5.0%	8.1%	4.5%	1.7%
Portfolio at Risk > 90 days	2.0%	3.1%	0.2%	1.3%	3.2%	2.5%	0.9%
Write-off Ratio	1.7%	4.9%	1.1%	4.6%	6.4%	4.4%	1.0%
Loan Loss Ratio	1.7%	2.7%	1.1%	3.7%	5.4%	2.7%	0.9%
Risk Coverage	96.3%	56.3%	111.3%	58.4%	56.6%	74.5%	79.9%
Non-Earning Liquid Assets As % of Total Assets	10.5%	2.6%	5.8%	3.8%	4.1%	4.0%	5.8%

Source: MIX/MCPI, 2008

Growing competition has motivated MFIs to be more competitive and to innovate, bring down cost and consequently, gain higher yields on their portfolio. Rural banks and cooperatives have put greater emphasis on deposit mobilization. Some have included micro-insurance and money transfer services among product offering while a few rural banks have pilot-tested the use of short-messaging service (SMS) in loan collection ²⁰. Some NGO-MFIs have started to provide clients with

²⁰ Rural banks are not allowed to sell insurance products. They, however, act as agents for insurance companies, which are tapped to provide typical life and personal accident insurance products to borrowers of rural banks.

training on livelihood skills and product development and have explored the use of mobile phones in loan disbursements and collections.

The relatively sound performance of Philippine MFIs may indicate resiliency to the volatility now plaguing financial markets (Table 7). MFIs seem to have adopted a “business as usual” attitude, claiming that they have no problem with fund generation, which they source mostly from domestic sources particularly government and private financial institutions. The MFIs see the crisis as an opportunity and a challenge to increase microfinance outreach, expand loan portfolios, maintain credit quality and put in place safety nets against potential setbacks and risks. The Mindanao Microfinance Council commented that MFIs could provide financing to livelihood ventures of those who lost jobs because of retrenchment or closure of firms.²¹

**Table 7: Snapshot of Microfinance in the Banking Sector
(as of June 2008)**

Micro Loans Portfolio				Savings Component (in millions pesos)
	No. of Banks	Amount (in millions)	No. of Borrowers	
Microfinance Oriented Banks				
Rural Banks	5	520.68	91,009	311.00
Thrift Banks*	4	182.88	57,780	57.95
TOTAL	9	703.56	148,789	368.94
“Regular” Banks with Microfinance Operations				
Rural Banks	178	3,923.51	557,169	1,177.38
Cooperative Banks	25	894.33	85,964	95.79
Thrift Banks	18	941.41	10,170*	4.04*
TOTAL	221	5,759.23	653,303	1,277.21
TOTAL	230	6,462.81	802,092	1,646.15

Source: Bangko Sentral ng Pilipinas

²¹ The general sentiment expressed during the annual conference of the Microfinance Council of the Philippines Inc. on May 12-13, 2009 is that it is “business as usual”. The MCPI counts as members the biggest MFIs in the country. BusinessWorld, “Mindanao microfinance group expects less clients due to weak economy,” Vol XXII, Issue 223, June 16, 2009.

The major risks, which MFIs believe they need to closely monitor, are, as follows:

Funding and liquidity. The current financial environment has made domestic and international capital scarce. A slowdown in the economy, which will cut incomes, will impact on deposit taking of rural banks and cooperatives. NGOs are likely to feel more the brunt of the crisis as donor funds become increasingly scarce. They are not allowed to mobilize deposits. However, many NGOs are learning how to tap funds from commercial sources. A few NGOs have indicated that because of their sound performance, availing themselves of commercial loans has not become a problem even amidst the financial crisis. One such experience in fund sourcing is presented in Box 1.

Some NGOs have transformed into banks or are planning to transform in the future. In recent years, several banks offering microfinance products and services have adopted a new strategy: establish NGOs and/or foundations that would engage in microfinance. This may be a tax avoidance strategy since NGOs and foundations are exempt from corporate income taxation²². The BSP monitors this recent phenomenon to make sure that banks that have established NGOs or foundations adhere to adequate standards of governance, transparency and disclosure.

²² The current corporate tax rate is 30 percent.

Box 1: NGO experience in fund sourcing during the crisis

How did the financial crisis affect the capacity of your MFI to generate funds for its operations?

- Didn't find it difficult to tap commercial loans during the crisis because of good financial condition and track record
- However, some funding agencies have waived or deferred acceptance of new proposals for grants; decided to fund smaller projects due to recession
- Funding from a partner was discontinued even if project has not been completed yet and despite MFI's good performance.

What have been the effects of these developments on your lending operations?

- The MFI allocated some of its own funds to continue the project but the money could have been used for other projects
- The MFI had to cut budget for capacity-building activities
- Cost of sourcing more grants and donations from other agencies has increased.

Portfolio quality. Despite the crisis, the MFIs interviewed for this paper have expanded their operations in 2007 and 2008. Some have developed and introduced new loan products and have pushed for innovations to reduce cost such as the mobile phone banking or text-a-payment, among others.

CARD Bank, one of the leading MFIs in the Philippines, noted that due to the bank's efforts to ensure credit discipline among clients, their portfolio at risk ratio (for loan balances delayed for at least one month) decreased significantly from 3.2 percent in 2007 to 1.9 percent in 2008. They also reported a decrease in past due loans from Php 17.7 million in 2007 to Php 14.6 million in 2008.

While there are some who experienced a slight decline in the quality of loan portfolios, the majority expressed optimism that the decline is temporary and may not even be a result of the global financial crisis. Instead, credit pollution or over-indebtedness of clients may explain the decline in loan portfolio quality. MFIs maintain a close watch over loan portfolios. Among their clients are businesses dependent on demand from overseas markets whose loan repayment capacity may be impaired by the crisis. However, the majority of MFI borrowers are micro-entrepreneurs who borrow very small amounts and operate micro-businesses that are

the least likely to be affected by the crisis. Box 2 below reports how the financial crisis has affected loan portfolio quality.

Box 2: How the financial crisis has affected portfolio quality

How has the financial crisis affected the quality of your loan portfolio?

There has been:

- Decrease in number of loan renewals
- Higher drop out rate
- Lower loan amounts requested by clients

Due to:

- Clients experiencing business slowdown
- Loss of employment of other family members of clients
- Credit pollution
- Personnel turn-over or staff fall-out

What have you done to address these problems?

- Reduced costs
- Provided business development services
- Tightened credit investigation and background investigation (CIBI) and verification procedures
- Aligned policies and procedures to adjust to changing needs of market including reorganization of microfinance unit and partial withdrawal on contractual savings.

Risk management practices. While many MFIs have reported that they have yet to see the negative impact of the crisis on clients, they are aware of the risk and have adopted measures to avert negative impacts. In addition to intensifying effort in savings mobilization are the implementations of better methods of screening of clients and stricter loan policies especially the treatment of loan delinquency, e.g. adopting a zero tolerance policy for loan delinquency.

1.2 Thailand

The Bank of Thailand reports that the Thai banking system has adequate capitalization and has remained resilient to the crisis. So far, no bank has shown any serious signs of financial distress. Loans provided by the entire banking system rose by 11 percent from THB 6,841 billion on March 2008 to THB 7,591 billion on March 2009. Local banks provided about 91 percent of these loans while foreign financial institutions account for the remaining 9 percent of loans. Similarly, total deposits increased by about 4 percent to THB 7,248 billion on March 2009.

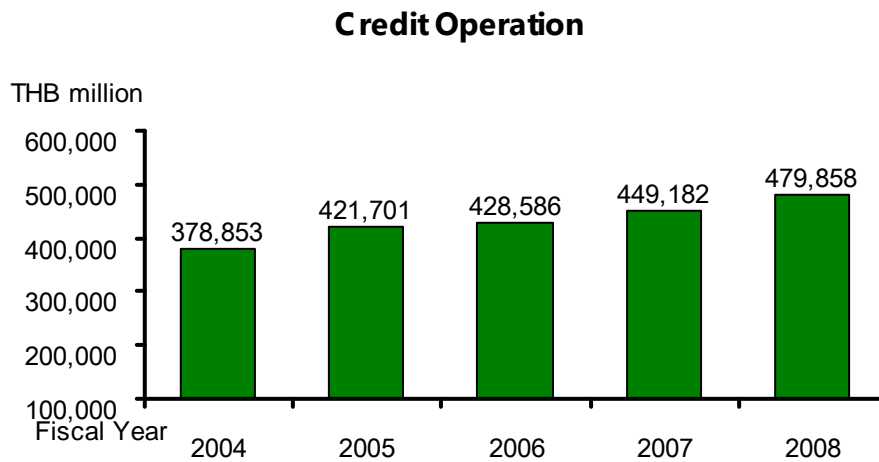
Since the 1997 Asian financial crisis, which greatly affected the country, the Thai government has put a great premium on microfinance and/or agricultural credit as a means for the poor to recover from financial difficulties. The Bank of Agriculture and Agricultural Cooperatives (BAAC) a government-owned agricultural development bank was primarily tasked to provide agricultural credit to farm households and agricultural cooperatives. The bank has 75 provincial offices covering 961 branches throughout the country.

Since the expansion of the branch network in 1988, the number of borrowers has more than doubled. In 2008, 6.07 million farm households obtained loans from BAAC. About 4.54 million of farm household-clients representing more than 90 percent of Thailand's total farm households borrowed directly from BAAC while the rest borrowed from agricultural cooperatives, which sourced funds from BAAC. The outstanding loans of BAAC as of end 2008 amounted to THB 479.858 billion; 87.2 percent (THB 418.475 billion) of this amount went to individual farmers; 5.1 percent (24.659 billion) went to agricultural cooperatives; 0.01 percent (THB 24 million) went to farmers' associations; 0.9 percent (THB 4.247 billion) went to government-secured loan projects and 6.8 percent (THB 32.453 billion) went to other types of borrowers.

In 2008 alone, loans to individual farmers grew by 8.5 percent for a total of THB 251.480 billion during the year. Similarly, loans to agricultural cooperatives in 2008 went up by 15.3 percent to THB 56.442 billion. A most significant increase was registered for loans to farmers' associations, which grew by 132.4 percent from 2007, to THB 165 million.

BAAC's loan portfolio, thus, grew at a steady rate over the last 5 years, from 2004 to 2008 as shown in Figure 1 below.

