Myanmar Dry Zone Development Project

Scoping Mission

Annex 4: Rural Finance

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Exchange Rate: USD 1.00 = Kyat 981 (January 2014)

Acronyms

BWP	Beneficiary Welfare Program
CCS	Central Cooperative Society
CGAP	Consultative Group to Assist the Poor
DZ	Dry Zone
FIND	Financial Inclusion for National Development (World Bank funded)
GDP	Gross Domestic Product
GOM	Government of Myanmar
HDI	Human Development Initiative
IAM	Independent Assessment Mission
IP	Implementing Partner
MADB	Myanmar Agricultural Development Bank
MARC	Myanmar Access to Rural Credit
MCHHE	Maternal and Child Health and Health Education
MEB	Myanmar Economic Bank
MFI	Microfinance Institution
MOAI	Ministry of Agriculture and Irrigation
MOU	Memorandum of Understanding
MMN	Myanmar Microfinance Network
MMCWA	Myanmar Maternal and Child Welfare Association
MMSE	Myanmar Microfinance Supervision Entity
MSC	Microfinance Supervisory Committee
OSS	Operational Self Sufficiency
QSEM	Qualitative Social and Economic Monitoring
SLE	Small Loans Enterprise Department
SRG	Self Reliance Group
UNDP	United Nations Development Program

1. Introduction

This annex provides support to the formulation of the Dry Zone (DZ) Development Project by FAO for possible eventual funding by LIFT. Following an inception mission which took place in October 2013, the current Scoping Mission is intended to provide sufficient information and analysis to permit the definition of major aspects of the proposed project, including its objectives and concept, geographical and thematical coverage, and likely costs and duration. Following anticipated approval by the Board of Directors of LIFT of the Concept Note arising from this report, it is anticipated that a final Design Mission will take place in May 2014.

This annex addresses one of the key areas of importance for the development of the DZ, the need, availability and cost of rural financing, not only for agricultural producers, but also for post-harvest operations and micro and small-scale entrepreneurs.

2. Background

The Myanmar financial sector has received considerable attention in recent years, in large part because of its limited development during the lengthy period of economic and political isolation which extended from the 1960s until 2012. During the latter part of this period formal banking sector operations in rural areas were limited by law to the state-owned Myanmar Agricultural Development Bank (MADB)[1] established under the 1990 Myanmar Agricultural and Rural Development Bank Law[2]. Close controls were placed on microfinance operations, particularly those funded from outside the country. MADB lending – primarily for rice production - occurred through community based groups at highly subsidized interest rates (15 percent per annum against inflation rates in excess of 50 percent in the early 2000s) but relied on cheap government financing which was limited by Government of Myanmar (GOM) budget considerations.

The informal banking sector during this period comprised a number of institutions, including a large number of credit cooperative societies, but most were urban based and had little impact in rural areas[3]. The government-owned Small Loans Enterprise Department (SLE) with 185 branches in the beginning of the 2000s, charged interest rates closer to market levels (3 percent per month), but also lent almost entirely to small enterprises. The only national organization apart from MADB with a widespread presence in rural areas was the Myanmar Maternal and Child Welfare Association (MMWCA), with branches in all 324 Townships, and which commenced micro-lending in 1996. However, their clients were primarily female small traders, rather than producers, and their total loan portfolio was small.

The first significant international support for rural microfinance was launched in 1997 under the UNDP Human Development Initiative (HDI). This program, established through a Memorandum

[1] *Myanmar Agricultural Sector Review and Investment Strategy*. Volume 1. UNDP, 2004. Section 13.17

[2] *Fiery Dragons: Banks, Money Lenders and Microfinance in Burma*. Sean Turnell. Nordic Institute of Asian Studies. Monograph Series 114. Copenhagen. 2009. Page 257.

[3] *Myanmar Agricultural Sector Review*. Op.cit. Section 13.29

of Understanding (MOU) with GOM, financed three microfinance projects, of which one was in the DZ. The three projects were permitted to charge interest rates of 38-45 percent per annum; considerably above government mandated levels but still insufficient to permit operational sustainability given inflation rates at that time. The projects rapidly became the largest source of agricultural credit in their operating respective areas (exceeding MADB loans) but their expansion was restricted by GOM for many years. CARE and Save the Children (through its Dawn program) also succeeded in obtaining clearance to establish microfinance operations in 2001 and 2002 respectively.

By 2006, the UNDP HDI projects had been merged into a single operation managed by PACT, an international NGO which had commenced operations in the DZ under HDI in 1997.

3. Legislation, Policy and Institutions

In addition to government controls on deposit and loan rates, and the difficulties of obtaining clearance to establish operations, the microfinance sector was seriously constrained historically by the lack of a clear legal, regulatory or policy framework within which to operate.