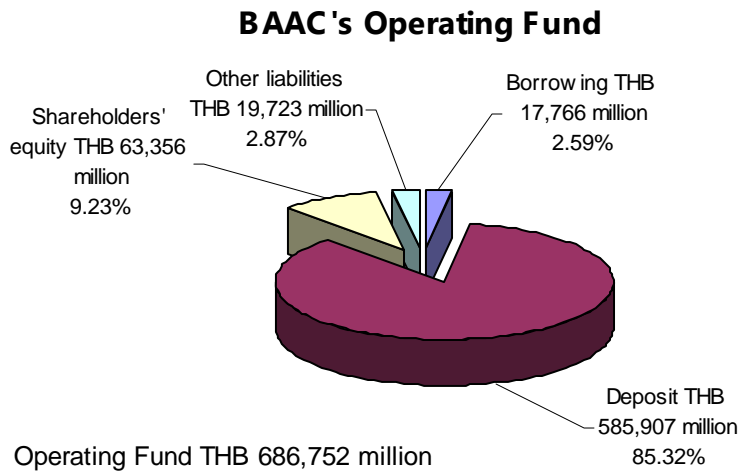
Figure 1. BAAC Credit operation, 2004-2008



Source: BAAC

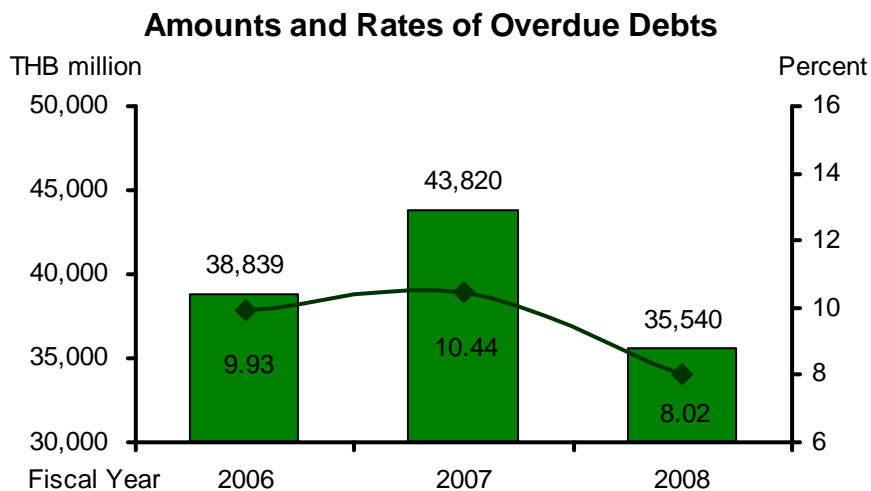
Funding and liquidity. BAAC's active rural deposit mobilization has led to a significant improvement in its resource base. The importance given to deposit mobilization is a result of lessons learned from the 1997 Asian financial crisis. BAAC, which then had foreign loans as a significant fund source, had to set aside a significant amount as reserves to offset foreign exchange losses arising from a currency devaluation brought about by the Asian crisis. Through deposit mobilization, the BAAC has become financially self-reliant and significantly reduced its dependence on domestic and foreign loans. Thus, amid the global financial crisis, BAAC's deposits reached THB 589.907 billion by end of 2008, representing the bulk or 85.3 percent of its total operating fund, up by THB 71.240 billion or 13.8 percent from 2007 levels. Borrowings, on the other hand, which share a mere 2.6 percent of BAAC's operating funds amounted to THB 17.766 billion; of which, THB 14.625 billion represent loans from domestic sources and THB 3.141 billion from overseas. Moreover, the shareholders' equity significantly increased by 51.5 percent from the preceding year, totalling THB 63,356 billion or 9.2 percent of the total operating fund (Figure 2).

Figure 2. BAAC's operating fund



Portfolio quality. At the end of 2008, BAAC's past due loans (i.e., overdue for more than 3 months) fell by 10.4 percent amounting to THB 35.540 billion or 8.0 percent of loans outstanding despite the global financial turmoil (Figure 3).

Figure 3. Amounts and rates of overdue debts



Source: BAAC

Response to global financial crisis. BAAC intends to maintain its capital base, further strengthen its deposit mobilization efforts and focus on improving farmer-clients' liquidity and creditworthiness. It will also undertake activities that will improve farm production efficiency, increase incomes of farm households, reduce the

risk of lending to farmers through crop insurance and promote cooperatives as the means to enhance production and marketing.

2. South Asia

2.1 India

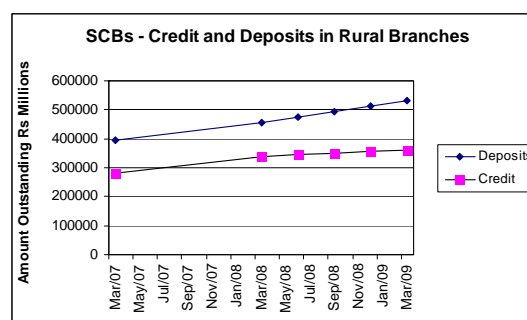
A wide network of rural financial institutions including banks, cooperatives and informal groups particularly, self-help groups (SHGs) characterizes India's rural financial market.

Outreach. The extent of growth in loan portfolio and deposits vary across types of financial institutions. For instance, the growth in loans among commercial banks fell to 6.3 percent for the period March 2008-March 2009 compared to 21.1 percent for the period 2007-2008. There had been a slight growth in deposits at 17 percent in 2008-2009 from 15.6 percent in 2007-2008 (Table 8 and Figure 4).

Table 8 & Figure 4. Growth of deposits and credit of scheduled commercial banks

SCBs – Annualized Growth Rates

	Deposit	Credit
2007 – 08	15.61%	21.11%
2008 – 09	16.95%	6.32%
2008-09 Q1	16.95%	6.51%
2008-09 Q2	16.27%	6.50%
2008-09 Q3	15.62%	6.36%
2008-09 Q4	15.03%	5.34%



Source: NABARD India Country Paper

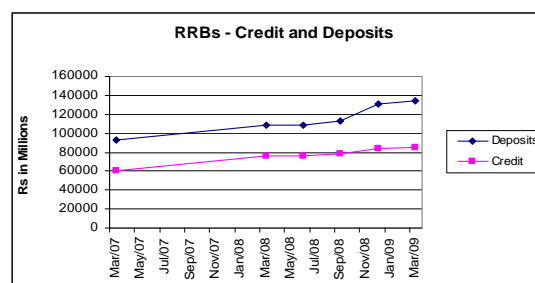
While the growth in loans from regional rural banks (RRBs) decreased to 12.4 percent in 2008-2009 from 25.8 percent during the preceding period, deposits generated by these banks went up by 22.7 percent in 2008-2009 from 17.0 percent in 2007-2008. The decline in loans can be explained by a recent government directive to waive farmers' unpaid debts under the Agricultural Debt Waiver and Debt Relief Scheme (ADWRS) resulting in the write-off by the banks of corresponding loan

accounts and partly by the slowdown in the export market on which some micro and small enterprises are dependent (Table 9 and Figure 5).

Table 9 & Figure 5 Growth of deposits and credit of regional rural banks

RRB – Annualized Growth Rates		
	Deposit	Credit
2007 – 08	16.96%	25.83%
2008 – 09	22.68%	12.42%
2008-09 Q1	-1.18%	-1.33%
2008-09 Q2	16.20%	15.99%
2008-09 Q3	64.48%	25.32%
2008-09 Q4	7.35%	8.01%

Source: NABARD Country Paper

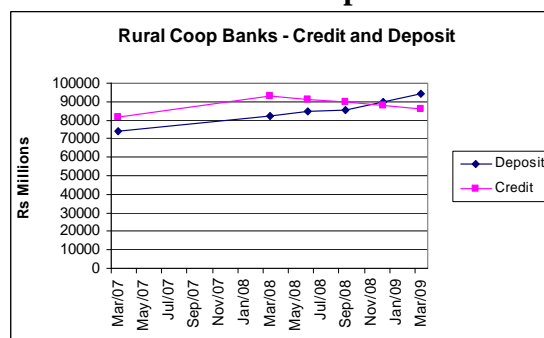


Rural cooperative banks (RCBs) posted a moderate growth of deposits to 14.6 percent from 10.6 percent but a sharp decline in credit growth from 13.7 percent to -7.7 percent in 2008-2009. Like regional rural banks, the decline can also be attributed to the Agricultural Debt Waiver and Debt Relief Scheme (Table 10 and Figure 6).

Table 10. & Figure 6 Growth of deposit and credit of rural cooperative banks

RCB – Annualized Growth Rates		
	Deposit	Credit
2007 – 08	10.63%	13.74%
2008 – 09	14.60%	-7.68%
2008-09 Q1	12.83%	-8.08%
2008-09 Q2	4.69%	-5.92%
2008-09 Q3	19.39%	-8.62%
2008-09 Q4	18.70%	-9.01%

Source: NABARD India Country Paper



Funding and liquidity. For all banks, the growth in borrowings declined for the period March 2008-March 2009 relative to the growth rate in deposits, which went up during the same period. More specifically, while borrowings of commercial banks grew by 43 percent in 2008-2009, the growth rate is lower than that in 2007-2008. Similarly, dependence on borrowings among regional rural banks declined by 8.3 percent and among rural cooperative banks, by 27.6 percent, during the period 2008-2009. Most resources of MFIs have been generated from domestic sources. This is

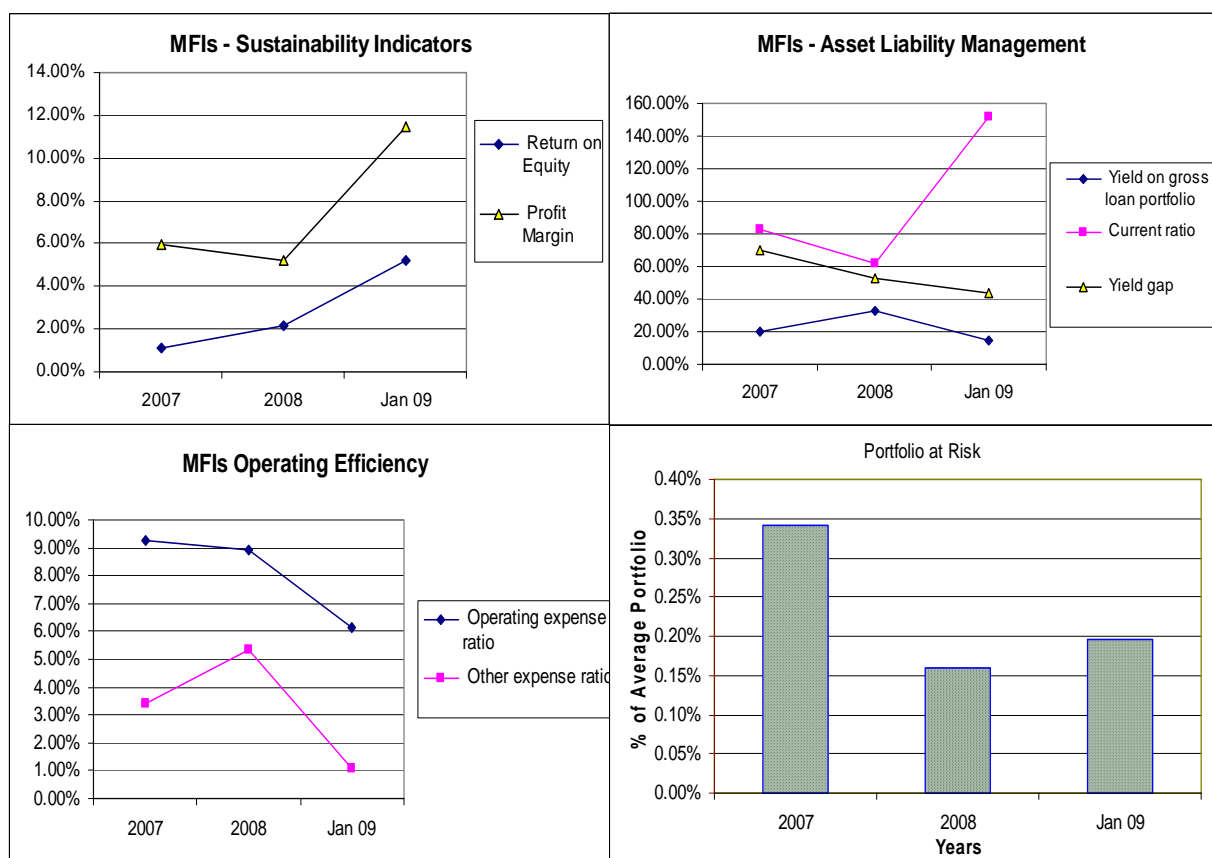
consistent with the findings of the 2008 Asia Microfinance Analysis and Benchmarking Report 2008 (Mix and Intellectap, March 2009) which showed that Indian MFIs borrowed less in 2008 but attracted new investors who infused fresh equity into their respective institutions. For example, SKS Microfinance, India's largest MFI, sealed an undisclosed deal with Sandstone, a US hedge fund, Kismet Capital and SVB India Capital, an affiliate of Silicon Valley Bank last November 2008. Despite the crisis, investors maintain their interest in microfinance in India because they seem to recognize an inherent strength of microfinance: loan repayment rates and profitability have remained relatively high amid the crisis.

The situation is different among non-deposit taking MFIs because they rely on external sources of funds to support operations and expansion. Nonetheless, non-deposit taking MFIs face better prospects for improved liquidity because Indian law mandates government banks to allocate 40 percent of financing to "priority lending" which includes microfinance as well as agriculture, small businesses and other neglected sectors. Thus, non-deposit taking MFIs receive a big chunk of the funds from government banks. However, government banks are starting to be risk averse with some becoming more selective, choosing to provide funds only to large, stable and financially sound MFIs.

Financial performance/portfolio quality. MFIs exhibited better sustainability and efficiency ratios for the period 2008-2009. Operational self-sufficiency ratio improved from 123 percent in March 2007 to 156 percent in January 2009. Financial self-sufficiency ratio was 120 percent in January 2009 compared to 108 percent in March 2007. The portfolio at risk of MFIs also improved from 0.34 percent in March 2007 to 0.16 percent in March 2008 but somewhat deteriorated to 0.20 percent in January 2009.

MFIs posted a slight decline in the yield on gross loan portfolio due largely to the reduction in interest rates charged to clients but this has been offset by the substantial improvement in their operating expense ratios.

Figure 7: Major indicators of microfinance institutions



Similarly, rural branches of commercial banks, RRBs and RCBs showed moderate growth in net profit for the period 2008-2009 but the extent of growth was lower compared to previous years. The Agricultural Debt Waiver and Debt Relief Scheme (ADWRS) affected RFIs because they had to write-off the loan accounts covered, bringing down the amount of loan receivables and potential returns from said loans previously give to farmers.

Nevertheless, Indian microfinance continues to expand despite the crisis. Many clients of MFIs/RFIs are still not connected to the global financial markets and thus, are less affected by external events such as those affecting international financial markets.

2.2 Pakistan

Pakistan's banking sector has remained resilient before a weakening macroeconomic environment since late 2007²³. Data for the final quarter of 2008 confirms a slowdown after a multi-year growth pattern. In October 2008, total deposits fell from Rs3.77 trillion in September to Rs3.67 trillion. Provisions for losses over the same period went up from Rs173 billion in September to Rs178.9 billion in October. The State Bank of Pakistan jacked up interest rates: the 3-month treasury bill auction saw a jump from 9.09 percent in January 2008 to 14 percent in January 2009, and bank lending rates are now as high as 20 percent per annum.

Overall, Pakistan's banking sector has not been as prone to external financial shocks as compared to American and European banks. Liquidity is tight but it seems that this has little to do with the global financial crisis but is rather brought about by heavy government borrowing from the banking sector, resulting in tight liquidity and a 'crowding out' of the private sector.

Outreach. The operations of MFIs, including microfinance banks (MFBs), non-governmental organizations (NGOs), rural support programs (RSPs) and commercial financial institutions have witnessed significant improvements over the last 5-6 years with respect to number of bank branches, growth of total assets, number of different products offered and clients reached. However, the number of microfinance borrowers as well as the amount of loans slightly declined in 2008. The performance of the microfinance sector in terms of outreach from 2003-2008 is shown in the Table 11 below:

²³ Source: 2007-08 Financial Stability Review conducted by the State Bank of Pakistan (SBP). According to Fitch Ratings, 'the Pakistani banking system has gradually evolved from a weak state-owned system to a slightly healthier and active private sector- driven system'.

Table 11. Outreach of the microfinance sector (000)

Year	No. of Borrowers			Gross Loan Portfolio (Rs)		
	MFBs	MFIs	Total	MFBs	MFIs	Total
Dec-03	95	237	333	737,660	1,871,903	2,610,228
Dec-04	178	274	451	1,610,150	2,344,057	3,955,109
Dec-05	248	365	613	2,344,414	3,343,875	5,689,515
Dec-06	371	627	998	3,922,337	6,820,374	10,744,706
Dec-07	477	994	1,471	4,702,310	10,431,381	15,136,633
Jun-08	566	1,188	1,754	6,090,880	13,557,120	19,648,000
Sep-08	623	1,249	1,872	7,021,000	14,406,000	21,427,000
Dec-08	543	1,190	1,732	6,461,462	12,290,538	18,752,000

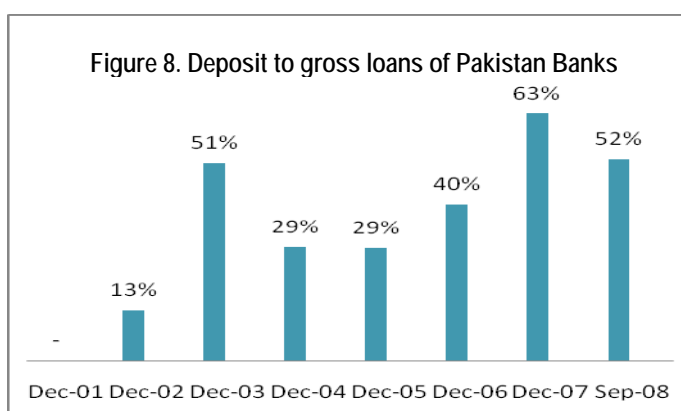
Source: Pakistan Country Paper by State Bank of Pakistan

Figure 7 shows the share of each sector to total loans provided by the banking system. The corporate sector has the biggest share, which grew to 59 percent in 2008 from 56.3 percent in 2007. Agriculture sector's share fell slightly to 4.9 percent in 2008 from 5.6 percent in 2007. The share of small and medium enterprises also declined from 16.2 percent in 2007 to 13 percent in 2008.

Figure 7 Share in total loans by various sectors, 2004-2008

	Percent share in loans				
	CY04	CY05	CY06	CY07	H1-CY08
Corporate Sector	53.9	52.7	53.3	56.3	59.0
SMEs	17.5	17.7	17.0	16.2	13.0
Agriculture	7.4	6.8	5.9	5.6	4.9
Consumer Finance	9.4	12.4	13.6	13.8	12.0
Commodity Financing	7.5	6.9	7.2	5.5	6.8
Staff Loans	2.5	2.1	2.0	1.9	1.8
Others	1.8	1.5	1.1	0.8	2.5

Funding and liquidity. Despite tight liquidity towards the end of 2008



following the implementation of a rigid monetary policy to curtail inflation due to the rising prices of oil and other commodities, total deposits managed to increase although at a lower growth rate compared to what has been achieved during the

same period in 2007. In particular, deposits increased by 8.7 percent during the first half of 2008 relative to 13.2 percent during the same period in 2007. Similarly, the

deposit to loan ratio of deposit-taking microfinance institutions fell slightly to 52 percent in 2008 from 63 percent in 2007.

Shareholders' equity went up because of the infusion of fresh equity and higher earnings by some banks. Investments, which are the second largest component of the assets of Pakistan banks, grew by 5.2 percent at Rs54 billion during the last quarter of 2008, thus, broadening its share in the banks' asset base by 19.1 percent.

Given the liquidity squeeze among banks due primarily to the tight monetary policy imposed in response to rising prices of oil and other commodities, MFIs give more emphasis to deposit mobilization as an important strategy to raise funds for on-lending.

Financial performance. The banks' cost of financial intermediation increased slightly in 2008 but the banks' strong growth in earnings compensated for the increase in administrative expenses. The profitability of the banking system has, therefore, remained stable although the amount earned in absolute terms has been lower in 2008 compared to previous years. This can be explained by higher loan loss charges and bigger operating expenses primarily due to the opening of more branches during the year, which somewhat diminished the profitability of the banking system (Table 12).