This started to change in 2011 with the public endorsement by President Thein Sein of the development of the microfinance sector and, later in the year, the passage of the Myanmar Microfinance Law[4], which for the first time established a coherent legislative and supervisory environment for the operation of microfinance institutions (MFIs). A Microfinance Supervisory Committee (MSC), later changed to the Myanmar Microfinance Supervisory Entity (MMSE) was established with responsibility for establishing policy, setting the rules governing MFIs, determining minimum capital requirements, issuing licenses and setting the associated fees as well as imposing administrative penalties, when required. Applicants for licenses can be local or international in origin and can include companies, partnerships or cooperative societies. Two categories of MFI are recognized under the law – deposit-taking and non-deposit taking, with the chief regulatory difference being the minimum amount of capital required (Kyat 30 million and 15 million, respectively). However, interest rates under the new law are still controlled, with lending rates not to exceed 2.5 percent per month and deposit rates not less than 1.25 percent per month.

In 2012, the World Bank funded Financial Inclusion for National Development (FIND), was established with the aim of strengthening the Myanmar Microfinance Supervision Entity (MMSE), responsible for overseeing institutions registered under the new Microfinance Law.

By January 2014, a total of 189 institutions were reported to have been licensed under the law[5], although many were cooperatives functioning primarily in urban areas[6]. It is estimated by Duflos

[4] This description is taken from the *Myanmar Microfinance Network* summary of the legislation. http://www.myanmarmicrofinance.org/?p=140. Note that this site states that the Microfinance Law was passed in 2012.

[5] http://www.cgap.org/blog/financial-inclusion-myanmar-10-things-you-should-know

et al that 2.8 million clients were served by microfinance operations in 2012, with a total loan portfolio of USD 283 million. The key agencies operating in the rural microfinance sector are summarized in Table 1 and discussed further below.

Myanmar Agricultural Development Bank

The MADB is still by far the largest agricultural lender in Myanmar, serving approximately one half of all microfinance borrowers (1.4 million) and with a loan portfolio of Kyat 84 billion, or one third of the national total. All loans are provided without collateral, but based upon mutual support groups of 5-10 farmers who are all responsible for loans to any group member.

However, MADB will lend a maximum of only Kyat 100,000/acre for rice and sugar cane, and only Kyat 20,000/acre for other crops, up to a maximum of 10 acres, so average loan size is low, at less than Kyat 60,000 per borrower, and is inadequate to cover a major proportion of cash production costs for any crop.

Table 1: Microfinance Providers in Myanmar

Category	Individual Institutions	Number of Branches / Outlets	Number of Borrowers	Outstanding Loan Portfolio (in Kyats)	Average Loan outstanding (in Kyats)	Number of Deposit Accounts	Total Savings (in Kyats)	Average Deposit Size (in Kyats)	Regulated	Supervisory Agency
State Owned Bank	MADB[1]	205	1,420,000	84,000,000,000	59,155	1,720,000	86,891,840,000	50,519	Yes	Ministry of
	MSLE[2]	143	208,778	31,341,790,000	150,120	N/A	N/A	N/A	Yes	Ministry of Finance and Revenue
Private Bank	MLFDB[2]	53	N/A	N/A	N/A	N/A	N/A	N/A	Yes	Central Bank of Myanmar
Non-Governmental Organization	PACT - UNDP[3]	105	365,410	52,701,000,000	144,224	420,133	10,930,000,000	30,000	No	N/A
	PACT MFI[3]	16	57,128	4,234,502,910	74,123	N/A	N/A	N/A	Yes	Microfinance Supervisory Enterprise
	GRET MFI[4]	4	6,155	840,041,000	136,481	*Non-deposit taking MFI*			Yes	Microfinance Supervisory Enterprise
	Save the Children MFI[5]	N/A	7,737	367,747,782	47,531	7,737	25,975,513	3,357	Yes	Microfinance Supervisory Enterprise
	World Vision MFI[6]	12	13,282	1,910,033,328	143,806	N/A	N/A	N/A	Yes	Microfinance Supervisory Enterprise
	Proximity Design MFI[7]	8	16,000	3,113,831,000	194,614	N/A	N/A	N/A	Yes	Microfinance Supervisory Enterprise
	AMDA[8]	N/A	1,510	55,109,960	36,497	N/A	N/A	N/A	No	N/A
	Total[8]	N/A	1,197	165,077,000	137,909	N/A	N/A	N/A	No	N/A
Cooperatives	Central Cooperative Society MFIs[9]	46	32,851	1,125,690,000	34,267	32,851	340,340,000	10,360	Yes	MSE / Central Cooperative Society
	Financial Cooperatives - Union of Savings and Credit Federation [9]	1625	476,632	16,500,000,000	34,618	476,632	24,200,000,000	50,773	Yes	Central Cooperative Society
Specialized Agricultural Companies	Rice Specialization Companies[10]	38	57,502	20,092,708,226	349,426	N/A	N/A	N/A	No	N/A
	Other Agri Specialized Companies[10]	22	140,000	20,000,000,000	142,857	N/A	N/A	N/A	No	N/A
Women's Union[11]		16	4,800	48,000,000	10,000	N/A	N/A	N/A	No	N/A
Union Solidarity Development Association[12]		N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Community Based Organizations[12]		N/A	N/A	N/A	N/A	N/A	N/A	N/A	No	N/A
TOTAL		2,293	2,808,982	236,495,531,206	119,763	2,657,353	122,388,155,513			

6 *Microfinance in Myanmar. Sector Assessment*. Duflos, Eric et al. International Finance Corporation and CGAP. January 2013.

Source: Microfinance in Myanmar. Sector Assessment. Duflos, Eric et al. IFC/CGAP, January 2013. Table 2.

MADB has been even more important historically as a savings repository, with 1.7 million savings accounts accounting for over 70 percent of all such accounts held by agencies identified as providing microfinance services. The reduction in interest rates on MADB loans which occurred in March 2012, from 13 percent per annum to 8.5 percent, has left the institution with a margin of only 0.5 percent per annum between deposit rates (which remain at 8 percent) and lending rates. As a result, the bank has reportedly stopped mobilizing savings and this total is expected to diminish significantly[7].

Despite its pre-eminent position as a source of microfinance services in Myanmar, the MADB faces a number of serious challenges. The institution is almost totally dependent on subsidized funding from the state-owned Myanmar Economic Bank (MEB), without which the institution could not maintain its current lending practices and which, in addition, limits its access to other forms of capital. It is also required to return 75 percent of profits to GOM, leaving it unable to invest resources in modernizing or upgrading its systems. Almost equally important, however, are the prudential risks that the institution faces as a result of its current administrative and lending practices. Among the most important of these are: (a) almost 90 percent of the total loan portfolio is directed at a single crop (rice) and 97 percent is distributed over only four crops[8]. Non crop production lending (principally term loans for farm machinery) accounts for only one percent of the entire portfolio.

As a result, MADB would suffer extremely heavy losses in case of a major disease outbreak in rice or a natural disaster affecting significant production areas of the country; (b) MADB plays no role in the selection or approval of borrowers and in fact has no field staff at all. The process of borrower selection and loan definition occurs at village level through a Loan Screening Committee comprised of MOAI staff and farmer and village representatives. Thus MADB has no control over the selection of its borrowers; (c) there is little internal or external supervision of MADB activities. The Board of Directors is composed entirely of government appointees, with no external directors, no independent audit department, and no published annual report for many years. Prudential controls applied to other banks do not apply to MADB, which is a department of MOAI. The identification of threats to the bank's survival would thus be a slow and uncertain process at best, and; (d) there is no internal communications platform to permit reliable contact between MADB offices and accounts data is entered and maintained in hard copy, without electronic versions, exposing the bank to serious risk of information systems failure in the event of a fire or other disaster.

In summary, therefore, MADB currently operates as a government mechanism for channeling subsidized resources to primarily smallholder producers, rather than as a sustainable

[7] *Myanmar Agricultural Development Bank. Diagnostic and Restructuring Options*. Unpublished paper prepared by the World Bank for LIFT. September 2013. Page 16.

[8] Ibid. Page 14. In addition to rice, the other crops are groundnut, sesame and beans.

microfinance institution. Given its position as the largest source of lending for small producers, this must be a concern.

PACT

PACT commenced operations in Myanmar in 1997 as the implementing agency for one of three UNDP HDI microfinance projects. An international NGO, based in the United States of America, PACT was awarded the entire HDI microfinance portfolio in 2006 and in 2011, with the new microfinance law, it established a standalone MFI subsidiary (PACT-MFI) which was given responsibility for all microfinance operations. As of September 2012, PACT-MFI's loan portfolio in Myanmar totaled USD 68 million and 365,000 borrowers in nearly 6,000 villages, 98 percent of which were women[9]. Including both UNDP-financing and PACT-MFI, the organization accounted for almost one quarter of all microfinance lending in Myanmar and is by far the largest non-state actor in the sector. The impact of PACT activities is expected to grow even further as a result of the LIFT-funded Myanmar Access to Rural Credit (MARC) program established in 2012[10]. MARC will provide resources for PACT to support and finance the activities of nine local MFIs, some of which have no previous experience in the sector. PACT is thus moving towards becoming a 'second floor' MFI in Myanmar, in which it acts to support the growth and activities of primary MFIs.

PACT's microfinance model has developed from the original approach adopted under the UNDP HDI program, and involves self-selected lending groups of five persons, with both compulsory and voluntary associated savings programs for members of the lending groups. A number of savings groups in the same community are consolidated under a Village Credit Organization (VICO). Loans of up to Kyat 100,000[11] are available to group members in a range of categories, including normal (typically for working capital needs), agricultural, small and micro enterprises, education, sanitary and health, each of which have different durations, ranging from 4 months to one year. Interest rates are typically 2.5 percent per month (although lower rates were reported to the mission by some PACT offices for some types of loans[12]). Each group is provided with weekly training sessions over a period of 5 weeks, covering book keeping, financial management and the identification of business opportunities. Loan officers, who provide their own motorbikes[13], visit each group periodically. Reportedly agriculture loans cannot be applied for during the first 6 months of membership[14].