**Table 12. Profitability of the Banking System,
in billion Rupees**

	1997	2001	2002	2003	2004	2005	2006	2007	2008
Profit before Tax	10.8	1.1	19.0	43.7	52.0	93.8	123.6	107.1	93.6
Profit After Tax	16.4	9.8	2.9	24.7	34.7	63.3	84.1	73.3	63.2

Source: Quarterly Performance Review – December 2008, State Bank of Pakistan

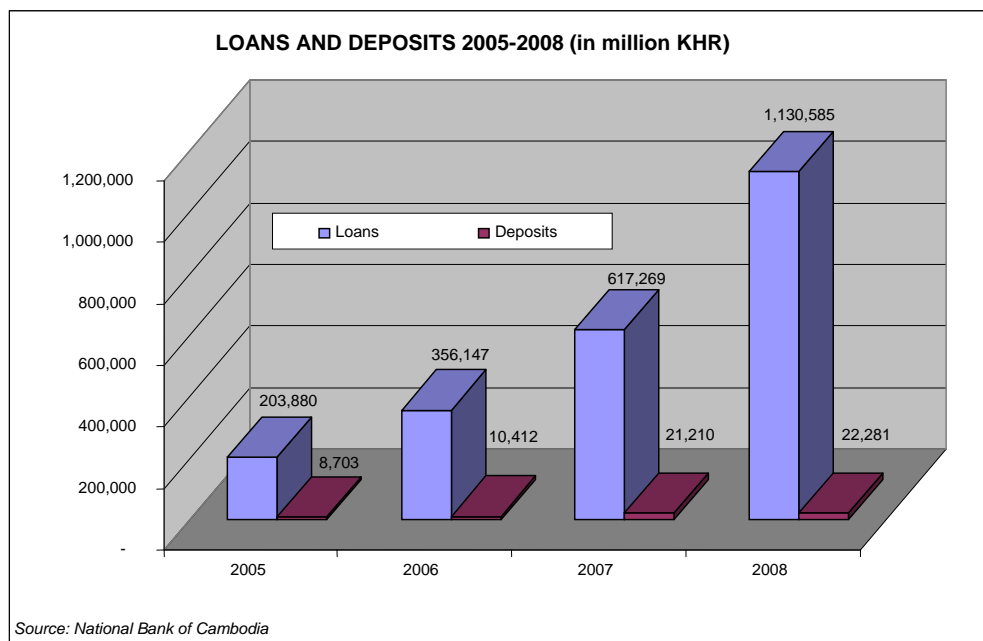
The capital to risk weighted asset ratio of the banking system posted at 12.1 percent by the end of June 2008 was well above the minimum requirement of 8 percent. Adequate reserves backed by stringent provisioning requirements against classified assets are behind the strong capital base of banks. Hence, the net Non-Performing Loans (NPLs) to net loans ratio has been well-contained at 1.3 percent by the end of June 2008.

3. Transition Countries

3.1 Cambodia

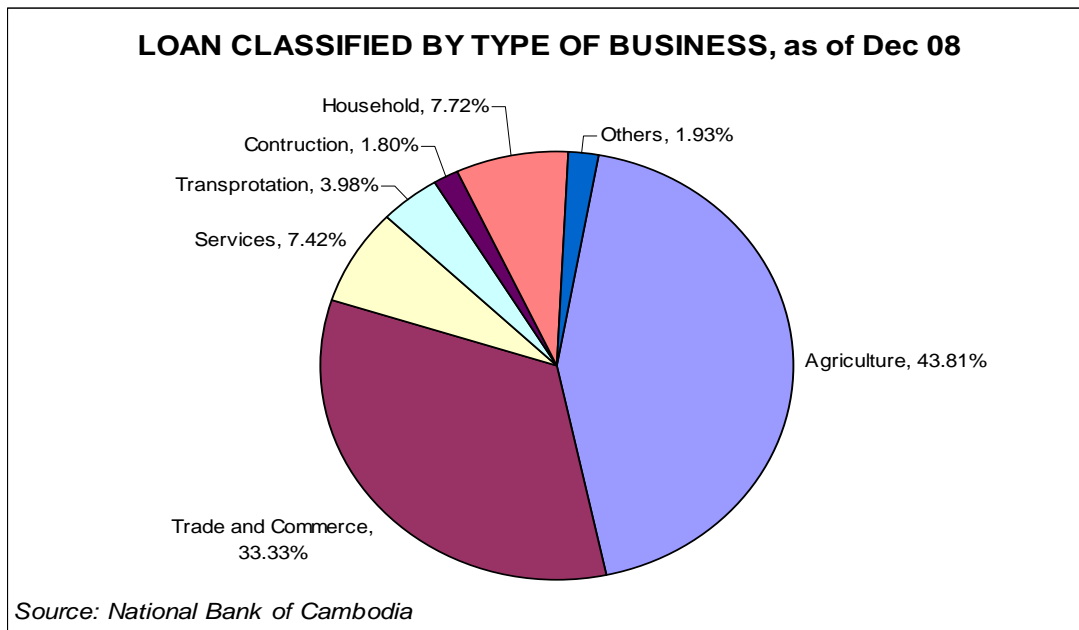
Cambodia has a microfinance network consisting of eighteen licensed MFIs and one microfinance-oriented bank (ACLEDA Bank). The microfinance sector has grown at an average annual growth rate of 20 percent since 2004 in terms of loans outstanding and number of active borrowers. As of December 2008, the microfinance institutions posted a 65 percent growth in loans outstanding from the previous year at US\$436.56 million covering one million clients. The number of borrowers also increased significantly while the number of depositors has more or less remained unchanged (Figure 9).

Figure 9. Loans and deposits, 2005-2008



By sector or type of business, agriculture has the biggest share of microfinance loans at 44 percent, followed by trade and commerce at 33 percent (Figure 10).

Figure 10.



Cambodia's microfinance sector is not directly affected by the global financial turmoil because it has little financial links with the rest of the world. MFIs, which cater to microenterprises and poor households, do not make big loans nor invest in sophisticated financial instruments such as derivatives.

Funding and liquidity. Should Cambodian MFIs be affected by the present financial crisis, it will be because of funding constraints. Foreign external debts comprise a big share of the outstanding borrowings of MFIs. Foreign loans have provided funds for lending. It is feared that funds flow from external lenders may become tighter, slower and more expensive because of the global financial crisis. Some foreign lenders have cancelled loan contracts without prior notification to those MFIs while some have agreed to extend contracts but at a higher interest rate. The Cambodian Microfinance Association reports that cost of capital has increased from an average of 7.5 percent to 9 percent per annum.

Given the growing scarcity of funds from abroad, MFIs have started to reduce loan disbursements to clients. This has somewhat diminished the confidence of clients

in the ability of MFIs to provide adequate and sustained financing, which has resulted in higher loan default rates. The reduction in loan disbursements has muted the incentive to repay an outstanding loan in order to get a another loan in the future. The loan delinquency ratio (i.e., non-performing loans to total loans outstanding) increased to 0.42 percent in 2008 from 0.19 percent in 2007.

Financial performance and portfolio quality. Cambodia is one of the countries in Asia that has experienced a decrease in operating expenses and improved returns in 2007²⁴. The growth in portfolio outpaced the growth in number of borrowers and the resulting increase in loan balances contributed to reduced operating expenses per dollar outstanding. The impact of the global financial crisis may be detected in the deterioration of the quality of loan portfolio, which could be attributed to souring consumer loans and loans issued for construction and transportation services. In the first quarter of 2009 the portfolio at risk (PAR) >30 days ratio increased from 3.3 percent to 4 percent. In 2008 the PAR>30 days ratio was not more than 2 percent. PAR was almost 2 percent in 2007 from less than 1 percent in 2006.

In the first quarter of 2008, there was a non-significant reduction of deposits. The amount of deposits generated fell by 2.5 percent. The fourth quarter of 2008 was the critical moment when most savings were withdrawn. However, the withdrawals of savings have stabilized by the beginning of 2009. In fact, savings grew by 4.9 percent in the first quarter of 2009. The growth of average saving interest rate was not significant and reached 0.8 percent per annum.

3.2 Myanmar

Myanmar reports a higher capital cost for the Myanmar Agricultural Development Bank (MADB), a leading RFIs due to the slower growth of deposits and the drying up of capital investments. MADB has to pay a 12.5 percent capital cost to Myanmar Economic Bank (MEB), a government-owned financial institution. MADB lends to the agricultural sector at a rate of 17 percent per annum. According to MADB the interest margin of 4.5 percent is not enough to cover operating costs and have sustainable operations. Each year MADB has to borrow from MEB and it is

²⁴ Source: Asia Microfinance Analysis and Benchmarking Report of 2008

getting to be more difficult each time to raise funds also because of the declining real value of saving deposits. MADB tends to provide more short-term loans than medium or long-term loans.

4. South Korea

As a developed country with a banking system closely linked to global financial markets, Korea has experienced external financing pressures as a result of the global financial crisis.

Short-term external debts. Concerns about access to and availability of external funding has arisen because of tightened liquidity among global banks and the large magnitude and short-term orientation of Korean banks' external debt. About 70 percent of Korean banks' external debt is short-term; this has increased from about US\$60 billion in 2005 to US\$150 billion in 2008.

Default risk. Using credit default swap (CDS) spreads, which measures the price of insurance against default losses of a particular institution as the means for investors to determine future losses on principal in the event of restructuring or rejection for external debt, Korean banks showed substantial increases in the CDS spread over a three-year period, 2007-2009. This means that because of the strong connection of Korean banks with global banks, which were directly affected by the global financial turmoil especially after the failure of Lehman Brothers, the default risk of Korean banks increased considerably after October 2008 as it followed the experience of international banks.

Spill-overs from the foreign exchange and overseas funding market problems. At the height of the crisis, the Korean Won (KRW) depreciated considerably against the US Dollar and the average daily market turnover volume among banks and other money changers decreased from US\$ 10 billion to US\$ 4 billion in 2008. Capital flowed out of Korea as investors withdrew their funds and transferred them overseas. Korean banks, finding difficulty in securing dollar-denominated funds resorted to converting KRW into dollars through foreign exchange swaps. The cash-strapped foreign exchange swap market exacerbated the problem forcing Korean banks to either roll over short-term borrowings or lengthen maturity.

IV. Impact on Bank Regulators and Policymakers

During the initial months following the outbreak of the sub-prime mortgage crisis in August 2007, there seemed to be an atmosphere of calm and confidence in the Asian region. This was because most banks in Asia had minimal exposure to those highly risky derivative instruments that started the financial crisis in the United States. The banking system has also strengthened following reforms introduced after the Asian Financial Crisis of 1997, e.g., banks have raised additional capital and have become more prudent in loan provision. However, by September 2008 several countries in Asia have begun to feel the pain from the tightening of global liquidity and the emerging credit crunch. A delicate situation has begun to develop with subsequent drops in the stock markets and weakening of currencies further confounding the situation. Since many banks and regulators (central banks) still have painful memories of the impact of the 1997-1998 Asian financial crisis they became extremely worried about a possible repetition of the experience of collapsing financial institutions and the loss of hard-earned monies placed in financial instruments. Maintaining market confidence and ensuring the stability of financial markets were the most immediate challenges faced by banks and regulators alike.

Thus, the central banks in East and South Asia formulated policies and implemented measures to help limit or contain the fall out of the crisis. Before the onset of the economic storm, East and South Asian governments were pre-occupied with various measures to forestall the impacts of rising food and fuel prices. However, wary of the economic slowdown and the risks of a loss of confidence in the banking system due to the crisis, governments and regulators (central banks) positioned several measures to spur lending, maintain confidence in the banking system and stimulate the economy (Table 13).

Table 13**Overview of actions announced by Asian authorities to support financial stability**

Based on publicly available information as of 7 November 2008

Country	Ease monetary policy	Arrange swap line with Fed	Lend foreign currency	Expand deposit insurance	Guarantee non-deposit liabilities	Prepare to inject capital in banks	Support for equity markets
Australia	✓	✓	✓	✓	✓		
China	✓						✓
Hong Kong SAR	✓		✓	✓		✓	
India	✓						✓
Indonesia			✓	✓			
Japan	✓	✓	✓	✓		✓	
Korea	✓	✓	✓	✓	✓	✓	✓
Malaysia				✓			✓
New Zealand	✓	✓	✓	✓	✓		
Philippines	✓		✓	✓			
Singapore	✓	✓	✓	✓			
Chinese Taipei	✓			✓			✓
Thailand				✓			

Source: Soesastro (2008)

1. The Philippines

Bangko Sentral ng Pilipinas (BSP) cut policy rates in the light of easing inflationary expectations and implemented several measures to boost domestic liquidity. Some of these include the following:

- *Enhancement of the BSP's standing peso repurchase facility by expanding allowable collateral and relaxing valuation on these;*
- *Creation of a US dollar repurchase facility to augment dollar liquidity in the foreign exchange market and ensure the ready availability of credit for imports and other legitimate funding requirements;*
- *Increase in the budget for the country's peso rediscounting facility to Php 60 billion; and*
- *Reduction in the regular reserve requirements on bank deposits and deposit substitutes by two percentage points.*

In addition, the government worked with the Philippine Congress to pass a law that expanded the insurance on bank deposits from Php 250,000 to Php 500,000 per deposit account.

Notwithstanding the challenges brought about by the global financial crisis, the Philippine financial system has remained stable. The Asian financial crisis of 1997 had imprinted valuable lessons, which motivated financial reforms that led to the strengthening of the Philippine banking system. Among the financial reforms include the following: (i) the clean up of banks' balance sheets, (ii) strengthening bank capitalization by complying with Basel II, (iii) improving bank governance structures, (iv) enhancing risk management systems and (v) and adherence to international accounting standards (Tetangco, 2009). The BSP mandated all banks to strictly comply with the capitalization requirement and implemented stronger bank supervision anchored on managing risk exposures and the reduction of non-performing loans via special asset vehicles. Some of the immediate results of the financial reforms are the following: (a) expansion of banks' asset base, (b) improvement of asset quality with non-performing loan (NPL) ratio currently at pre-

1997 crisis level and (c) capital adequacy remaining above national and international standards.

Philippine financial institutions have limited exposure to structured products, which were the main causes of the large losses of crisis-affected international banks. They are also more domestically oriented and have relied more on local equity and local deposits as sources of funds. They invest in traditional loan assets than on complex financial products such as derivatives. Corporate sector bond financing is also minimal and private sector reliance on external loans is limited.

In 2009, BSP has vowed to continue to focus on its primary mandate of maintaining price stability. In addition, it will ensure appropriate levels of market liquidity, provide the necessary conditions that will allow economic growth to continue and keep inflation at manageable levels for sustainable long-term growth. BSP also aims to sustain financial reforms geared toward the financial system's soundness. It will pay greater attention to policies and regulations that will promote better risk management, a stronger capital base, bolder disclosure mechanisms and better corporate governance standards.

With respect to microfinance, BSP vows to continue enabling banks to increase the scale and scope of their microfinance operations, develop products, and pursue technological innovations such as electronic money to broaden financial inclusion. BSP has liberalized branching policy and has allowed the collection of savings from microfinance clients through banking offices rather than only through bank branches (Tetangco, 2009).

2. Indonesia

The sharp increase in world commodity prices pushed the inflation rate from 6.6 percent in 2007 to 11.0 percent and 12.1 percent during the second and third quarter of 2008, respectively. To reduce inflation, Bank Indonesia reduced money growth by raising interest rates during the same period. Bank Indonesia did this at a time when other central banks in the region were doing the opposite, i.e., cutting policy rates to stimulate the market.

Nonetheless, the amount of loans continued to rise growing at a rate of 26.4 percent in 2007 to 29.5 percent and 33.6 percent in the first and second quarter of 2008, respectively. This further rose to 36.6 percent in the third quarter of 2008, the highest so far since the 1997 crisis.

In October 2008, Bank Indonesia lowered the reserve requirement for local currency deposits to 7.5 percent and for US dollar deposits, from 3.0 to 1.0 percent. This measure was meant to help provide banks with more funds for lending especially dollar- denominated loans.

3. Thailand

At the height of the global financial crisis, the Bank of Thailand raised interest rates to contain rising inflation rates and brought down interest rates when the economy started to slow down.

Amid the global financial stress, the Bank of Thailand's (BOT) approach to bank supervision was to ensure that the banking system has good risk management and adequate capital to be able to support the economy. At the end of March 2009, the BIS ratio for capital adequacy for Thai banking system is 14.9 percent, of which the ratio for tier-one capital is 11.8 percent.

Bank of Thailand's strategy to ensure adequate flow of credit has been to encourage greater competition among banks, which determine the level of interest rates through a process of close consultation and dialogue.

To help banks better manage the increased credit risk and promote lending by banks to small and medium enterprises, a credit guarantee scheme backed by government funding was set up. To help resolve problems related to bank lending, the Bank of Thailand also set up a customer call center that enables it to look into problems related to loan applications and approval. While the slow down in the Thai economy will continue to put pressure on the asset quality of banks, BOT will continue to emphasize the management of credit risk among banks in terms of requiring a strong capital base and a good risk management system. It is noted that

both of these measures have been strengthened significantly in the past years in line with Basel II and international best practices.

Bank of Thailand will continue to push for financial sector reforms. It is set to launch the second phase of the Financial Sector Master Plan in 2009 to further enhance the efficiency, robustness, and competitiveness of the Thai banking system. The Financial Sector Master Plan Phase II aims to promote financial system efficiency so that financial institutions may be able to perform their functions more efficiently, become more competitive with increased financial access to the public. The plan comprises three pillars. The first pillar is to improve the regulatory environment by reducing or eliminating unnecessary regulatory requirements. This pillar will focus on streamlining regulation and on promoting measures and incentives to deal with the legacy of non-performing assets (NPA) and non-performing loans (NPL), without compromising prudential oversight or good risk management.

The second pillar is to enhance efficiency by injecting more competition into the financial system. The focus will be on financial liberalization, increasing competition from current and new players and promoting greater financial access. The latter will give importance to expanding the retail banking businesses and promoting new microfinance business models and players.

The third pillar is to substantially improve the economy's financial infrastructure in the areas of risk management, credit information system, legal reform, information technology and upgrading the quality of human resource.

4. India

The Reserve Bank of India (RBI) implemented measures to maintain financial stability including those that address foreign exchange market concerns; liquidity management; liquidity problems of financial institutions; lack of credit to productive sectors; and problems of priority sectors such as the small and medium enterprises.

Some of these measures include the following:

On foreign exchange market concerns

- a. Interest rate ceilings on foreign currency deposit accounts were increased by 50 basis points successively in September and October 2008 and by another 75 basis points in November 2008 to improve the attractiveness of foreign currency deposits.
- b. Both Indian public and private banks that have foreign branches were provided a foreign exchange swap facility of tenor up to three months with the Reserve Bank of India.
- c. To fund the swap, banks were allowed to borrow under the Liquidity Adjustment Facility (LAF) provided by the Reserve Bank of India for the corresponding tenor at the prevailing repo rate. The swap facility was further extended to June 30, 2009.
- d. Export credit refinance facility from the Reserve Bank of India for scheduled banks was enhanced from 15 percent to 50 percent of the outstanding export credit eligible for refinancing.
- e. Banks were allowed to borrow funds from their overseas branches and correspondent banks. Non-deposit taking non-banking financial companies were likewise allowed to raise short-term foreign currency borrowings.

On liquidity management

- a. On September 2008, a second Liquidity Adjustment Facility (LAF) was introduced on a daily basis in addition to the facility already available.
- b. The repo rate was gradually brought down to 5 percent from 9 percent prior to October 20, 2008. The reverse repo rate stands at 3.5 percent, providing an informal short-term interest rate corridor of 3.5 percent to 5.0 percent.
- c. As a temporary measure, Scheduled Commercial Banks were allowed to avail of additional liquidity support under the LAF to the extent of up to one per cent of their net demand and time liabilities from their SLR portfolio and seek waiver of penal interest. Prior to this period, the banks availed of the LAF against the collateral of eligible government securities in excess of prescribed SLR stipulation, which was 25 percent of the Net Demand and Time Liabilities of the bank. Failure to meet the prescribed level makes the bank liable for penalty.
- d. In January 2009, the Government announced the setting up of a special purpose vehicle (SPV) to address the temporary liquidity constraints of non-deposit taking non-banking financial companies.

Augmenting liquidity of financial institutions

- a. Funds in the amount of Rs. 20 billion (US\$400 million) were made available to Small Industries Development Bank of India and the National Housing Bank

Facilitating credit to productive sectors

- a. A refinance facility was opened for Small Industries Development Bank of India, National Housing Bank and EXIM Bank for Rs. 70 billion (US\$ 1.4 billion), Rs.40 billion (US\$ 800 million) and Rs.50 billion (US\$ 1 billion) respectively on December 2008 until March 31, 2010.

- b. Banks were encouraged to use the special refinance facility from the Reserve Bank of India for the purpose of lending to micro and small enterprises.
- c. Loans granted by banks to housing finance companies for on-lending for housing up to Rs.2 million (US\$ 40,000) per dwelling unit have been allowed to be classified under priority sector.