[9] *Results from Pact's Microfinance Projects in Myanmar*. Undated. h*ttps://www.**pact**world.org/sites/default/files/**Pact_Microfinance**_Revised_Final.pdf*
[10] https://www.pactworld.org/blog/pact-lift-myanmar-access-rural-credit-project-marc
[11] Loans of up to Kyat 500,000 were reported by the PACT office in Yesagyo Township for agricultural purposes (onion production).
[12] The Yesagyo Township PACT office, for example, reported rates as low as 1.2% p.m. for some loan categories.
[13] A mileage allowance of Kyat 80 per mile is paid to loan officers.
[14] Interview with Yesagyo Township PACT office.

PACT provides all borrowers with a limited form of micro-insurance, funded by a one percent mandatory contribution from the loan, as well as one percent of the MFI's gross income. These inputs fund a Beneficiary Welfare Program (BWP), which is utilized to write off loans following death, serious illness or crop failure. Small grants may also be made from the fund in cases of need. In part because of this insurance, and in part due to the group responsibility system utilized for lending, recorded repayment rates on PACT microfinance loans are close to 99 percent. Overall, PACT reports an Operational Self Sufficiency (OSS) of 200 percent, indicating that its activities are fully financially sustainable[15].

Not all of PACT's activities are in microfinance lending or agriculture, however. Under the WORTH program, focusing on the empowerment of women and using a methodology originally developed by PACT in Nepal, technical and organizational support is given to women in a variety of areas including literacy and nutrition. As part of their activities, participants are encouraged to establish savings groups and use the funds to finance small loans among group members (typically 25 persons per group). The duration and interest rates charged members is determined by the group. Typical group loans have been for non-agricultural activities such as establishing small grocery shops and making and selling clothing. All savings are kept by the women's group unless large amounts accumulate, at which time they are encouraged to open bank accounts.

Maternal and Child Health and Health Education (MCHHE) groups are also supported, with an emphasis on nutrition, sanitation and water. MCHHE groups are also encouraged to establish a Health Development Fund financed by group member savings. This fund assists members who face medical costs (transport to hospital, medicines etc.). For both WORTH and MCHHE groups, PACT staff are supplemented by village-level volunteers.

Other NGOs

In addition to the activities undertaken by UNDP and PACT, a number of other, smaller NGOs are active in the rural finance field in Myanmar. The most important of these are described briefly below but others, such as the Myanmar Ceramic Society, are also active in minor roles:

(i) **Proximity**, a USA based NGO focusing on production and water technologies cumulatively serving approximately 100,000 rural households since 2004. Loan provision commenced in 2009 to allow participants to purchase Proximity irrigation products and technologies, as well as other production inputs (43,000 loans as of September 2012), and for smallholder rice producers requiring inputs and paid labor (16,000 borrowers). Proximity uses a network of local agents to supply its products and operates eight credit offices, some within the Dry Zone;

[15] Duflos, 2013. Op cit. Page 35

(ii) **Save the Children**, an international NGO, which supports the Dawn microfinance program in Myanmar referred to above. However, most of its operations (savings mobilization and micro lending) occur in urban and peri-urban areas;

(iii) **World Vision**, also an international NGO, active in Myanmar since 1958. In 1998 it launched a micro lending program directed at agriculture and commerce utilizing the group lending approach which is widespread in the country. As of late 2012 it operated 4 branches, but was only active in one region of relevance to the current project, Mandalay. Importantly, however, it has implemented in Myanmar a loan management information system for microcredit which provides more secure reporting and improved analysis of client data;

(iv) **GRET** has been active in Myanmar since 1995 but does not have any operations in the DZ. Unusually within the Myanmar context, in 2008 it pioneered an individual loan approach. GRET's license under the 2011 Microfinance Act is as a non-deposit taking MFI;

(v) **Central Cooperative Society**. The CCS acts as an apex organization for almost 23,000 primary cooperative societies, encompassing four percent of the national population, of which just over 7,000 were primarily involved in agricultural production and more than 9,000 in microfinance[16]. Although many of the microfinance cooperatives are active only in urban areas, cooperatives with financial operations are reported within 4 of the six target townships. Following the enactment of the Microfinance Law in 2011, CCS registered itself as an MFI[17].

Private Banks

Although two private banks (Yoma Bank and Kanbawza bank) did commence microfinance operations in association with the UNDP HDI program prior to the liberalization, they were instructed to cease by the Myanmar Central Bank after a single lending cycle, although the reasons for this are unknown[18]. Private bank involvement in microfinance since liberalization in 2011 has been limited, primarily due to restrictions on interest rates which, combined with relatively high transaction costs for microfinance, have made it generally uneconomic for banks to intervene directly. However, private banks do play an important indirect role. Firstly, many finance agricultural trading companies which may, in turn provide finance to input and equipment purchasers, although this did not appear to be a significant source of financing in the target communities within the DZ. Secondly, the second largest bank in Myanmar, the Myanmar Cooperative Bank, provide significant levels of funding to member cooperative associations through the Central Cooperative Society (CCS).

16 Ibid. Page 15.
17 *Consultancy on Co-operative Systems in Myanmar*. Jo-Anne Ferguson. LIFT, May 2013. Page 12.
18 *Agricultural Sector Review and Investment Strategy*. Op cit. Volume 1, page 139.