Mitigating the stress of affected industries

- a. Banks were advised in October 2008 to consider restructuring qualified loans of small and medium enterprises (MSE) and also continue to disburse loans to the sector.

The Government of India has also announced a fiscal stimulus package in the amount of approximately US\$ 6.46 billion on December 7, 2008 to stimulate additional spending. It also introduced excise duty cuts to increase consumption. On January 2, 2009 the Government of India announced additional measures to provide liquidity support to Non Banking Finance Companies (NBFCs) and revised credit targets of Public Sector Banks to reflect the needs of the economy. Further, on February 24, 2009, additional stimulus measures were introduced to develop infrastructure and generate employment.

5. Pakistan

In response to the sharp rise in inflation rates in 2008, the State Bank of Pakistan pursued tighter monetary policies such as increasing interest rates in order to curb the impact of inflation and preserve economic growth.

Despite the economic shock and stress in the stock market the banking system showed an increase in profitability in the first quarter of the fiscal year 2009. The policies, regulations and supervision system of the State Bank of Pakistan (SBP) have been substantially transformed.²⁵ This can be attributed to the capacity building programs of the bank for its highly qualified cadre of staff who trained locally and abroad (SBP Report 2009).

²⁵ SBP regulatory and supervisory framework can be considered almost completely in line with international best practices and norms.

In line with international trends, SBP introduced Basel II requirements and banks have, since then, achieved higher capital adequacy levels --well above the minimum level for the sector as a whole.

Given the pressures in the global financial market, the SBP revisited its “Banking Sector Reform Strategy” (BSS) to reinforce the need for implementing the reforms that will make the financial sector more stable and Pakistan a more attractive destination for domestic and foreign direct and portfolio investment.

The broad objectives of the BSS are to:

- a. Make the banking sector more responsive to the needs of the economy and thus help achieve a more rapid and sustainable economic growth. This will include: (I) increased diversification into underserved economic subsectors; (ii) deeper penetration into underserved regions and population groups; (iii) more innovation and competition with new products and delivery channels; (iv) more effective mobilization of domestic and foreign resources; and (v) more effective channelling of resources into private investment, which will remain a key driver of economic growth.*
- b. Make the banking sector financially stronger, more resilient and stable by: (I) improving governance and risk management in banks and non-bank financial institutions (NBFIs); (ii) strengthening banks’ and NBFIs’ profitability and capitalization; (iii) facilitating better liquidity management; (iv) strengthening the financial safety net; and (v) resolving unviable institutions before they damage the system.*
- c. Make the banking sector better regulated and supervised by: (i) strengthening SBP independence and its powers to maintain monetary and financial stability; (ii) updating legislation and regulations, (iii) strengthening SBP authority and its methods of supervision.*
- d. Make the banking sector more efficient and stable by improving the infrastructure for financial intermediation, especially the payment systems, but also other areas to allow for improved efficiency and reduced uncertainty in*

financial sector transactions: human resources, credit information, credit rating agencies, land and property registries and improved legal procedures.

The Banking Sector Reform Strategy has the following ten main areas of reform:

- a. Create a more diverse and inclusive banking sector
- b. Improve consumer protection and financial education
- c. Strengthen competition and efficiency
- d. Consolidate and strengthen the banking sector
- e. Strengthen prudential regulation and supervision
- f. Introduce a framework for consolidated supervision
- g. Develop a financial safety net
- h. Strengthen SBP autonomy, accountability and governance
- i. Develop a more balanced financial system
- j. Develop the financial infrastructure

SBP and the Pakistan Microfinance Network (PFM) have developed a microfinance strategy to triple the number of microfinance clients from 1 million to 3 million by 2010 and then to 10 million by 2015. To support this program, SBP has encouraged the commercialization of the microfinance industry so that it may become financially and socially sustainable. Some of the specific actions being taken to achieve this objective include the following:

- a. A more flexible prudential regulatory regime for microfinance banks (MFBs) to allow innovation and organic growth without abandoning prudential objectives. Limits for MFBs and other MFIs will be adjusted at least in line with inflation and a two-tier regime is to be considered under which MFBs and MFIs with track record of prudent governance, risk management and financial success could be given more room to operate. This includes recently introduced capital adequacy requirements, which bring MFBs and MFIs into a competitive position at par with that of other banks.

- b. Encouragement of MFBs to improve their earnings quality and asset portfolios through improved risk management structures and practices, credit analysis and end-use monitoring. These measures will address the concerns over reduced capital adequacy ratios of these banks.
- c. Encouragement of MFIs to develop commercially viable and financially sustainable operations, which will allow them to transform into MFBs to provide holistic services, such as savings, credit and fund transfers. A five-year tax holiday is given as an incentive to MFIs to transform themselves into full-fledged MFBs.
- d. Encouragement of partnerships between commercial banks and MFIs to help banks engage in microfinance.
- e. Encouragement of a partnership between the post office (PO) network and MFIs. The post office network already manages over 4 million savings accounts, mainly small accounts below Rs 10,000, through more than 12,000 branches. There is scope for the PO and MFIs to join forces with the latter acting as intermediaries for funds raised by POs, especially as the operations of many MFIs are constrained by limited funding.
- f. Encouragement of mobile phone-based banking services, a cost effective way of bringing financial services to the most remote areas of the country. This is an option with enormous potential as there are already nearly three times more mobile phone owners (some 90 million individuals) than there are depositors. Mobile phone services reach almost every part of the country and are an extremely cheap way for banks and other financial institutions to extend their reach.
- g. Banks, including MFBs, are encouraged to take advantage of SBP's recently introduced *Branchless Banking Regulations* for enhancing the provision of financial services through alternative delivery channels.
- h. Development of domestic and international MFI partnerships.

- i. Financial literacy and customer awareness programs.

6. Cambodia

The National Bank of Cambodia (NBC) has doubled its efforts to include both banks and MFIs in the pilot program on credit information sharing system. The pilot program is an interim project meanwhile that the NBC is working for the establishment of a credit bureau with the help of the International Financial Corporation. The country is in the process of amending the Banking and Financial Institution Law to include the legal principles and framework for the operation of the credit bureau.

Because of the increasing need for MFIs to generate deposits as an important fund source given current economic conditions, the NBC with support from the Asian Development Bank is developing an appropriate framework for the regulation and supervision of MFIs, especially with regard to deposit-taking from the public. While MFIs previously generated savings only from their members, the NBC has allowed qualified MFIs to mobilize deposits from the public. As of March 2009, two MFIs compliant with the requirements have been granted a license to collect deposits from the public.

The NBC is also helping the integration of microfinance into the financial mainstream by allowing the development of new products and a relevant financial infrastructure for efficient operation. One of the priorities is to support the link of MFIs with commercial banks to get funding for expansion activities. The NBC has also lent wholesale to the Rural Development Bank and MFIs at an interest rate of 6 percent per annum. The loan has been an important source of funding for MFIs.

7. Korea

The Bank of Korea (BOK) implemented a series of market stabilization measures to avert the impact of the global financial turmoil on the banking system of Korea. This included the following:

- a. **Interest Rate Cuts**. The BOK lowered its policy rates from 5 percent to 2 percent, six times during the period from July 2008 to February 2009. The

policy rate cuts, which are considered unprecedented in terms of frequency and size, were done to help ease liquidity pressures due to the global financial mayhem.

- b. **Provision of Liquidity**. The BOK provided emergency liquidity to the financial system by undertaking open market operations through the expansion of eligible securities of financial institutions. The BOK also provided loans in the amount of 5 trillion Won for the Bond Market Stabilization Fund as well as for the Capital Recapitalization Fund. The BOK also subsidized commercial banks by paying interest payments on reserves, which commercial banks are required to hold in their BOK current account, in view of the decreasing earnings of those banks. Moreover, the BOK made foreign exchange swap arrangements with major foreign central banks such as the Federal Reserve Bank of New York, the Bank of Japan and the People's Bank of China and distributed the proceeds to the dollar-strapped domestic commercial banks.

V. Impact on clients

Developing countries in Asia and the Pacific, which do not have strong financial links with the U.S. and Europe, have begun to experience the ill effects of the crisis through indirect impacts on the financial sector and also through changes in the real economy. Falling demand in chiefly in the United States and Europe has led to drastic cuts in exports and related trade activities, resulting in idle manufacturing capacity and increasing unemployment. The first to feel the pain are the electronics-exporting industries across East Asia. Second are the major export-oriented industries in such traditional labor-intensive exports as textiles and garments, footwear and leather products, electronics, handicrafts, toys, gems and jewellery, processed wood, processed seafood and agriculture export crops e.g., coffee, rubber, rice, cashews. Indian exporters expect to cut about 10 million jobs by March 2009. The year 2009 is expected to be the worst year in Indian history²⁶.

²⁶ Mukesh Jagota, Dow Jones Newswires, January 6, 2009 as quoted by Magnoni and Powers (2009).

Owing to the concentration of women to labor-intensive export industries, the contraction of global markets for these sectors implies a huge risk for women workers. Temporary, casual, seasonal and contract laborers and low-skilled workers are laid-off first when manufacturing and industrial activities decline (Dejardin and Owens, 2009). The current crisis will reduce women's income in developing countries as a result of job losses in export-oriented industries. There could be a drop in remittances as overseas workers get laid off or as labor contracts fail to be renewed. Women are engaged in home production and micro-enterprises and dominate employment in export manufacturing and high value agriculture. Because women are the majority of clients of MFIs, their earnings from microenterprises would drop as credit dwindles (Sabarwal and others, 2009). It is noted that according to the 2007 Microcredit Summit Campaign Report, around 85 percent of the poorest 93 million clients of MFIs are women²⁷.

An increasing number of overseas foreign workers from East Asian countries have lost their jobs in the developed countries and have started to return to their home countries, putting additional pressure on domestic labor markets. The World Bank (2008) forecasts that the growth of remittances from abroad will slow down, which will affect consumption and investment among the poor in East Asian countries, notably the Philippines. Magnoni and Powers (2009) report the decline in remittances as estimated by the BSP to be as low as 6 percent in 2009, down from an estimated 13.5 percent growth in 2008. If realized, this will be the lowest rate of growth of remittances since the 1970s. Many households dependent on those remittances will face drastic cuts in consumption and other activities, thereby experiencing a welfare loss.

The country studies did not provide any information on just how many of the clients of RFIs and MFIs depend on remittances from relatives working abroad. It is, however, hard to think that the decline in remittances will not affect MFI clients themselves even in cases where the client's household is not dependent on overseas remittances. The decline will reduce disposable incomes in communities where MFI clients operate micro-enterprises. This may result in a reduction in demand for

²⁷ Cited by Sabarwal and others (2009)

products and services produced by those micro-enterprises, which will affect the profit margins of micro-enterprise borrowers and will strain loan repayment capacity.

Coupled with rising food prices the reported job losses in domestic and overseas labor markets would constrain household incomes and some MFI clients may fall back on loan obligations or withdraw their savings. Chen and Ravallion (2009) believe that “the crisis will add 53 million people to the 2009 count of the number of people living below US\$1.25 a day and 64 million to the count of the number of people living under US\$2 a day”. Magnoni and Powers (2009) note that some MFIs in Cambodia, Vietnam, Nepal, Bangladesh, Pakistan, Indonesia and the Philippines are experiencing higher loan delinquencies as a direct result of food price increases. Siu (2008) reports that 25 of 45 surveyed MFIs have reported that PAR is increasing as a result of high food prices. Helayel (2009) comments that for the poorest borrowers, who spend most of their meagre incomes on food, the burden of interest payments will be heavier, which may lead to more loan delinquencies²⁸.

Available evidence from a few seminal analyses of the impact of the crisis on MFI clients is largely anecdotal. Not all countries would face the same level of vulnerability due to varying dependency on global trade and foreign direct investment and the fragility of their financial systems (FDC Briefing Note, 2009). Because of unemployment and diminishing incomes, demand for microfinance loans for livelihood and various microenterprise could increase as households try to cope with the grim economic situation. The influx to the informal sector and an expected increase in demand for micro-loans for starting up new livelihood ventures or continuing with existing microenterprises in the midst of disappearing market demand and volatility in incomes will test the skills of many RFIs and MFIs.

Magnoni and Powers (2009) aver that the profitability of microenterprises will likely be impacted even with the much-touted resilience and flexibility of micro-entrepreneurs. They cite figures coming from Nicaragua where the Micro, Small and Medium Enterprise Council announced that sales for micro-entrepreneurs fell 15 percent year-on-year in December 2008. It appears that the loan portfolios of RFIs

²⁸ Siu (2008) and Helayel (2009) are cited by Magnoni and Powers (2009).

and MFIs will be at risk as small and micro-borrowers face loan repayment problems in the face of lower returns to their respective businesses.

1. Philippines

While some MFIs have clients whose businesses are dependent on demand from markets overseas, the majority are micro-entrepreneurs who borrow in very small amounts and operate projects that are least likely to be affected by large-scale global banking problems. The majority of MFI clients cater to the domestic market. However, the global financial crisis is only one of many problems being faced by the Philippines and other developing countries today. Prior to the global financial crisis, these countries had to ward off the adverse effects of the food and energy crisis, which brought inflation rates to double-digit levels. As noted by CGAP (2009), “it is not easy to separate the effects directly related to the financial crisis from pre-existing conditions like the food crisis”.

The leading MFI in the Philippines, CARD Bank, noted that amid the global financial turmoil, there was a significant rise in the number of its microfinance borrowers, which more than doubled from 50,990 in 2007 to 121,752 in 2008. Consequently, the total amount of microfinance loans granted also increased sharply to Php 1.8 billion in 2008 from Php 643.7 million in 2007. At the same time, however, the number of clients who dropped-out from the bank’s microfinance program went up from 6,297 in 2007 to 14,853 in 2008. Another interviewed MFI indicated that the decrease in loan renewals as well as the increase in accounts written-off are due not only to the global financial crisis, which has caused huge job losses worldwide and business slow-down, but also to domestic issues such as credit pollution and staff turn-over (Box 3). There is yet no systematic investigation on which of these factors, external (global financial crisis) and internal (credit pollution, staff turn-over, faulty loan screening and other factors) is the principal reason behind reported loan delinquencies of some microfinance institutions.

Box 3: Responses of MFI on Impact of Financial Crisis on Clients/Quality of Loan Portfolio

How has the financial crisis affected your clients and/or the quality of your loan portfolio?

There has been:

- Decrease in number of renewals
- Higher drop out rate
- Lower loan amounts requested by clients

Due to:

- Clients experiencing business slowdown
- Loss of employment of other family members of clients
- Credit pollution
- Personnel turn-over or staff fall-out

What have you done to address these problems?

- Tightened spending to reduce costs
- Provided business development services
- Tightened Credit Investigation and Background Investigation (CIBI) and verification procedures
- Aligned policies and procedures to adjust to changing needs of market including reorganization of microfinance unit and partial withdrawal on contractual savings.

2. Cambodia

The impact of the crisis on clients can be seen through the increasing number of factories closing down and the lay-offs of workers as well as a noticeable decrease in income and overseas remittances. An Economic Institute of Cambodia (EIC) report on the garment industry showed that while US\$50 million of the workers' salaries in the industry supported rural economic activities in 2008, official figures released by the Ministry of Commerce indicated that the growth in garment exports to the United States and the European Union decreased by 2 percent in 2008 as compared to 2007. Some garment factories have closed down. Increasing unemployment with the concomitant loss of income is a source of concern since it could foster non-performing loans and loan delinquencies and could also result in increased savings withdrawals. It could also dampen deposit mobilization.

With respect to the impact on loan portfolio quality, in 2007 MFIs experienced an increase in total arrears for loan balances over 30 days as well as those over 90 days, which consequently brought up the portfolio at risk (PAR) to almost 2 percent in 2007 from less than 1 percent in 2006. PAR was 2 percent in 2008.

3. India

The results of focused group discussions with some clients of MFIs indicated that:

- a. Despite the crisis clients have not experienced any problem in accessing credit from bank branches.
- b. The government continues to provide crop loans at a concessional rate of 7 percent since 2005. Individual private banks determine all other loans.
- c. Some clients are already feeling the impact of the crisis especially those in the brick industry due to a fall in domestic demand, which has resulted in delayed loan repayments of workers associated with that industry. The Reserve Bank of India has advised the banks concerned to allow a restructuring of loans given to the brick industry.
- d. Other clients who export their products or are dependent on demand from overseas are also facing problems. For example, overseas demand for large and costly diamonds has significantly gone down resulting in the closure of many cutting and polishing units in Gujarat with an estimated 413,000 workers losing their jobs. A Task Force constituted by the Reserve Bank of India to look into the problem recommended measures for the restructuring of loans and refinancing of existing loan accounts of those affected by the economic slowdown. Training programs were proposed to help displaced diamond workers find alternative employment.

4. Pakistan

Microfinance clients had been most affected by very high inflation rates brought about by surging prices of energy and food in the world market and consequently, in the domestic market. This quickly eroded the purchasing power of low-income households, which spend 66 percent of their income on food. Rising prices of food will leave poor households with very little left to pay for other essentials including their loans.

The global financial crisis worsens the situation and could bring about the following: Diminished capacity of low-income households to repay loans, which could damage the loan portfolio quality of MFIs;

- a. Increased demand for loans because of need for additional funding to stay in business, expand for those lucky enough to have rising demand for their products or services, or set up new businesses.
- b. Decreased capacity of households to provide for other household needs including nutrition, health care, education, etc.

The survey by the Kashf Foundation on the impact of inflation found that microfinance clients are demanding bigger loans to sustain their existing businesses as well as to support the establishment of new ones, which are intended to help augment household income. The survey shows that inflation has forced many of the microfinance clients, 99 percent of whom are women, to take on new jobs in addition to their existing businesses.

The survey also indicates that 79 percent of the microfinance clients now eat significantly less than before the 2008 surge in inflation. It is reported that 29 percent of respondents' families have gone hungry for 1 to 4 days during the survey period. Almost all of respondents (95 percent) said that their families were getting less nutrition especially because they were eating lesser quantities of fruits and vegetables. Malnutrition and undernourishment can lead to poorer health status and lower productivity, which in the long run, can affect the overall loan repayment performance of low-income households. This will contribute to the deterioration of the quality of loan portfolios of microfinance institutions.

VI. Conclusions and recommendations

This paper is an attempt to describe the impact of the global financial crisis on RFIs, MFIs, regulators and clients in East, and South Asia using very limited data from country papers submitted by APRACA member institutions. The Benchmarking Report of MIX and Intellectap, which assessed the performance of the microfinance industry in 2007 provided an essential backdrop to appreciate the impact of the global financial crisis on rural and microfinance institutions, regulators and clients of those

institutions as reported in the country papers.

The microfinance sector in Asia continues to evolve with emphasis on efficiency and strong growth in outreach. The country papers submitted to APRACA validate the growth in loan portfolios and increase in the number of clients, with growth varying significantly by country depending on internal and external factors. RFIs and MFIs continue to maintain a positive attitude and expect that business will pick up as a result of an increase in demand for loans to finance livelihood projects and various micro-enterprises. They are aware of the threats and opportunities brought about by the global financial crisis.

In general, RFIs and MFIs showed good performance in the run up to the onslaught of the global financial crisis in the region. Loan portfolios have expanded while an increasing number of clients are being provided financial services. Operational and financial self-sufficiencies indicate that many MFIs are covering their costs and generating positive margins from operations.

However, the period of rapid growth in the past decades could decline or be stalled depending on both *internal* (MFIs' and RFIs' individual strengths and weaknesses, management capacity, ability of loan officers and staff and others) and *external* (macroeconomic and financial environment, government and regulators' policy responses) factors affecting MFI or RFI performance. Rising food and fuel prices have exacted a heavy toll on poor households with dire implications to their health status and productivity. The situation is worsened by the global financial crisis with many poor households facing loan repayment difficulties, which could trigger a deterioration of the quality of loan portfolios. RFIs and MFIs that cannot effectively manage loan portfolios will face severe challenges to their viability and sustainability.

CGAP (2009) has observed a larger decline in loan portfolio quality and rising loan delinquencies in Eastern Europe and Central Asia compared to East Asia and the Pacific, where fewer MFIs are reporting increases in portfolio-at-risk. Country papers noted the same experience with a report on deteriorating assets and rising loan delinquencies among MFIs but these have been attributed to slowing economies, credit pollution, fast turnover of staff and not necessarily to the global financial crisis.

With the advent of the crisis, funding of non-deposit-taking MFIs could be a problem even as expansion plans have been discreetly cut down or postponed in view of a climate of uncertainty and creeping recession in the region. CGAP (2009) points out that fundraising from institutional investors including microfinance investment vehicles, which are mostly from the U.S. and Europe, would be tougher in the near future. The liquidity contraction will raise the cost and availability of funding especially for MFIs that are dependent on external sources for their operation. This observation is confirmed by the experience of Cambodia although the information supplied seemed preliminary.