Other Actors

In addition to the above, an estimated 60 specialized agriculture development companies were in operation in 2012 providing loans, primarily for rice production.

4. Status & Situation Analysis

According to a number of published studies, the overall availability of financing in Myanmar - particularly in rural areas - is very limited. The ratio of outstanding loans to GDP nationally has been estimated at only 4.7 percent, compared to 20.1 for Cambodia and 111.6 for Vietnam[19], yet even at these low levels the agricultural sector accounts for only 2.5 percent of all outstanding loans, despite generating 43 percent of GDP[20]. A widely quoted estimate from 2012 puts the unmet demand for microcredit in Myanmar at USD 1 billion[21], almost four times the estimated total loan portfolio in 2012, while the CGAP Microfinance Gateway reported in 2011 that only 10 percent of microfinance demand was being met[22].

Much of the deficit in formal financing availability is made up by borrowing from informal sources. The LIFT 2012 Baseline Survey[23], drawing on a sample of 662 households within the DZ, found that 83 percent of households had taken a loan over the last year (in line with the results of other agro-ecological regions included in the survey). The highest percentage of loans reported in the DZ were provided by money lenders (49 percent), with 47 percent reporting borrowing from family and friends, 36 percent from an MFI and 21 percent from a shopkeeper[24]. Loans from the government (primarily MADB) accounted for a further 19 percent of respondents. No other source of credit was utilized by more than five percent of DZ respondents.

Despite, or perhaps because of, the absence of formal credit sources, the LIFT survey found that debt within the DZ was increasing, with almost half of all respondents reporting that their level of debt had increased over the last year (only 31 percent reported that their debt had declined). This finding is confirmed by periodic Qualitative Social and Economic Monitoring (QSEM) field work undertaken with LIFT financing. The largest single use of credit – accounting for 44 percent of all loans – was for the purchase of food, which may well not be a discretionary expenditure. This suggests that income levels for many rural inhabitants are insufficient to meet both consumption needs, at least during some parts of the year, and debt repayment requirements. This appears to be the case despite widespread coping strategies such as decreasing both the amount and quality of food consumed during the most vulnerable part of the

[19] *Background Paper No.3: Rural Finance in Myanmar*. Renate-Kloeppinger-Todd and Tun Min Sandar. Michigan State University. June 2013. Quoting World Bank studies.
[20] Eric Duflos et al. 2013. Op cit. While there is no direct linkage between sector value added and borrowing needs, such a wide variation implies a shortfall in availability and/or utilization to producers.
[21] Ibid. p.iv
[22] http://www.microfinancegateway.org/p/site/m/template.rc/1.1.12098/
[23] *Baseline Survey Results – July 2012*. LIFT. Page 60.
[24] Multiple responses

year[25]. In addition, in the absence of sufficient formal credit, loans from money lenders and shopkeepers attracted high rates of interest. The survey reported that, even when borrowers were able to offer collateral (typically in the form of gold jewelry), interest rates were generally 5 percent per month. Without collateral, rates averaged from 10-20 percent per month. These rates contrast strongly with the highly concessional rates charged by the government-owned MADB (8.5 percent per annum), or the typical 2.5 percent per month rate charged by PACT.

However, one perceived disadvantage of formal credit identified by the LIFT survey was the relative inflexibility of loan durations. While money lenders and other informal sources were considered to be open ended and required only the interest to be paid, loans from PACT (as well as the MADB) were fixed term and, in some types of PACT loans, required payments every two weeks[26].

Despite a number of interventions over the last two decades to support the establishment and growth of village savings and loan associations, including through PACT, less than two percent of the LIFT survey respondents reported borrowing from this source. One concern is sustainability of village groups. The 2010 Independent Assessment Mission (IAM) report on UNDP HDI activities in Myanmar noted that "a very limited number of self-reliance groups (SRGs) will survive should the HDI exit from the village", suggesting that efforts placed in developing such groups has not be effective. The 2012 IAM report, however, questioned that finding and concluded that substantial improvements had been made, citing evaluations to show that between 38-46 percent of supported groups could now be considered self-reliant. These two statements do not necessarily contradict each other, however, as more than half of all groups are likely to fail to continue operations once support is withdrawn. This is below the rates achieved with the VSLA elsewhere and is not cost-effective.

It is worth noting that, with the exception of the PACT operated Beneficiary Welfare Program, which provides debt relief to borrowers in the case of serious illness, death or crop loss, no insurance or social protection schemes of any description are available for smallholder producers in Myanmar. As smallholders, who generally possess only very limited capital (chiefly in the form of livestock), are forced to adopt a very risk adverse approach to their production operations, this lack of risk coverage under most credit programmes places severe constraints on such activities as the purchase of inputs, the adoption of new varieties, the diversification of cropping patterns and the development of non-farm income generation, as these could result in unacceptable losses.