Asian MFIs, which are dependent on external sources to finance operations, have used a variety of funding strategies. Some MFIs draw funding from government and external sources; still others (RFIs such as BAAC and MADB) are given loans or equity capital by their respective governments.

MFIs seeking equity capital or investments from donors and institutional investors may find that not many would likely invest in an uncertain economic environment. □ Private investors and institutional investors, which are major sources of funding mainly for non-deposit-taking MFIs, are adopting a cautious outlook. However, it seems that there still are a few investors who would be willing to invest in MFIs notwithstanding the global financial crisis as reported by India²⁹. Nonetheless, Magnoni and Powers (2009) maintain that the slowdown in private external funding will not only be a short-term phenomenon. In their view, there will be less new institutional capital entering the microfinance sector than expected in the medium term. Individual investors may not fill the gap. The name of the game will be track record as there will be a shift in investor appetite toward stronger and sustainable RFIs and MFIs. If the global economy continues to worsen, RFIs and MFIs that are dependent on foreign funding will have a limited scope for raising the extra liquidity that they need to sustain lending activities and meet refinancing needs when loans from foreign sources become due in the near future.

²⁹ As stated above, for example, SKS Microfinance, India's largest MFI, sealed an undisclosed deal with Sandstone, a US hedge fund, Kismet Capital and SVB India Capital, an affiliate of Silicon Valley Bank last November 2008.

The crisis has caused a liquidity shortage and credit crunch worldwide that will have more adverse impact on RFIs and MFIs that cannot mobilize deposits because of restrictions imposed by the country's banking laws and regulations. Those MFIs would typically be NGOs that are non-deposit-taking institutions. Many Cambodian and Philippine NGOs fall into this category. The safety valve for non-deposit taking MFIs is the interest and willingness of domestic commercial banks and government banks to lend. The limit will be the availability of commercial funding and the fiscal capacity of governments to continue with the subsidies. The essential factors for getting commercial funding are a good track record of a MFI in providing loans to a growing client base and successful recovery of those loans with healthy margins.

In spite of the arguments that microfinance will remain stable, the likelihood is that MFIs that greatly depend on government donor agencies, foundations, NGOs, or apex institutions for funding are more likely to be negatively affected. The extent of impact will depend on factors such as the structure of an institution's liabilities, its financial state and the economic health of its clients. The effect of the global financial crisis on microfinance may, thus, differ from one country to another.

Deposit mobilization is a strong suit of microfinance banks while non-deposit-taking MFIs have to rely on loans and grants and institutional investors for financing. Deposit taking MFIs have utilized deposits as a steady and substantial source of funds for their lending operation, which have served them well in the crisis-driven situation of a liquidity shortage and credit crunch. Access to deposits has created an incentive for non-deposit taking MFIs to transform into (regulated banks).

Indian, Pakistan and Philippine banks (that are engaged in microfinance) are better situated than non-deposit-taking MFIs in the region because they can mobilize deposits. The downside risk is a general loss of confidence in the domestic banking system, which may lead to a run on deposits and affect even the strongest MFIs and RFIs in the region. Regulators and governments are aware of this risk and they are doing their best to stabilize the financial markets and restore confidence in the economy. They have used various instruments, e.g., expanding deposit guarantees,

easing monetary policy in order to calm down the financial markets and maintain confidence in the financial system and fiscal stimulus packages.

It helped that many Asian banks are not deeply linked to the international financial markets, which could have exposed them to structured products, now called “toxic assets.” Regulators have required banks to comply with Basel II requirements to build their financial muscle. Capital adequacy is an important factor in the sustainability of MFIs and RFIs, which they have striven to achieve. While banking institutions in the region have strengthened their capitalization as part of the financial reform package in the wake of the Asian financial crisis of 1997, there still remain gaps in capitalization especially among cooperatives and NGOs that have rural and microfinance operations.

Data monitored by MIX indicate the development of many Asian MFIs into sustainable financial institutions, which earn sufficient returns to cover their costs. The operational and financial self-sufficiency and PAR indicators, among others, attest to the profitability of many of those MFIs. Before the onset of the global financial crisis there were various plans for expansion and continuing efforts to innovate in order to broaden financial inclusion. However, some of those expansion plans may have been put on hold pending the emergence of a better economic environment.

Prolonged recession in countries of the region will lead to more output loss and rising unemployment and a general weakening of urban and rural economies, which will reduce demand for products and services offered by micro-enterprises and small businesses. Declining household incomes will eventually be felt by RFIs and MFIs in terms of falling loan repayment rates or rising loan delinquencies. There is a variation in the experience of clients: some point out to the effects of rising food and fuel prices (before 2008) as significant problems; others to falling demand for products and services in 2008 when the recessionary impact of the global financial crisis has started to rear its ugly head. Falling demand for MFI clients’ products and services leads to declining incomes or even income loss, which impacts on the loan repayment capacity of those client-borrowers.

The most vulnerable to high food prices are children and women. The closure of export manufacturing establishments following a fall in overseas demand and a slowdown in trade activities and a general weakening of the local economy will hurt women who are the dominant clients of microfinance institutions. The inability of MFIs, especially the non-deposit taking MFIs to raise more external funding in order to continue to extend loans and expand operation will hurt their clients, the majority of which are women.

Rural and microfinance institutions in the region are certainly aware of the liquidity and credit risks that arise from a drastically changed financial landscape. CGAP (2009) comments that surprisingly MFI managers who participated in the 2009 opinion survey (conducted by CGAP) are optimistic that their performance will remain stable or improve in the next six months. Members of the Microfinance Council of the Philippines expressed a similar sentiment. The RFIs and MFIs in the region have noted that the majority of their borrowers are micro-entrepreneurs who borrow in small amounts and are engaged in businesses that are least likely to be affected by global banking travails. However, there is no reason to have an overly sanguine attitude. Hard-nosed RFIs and MFI are aware that they have to improve the quality of loan portfolio, improve risk management, intensify savings mobilization effort, find alternative sources of funding, diversify loan portfolios and effectively monitor loan delinquencies.

This is a not far-fetched idea. According to MIX and Intellecap the Asian microfinance sector has demonstrated its leadership in the global financial arena through its impressive scale of outreach and tight operating cost. The challenge in 2008-2009 is how to continue strong growth in outreach amidst economic slowdowns while securing funding from financial markets that are in crisis (MIX and Intellecap, 2009).

Regulators and financial institutions alike have learned quite well the lessons of the 1997 Asian financial crisis and have applied reforms that strengthened the financial system, which served East and South Asian countries well when the global financial storm inflicted itself on the region. Regulators and governments in the region have been pro-active in crafting policy interventions designed to stimulate the

economy and build confidence in the financial system. In this regard, governments and regulators in the region focus on developing enabling environments, creating supporting infrastructure and calibrating policy responses to invigorate domestic economies even as they are committed to a policy of financial inclusion.

The global financial crisis has strained the region's economies and the rural and microfinance industry. At the same time, the crisis leads to a need for RFIs and MFIs to become nimble in grasping more innovative business models, working for greater efficiencies and diversifying funding sources, tapping local savings, and having better information on clients and local economies amid a totally different and changing economic and financial landscape.

Notwithstanding the constrained data and information culled from the country papers submitted to APRACA, lessons were drawn from an appreciation of the emerging situation of MFIs and RFIs. Those lessons lead to the following recommendations:

1. Regulators should continue with their efforts to create an enabling environment, build the necessary financial infrastructure (e.g., credit bureaus, deposit and credit guarantees, liquidity facility) and develop more appropriate regulatory and supervisory approaches (e.g., risk-based supervision of financial institutions, requirement for corporate governance) for rural and microfinance institutions.
2. Rural and microfinance institutions should strengthen their financial and credit policies and processes for credit analysis, loan screening, risk management, monitoring performance and diversifying asset portfolios. Improving efficiencies will be a primary responsibility.
3. Rural and microfinance institutions should raise more than adequate capital to have a strong buffer against financial stresses and tap more domestic sources of funds. As the experience of Asian MFIs show local equity capital and domestic deposit base can provide the necessary funds for lending and help shield them from currency volatility brought about by heavy reliance on foreign borrowing.

4. Donors, governments and stakeholders should continue with and expand efforts in training and capacity building among rural and microfinance institutions. Priority areas for capacity building include the following: risk management, improved credit analysis, loan delinquency management, strengthening loan portfolio quality, streamlining operational procedures, product development, improving governance structures, strategic planning and capacity to do better external environment scan.

5. Governments, donors and rural and microfinance institutions should unite their various efforts to (a) help build client capacity in areas such as financial literacy and numeracy, product development, among others, (b) provide access to safety nets especially for vulnerable children and women, (c) link small businesses to supply or value chains and (d) promote entrepreneurship.

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Annex A

List of country papers submitted to the APRACA Secretariat

Cambodia

India

Korea

Pakistan

Philippines

Russia

Thailand

Vietnam

Annex B

Data, methodology, scope and limitations

The lead consultant will prepare a topical outline for country papers to be prepared by country writers who will be selected by APRACA from selected member countries. Local country writers in the selected member countries will prepare individual papers that will be submitted to APRACA Secretariat. The lead consultant will integrate the papers submitted by country writers into a Report, which will be presented to the EXCOM meeting in Seoul, Korea on June 29, 2009.

The country writers will prepare the country paper in consultation with RFIs/MFIs and regulators in the countries assigned to them. The information on impact on clients will come from information to be provided by RFIs/MFIs in view of time and budget constraints that prevent an actual survey of a sample of clients in the selected countries. The focus of the clients' story will be around key themes of (a) outreach (accessibility), b) affordability of financial products and services, (c) and financial inclusion.

APRACA Secretariat will choose one RFI/MFI per country to be interviewed/examined by the country writer. The regulator to be included in the study will be the central bank of the sample country. The country writer will get information on the impact of the global financial crisis from the sample MFI/RFI.

The Integrative Report relies heavily on information and data supplied by country writers. Hence, its quality is dependent to a very large extent on the timely submission of quality papers by country writers. The lead consultant will also use available secondary sources of data to address problems of deficiency in information and data gaps that may arise because of poorly-written country papers. Time and budget constraints prevented the conduct of a rigorous survey of microfinance institutions, regulators and clients, which would have yielded a richer cache of data and information on the impact of the global financial crisis on the microfinance industry in Asia and the Pacific. It is noted that a much better designed and implemented survey of MFIs, regulators and clients with sufficient time to do the survey and analyze the results and adequate budget would elicit better data and information for the analysis of the impact of the global financial crisis.