5. Key Constraints and Opportunities

A number of immediate and important **constraints** exist to the development of widely available and affordable rural financial services. These are described briefly below:

[25] See Annex 4: Community Development and Social Protection
[26] Baseline Survey Results – July 2012, p.67

- **Lack of sufficient capital to meet rural credit needs**. Data presented in this report indicates clearly that rural credit demand is much higher than supply and this was confirmed during field visits when the availability of financing was identified by community respondents as one of the most important issue facing villagers[27]. While MADB provides heavily subsidized financing to a large number of clients, the amount it can provide is limited by GOM budgetary allocations and loan amounts are insufficient to meet a significant portion of cash-based production costs. Furthermore, MADB finances only a very limited range of crops (e.g. not vegetables or fruit) and does not finance post-harvest and agro-enterprise related needs. NGO-sourced financing has grown rapidly in recent years, but is still far less than demand and is still restricted in its geographical coverage, even within the DZ which has been a primary target for many programs (UNDP, PACT, LIFT, etc.)
- **High interest rates for loans from informal sources**. In the absence of adequate volumes of credit, almost 60 percent (70 percent in the DZ) of all respondents to the LIFT Baseline Study undertaken in 2012 reported using credit provided by money lenders or shopkeepers. In such cases 5 percent per month is typically the lowest rate available and rates can reach as high as 20 percent/month. The impact of such interest rates is evident in another finding of the survey; that over 60 percent of respondents (46 percent for the DZ) had experienced increased levels of debt over the last 12 months.
- **High transaction costs for formal financing sources operating in rural areas**. Rural credit always suffers a disadvantage compared with urban operations as a result of the greater spacing and isolation of clients. This is exacerbated in Myanmar as a result of the poor state of many rural roads and the relative absence of cellphone technology. While cellphone use does appear to be expanding rapidly, and the government has recently licensed two international telecom providers to operate in the country[28], coverage is still limited and no action has yet commenced to develop a phone-based money transfer system such as is transforming the economies of a number of developing countries through its impact on transaction costs.
- **Limited development of sustainable community level savings and loan groups**. The history of community based groups in Myanmar over recent decades has not created a conducive attitude towards group formation of any type. During the period of military rule, close controls were imposed on the formation of community associations and those that were permitted were often obligatory. While this approach has changed in recent years, it has not disappeared; communities interviewed during the field portion of the Scoping Mission reported that they had received instructions to form a number of

[27] However, not all cash needs may be for productive purposes, given the heavy use of credit for food purchase detailed in the LIFT baseline survey.

[28] *Wall Street Journal report*. 30 January 2014. http://online.wsj.com/news/articles/SB10001424052702303743604579352310422552966

community groups for different purposes[29]. Partially as a result of this history, few communities visited within the DZ had strong mutual support groups, whether in agriculture, community development or marketing. Active savings and loan groups are present in only a few communities not participating in NGO programs, and generally have arisen from the efforts of a single individual. As a result, considerable efforts are required to nurture sustainable community-based groups, further increasing transaction costs for rural credit providers supporting their development.

- **Poorly developed regulatory and supervisory environment**. Although change has started to occur in the regulatory and supervisory environment for rural lending agencies, including crucially the passage of the microfinance law in 2011, the overall framework remains weak. Significant concerns continue to exist as to the capacity of the MSC to oversee sector institutions, while no credit bureau or microfinance apex association exists. Even the 2011 legislation is considered inappropriate in some respects, particularly its specification of minimum capital requirements and interest rates. At a more commercial level, the payment clearance system in Myanmar is still only partly developed.
- **Inflexible term and repayment conditions for some loans**. As has been observed in many developing countries, money lenders and similar sources of credit continue to be utilized even when far cheaper alternatives are available. One key reason for this is the flexibility, lack of formal procedures and collateral requirements, as well as speed of response of such informal sources (often present in the same community) when loans are requested. While most of the NGO-led programs reviewed in Myanmar have taken pains to permit loans for a range of purposes, such as medical emergencies and education (not always the case in many countries), the terms and conditions attached to their loans are sometimes considered restrictive. Increased documentation requirements are probably unavoidable, given the need for formal sources to maintain clear and accurate records, as well as to ensure that production and enterprise loans are provided only for activities which have a possibility of becoming profitable. However, the duration of many agricultural loans, in particular, requires repayment immediately after harvest and sometimes frequent periodic repayments are specified, even where no production income is available until the harvest.
- **Indebtedness of rural populations**. The high and increasing levels of indebtedness reported among target populations is troubling and must be viewed as an indication that some key aspects within the financial sector require revision. Nevertheless, three conclusions can be drawn from this: first, that savings mobilization is indispensable; secondly, that credit must not be expanded at all costs, especially in the case of very poor and vulnerable sections of society, and; thirdly, that efforts to expand credit provision

[29] Including, in all cases, volunteer fire brigades, although no participant in the meetings could explain what the duties of brigade members comprised.

should be paralleled by the promotion of social protection networks and systems to reduce the vulnerability of the poor.

Despite the many constraints on the existing supply of rural financial services, a number of important **opportunities** can also be identified:

- **Demand for credit and other financial services is high**. Although perhaps a truism, the development of an expanded rural financial services sector offers far more opportunity, and justification, when existing demand is high. Although published estimates of total unmet demand within the sector – from four to ten times current lending - may well be inaccurate, it is certainly apparent that there is a considerable unanswered need for expanded microfinance services. Even at current volumes of lending, and the relatively high interest rates currently typical within the formal sector (with the exception of MADB's subsidized loans), formal credit providers offer a major cost advantage to borrowers over the rates from informal sources, offering further opportunities.
- **Loan repayment rates are high**. Very few complaints are encountered in Myanmar from credit providers with respect to delayed or defaulted payments. Although it is unclear why such an attitude has developed among borrowers, most formal credit sources report repayment rates close to 100 percent, including the state-owned MADB. As a result, provisions for bad debt can be much lower in Myanmar than in many other countries, providing an opportunity for lowered operational costs. On the negative side, however, anecdotal evidence suggests that at least in some cases such high repayment rates result from borrowers turning to higher cost informal sources for funds to allow repayment, contributing to the increasing levels of indebtedness noted earlier[30].
- **Operational Self Sufficiency (OSS) appears achievable**. Internationally, many NGO credit providers struggle to achieve operational self-sufficiency, and thus long term sustainability. This was also the case in Myanmar during the majority of the period of the UNDP HDI credit program, when interest rates were constrained at unrealistic levels and is still the case for MADB which relies on heavily subsidized funds from GOM to continue in operation. However, current typical NGO lending rates of 2.5 percent per month, together with the low default rates indicated above, allow at least the larger and more establish lenders to cover all operational expenses with ease. Indeed, the 200 percent OSS ratio attributed to PACT suggests that, reinvestment for growth aside, there may well be opportunities for either reduced interest rates or the return of some portion of the repayments to community level savings and loan groups.
- **MFIs now have legal status**. Although, as indicated under constraints above, there continue to be significant weaknesses in the legislative and regulatory environment with respect to microfinance institutions, there is little doubt that the long awaited

[30] It should also be noted that in the absence of solid supervisory agency monitoring which enforces adequate repayment records, proper loan loss procedures and independent audits, the records of financial insitutions alone cannot always be relied on.

microfinance law of 2011 represents one of the most important opportunities in the sector in many years, leading to almost 190 organizations requesting and receiving legal approval (as of early 2014). Prior to the enactment of the legislation, NGOs operating in Myanmar had no legal status and had to operate under specific MOUs with GOM, rendering forward planning and institution building fraught with difficulties.

- **Changing political and macro-economic environment**. The dramatic political changes which have occurred in Myanmar in the last few years have raised the real possibility of renewed national economic growth as a result of new investment, reduced regulation of economic activity and the entry of international organizations (commercial, development and non-governmental), bringing with them new technologies and management practices. Given Myanmar's rich endowment of natural resources, such growth can be expected to offer new opportunities for the agricultural sector and a consequent increased demand for credit and savings services.
- **Experience gained in operation and management of microcredit programs**. Despite the difficulties faced by NGOs and others in working in Myanmar over the last 15-20 years, considerable experience has been gained through their operations as to the best practices in rural finance. Many of these organizations are international and bring with them also knowledge of the results of similar methodologies in other countries. Any expansion in rural financial services will not, therefore, have to commence from zero but can benefit from these experiences.
- **Creation of microfinance networks and support systems**. Although there is as yet no recognized apex organization or industry association focusing on microfinance in Myanmar, at least two organizations have been created to provide a shared platform for microfinance institutions and practitioners; the Microfinance Working Group (MWG) and the Myanmar Microfinance Network (MMN)[31]. These organizations offer a strong opportunity for further development of a practitioners' network which can eventually represent stakeholders in discussions with government and international agencies in determining appropriate policies and practices for microfinance in Myanmar. In addition, the introduction of World Vision's loan management information system offers smaller MFIs the possibility of adopting a tested and effective support system for their operations.

6. Development Objectives and Concepts

The **principal objective** of the rural finance component of the Dry Zone Development Project is to facilitate the welfare of target populations through the availability of sufficient appropriate financing for production and important household needs. To achieve this objective, the component would promote not only the availability of financial resources for production

[31] See *www.**myanmarmicrofinance**.org/*

purposes, but also savings mobilization, access to credit for investments, and the development of effective social protection networks to reduce the vulnerability of the poor.

To achieve the objective, three overriding concepts will guide investment related to microfinance services in the DZ. The **first concept** is that credit is a vital element in the overall smallholder production process. The need to improve access to, and reduce the costs of, credit is paramount. Achieving such access would be anticipated to: (a) significantly increase productivity by permitting the expanded purchase of critical production inputs such as improved seed, fertilizer, agrochemicals and, to a much lesser extent, labor, and; (b) reduce the rising levels of indebtedness which, it is argued, result from the present heavy dependence on high cost informal sources of credit and insufficient savings and reserves.

The **second concept** is that, for credit to be useful, smallholder producers must have access to appropriate inputs and technical assistance which can ensure that the required productivity increases can be achieved. Financial resources are only one of the key inputs to the production process, whether for agriculture, agroindustry or small enterprises, and cannot, in themselves, guarantee such productivity. There is thus a clear need for credit provision to be more closely linked to other production aspects than has often been the case in the past. Such linkage is further described below, and serves the dual purpose of improving the probability of increased incomes and protecting the poor and vulnerable from investing in activities with high risk levels.

The **third concept** is that, given the high transaction costs in rural areas for both MFIs and borrowers, the development of sustainable community level funding mechanisms – covering both savings and loans - is the most cost effective mechanism for dealing with the need for credit for such important, but minor, expenditures such as food purchases, education and medical emergencies, and provides the least cost mechanism for mobilizing savings. The larger sums required for production operations should remain with the MFIs for the foreseeable future but it may well be the case that some portion of the net income derived from such lending operations can be returned to these community level organizations – perhaps on a matching grant basis – to support their development.

It is worth noting that some form of loan insurance system, similar to that developed by PACT under its Beneficiary Welfare Program (BWP), is seen as vital to ensure that personal and natural disasters do not leave vulnerable families deeper in debt and force the sale of their livestock (frequently the only assets they may possess) or the termination of the education of their children, and would ensure that community level savings and loan associations are not overwhelmed by major disasters within the community.

7. Proposed Principal Activities

As noted in the previous section, considerable experience already exists with respect to successful microfinance operations within Myanmar in general and the DZ in particular. The proposed activities under the rural finance component over a four year period would build on that experience, but test some modifications which may offer improvements to the current approaches. Among the key elements of many of these approaches which would be adopted under the proposed finance activities are the following:

- The use of a group lending methodology in which all members of the group guarantee the loans received by any member and no collateral is required for borrowing;
- The utilization of Village Development Committees[32] (VDCs) where feasible to monitor all groups within the community and whose executives can receive additional training and support;
- The provision of financial and business training by MFI field staff to all groups prior to their accessing loans and the continued monitoring of these groups by these staff, at least until the VICOs are considered sufficiently well established and competent;
- The requirement for compulsory savings as a condition of group membership combined with the opportunity for additional voluntary savings;
- The application of interest rates which will ensure the operational sustainability of the MFI over time. It is expected that, initially at least, loans would be provided by the MFI at the standard rate of 2.5 percent per month;
- The availability of loans for a range of purposes, not just productive activities, albeit with sufficient safeguards against over-borrowing, indebtedness and proper use.

Among the elements for which modifications would be tested under the project would be:

- The linkage of lending activities within the target communities to implementation activities of other programme components, including technical approval where appropriate from programme staff or the Village Development Committee;
- The adoption of more flexible durations for agricultural loans, in order to permit those producers who are financially able to do so to retain the crop after harvest and market the product during times of higher prices;
- The expansion of the role and training of the VDC to include the establishment of a community-based savings and loan association which would focus on the mobilization of savings and the provision of loans for non-productive purposes (medical, educational, food purchase etc.). While specialist thematic groups such as the Mother and Child Health groups would be expected to continue to function for training, technical assistance and activity planning purposes, they would no longer need to maintain their own savings and loan operations. If sufficient funds are accumulated within the community and there is demand, funds could also be utilized to finance the construction of community infrastructure for such purposes as crop storage and cattle penning and treatment;
- The expansion of micro-insurance coverage through the VICO to include all members of the community participating in microfinance activities, whether current borrowers or not (if the premium is paid). This would entail extending the compensation provided to

[32] See Annex 5 for a discussion of the role and activities of VDCs.

include a range of losses, rather than just the forgiveness of the loan. The primary objective of the fund would be to reduce the risks facing community members, thus both increasing general welfare and limiting the need for risk adverse strategies;

- Where financial conditions permit, the MFI would return a portion of the net income generated to the community savings and loan group, probably on a matching grant basis, to support its growth and development. The MFI would thus gradually withdraw from non-productive loans (where transaction costs are highest and timeliness of loan processing of greatest importance);
- Trials would also be undertaken of longer term loans of up to three years to finance the establishment of small enterprises, subject to an adequate feasibility assessment of the proposal using objective evaluation procedures such as the FAO-developed RuralInvest.

8. Implementation Modalities and Provisional Costs

The estimation of component costs is rendered difficult by the fact that the final decision with respect to the implementation modality to be adopted will not be taken until the Design mission later this year. Several implementation modalities have, however, been considered for the component. That covered in the costs estimates provided in Appendix 1 is based upon the staffing of a complete field presence, even though this approach is not considered the most probable, given the current operations of a number of MFIs within the Dry Zone. It does, however, provide an upper limit to the expected costs and where personnel and related costs are reduced, would permit further funds to be applied directly to lending operations.

A second modality would be to make a specific agreement with one of more microfinance providers in which the agreed upon services and conditions are explicitly laid out and payment is provided to cover the anticipated difference between costs and income during the programme. This would be expected to require lower costs than those laid out in the budget as the selected MFI would already be expected to possess a number of the staff and other assets required for operation within the zone.

A third possible modality would be to offer matching grants to cover a portion of the establishment or start-up costs for all MFIs willing to establish operations within the zone under a set of requirements established by the programme. This last modality, however, has both advantages and disadvantages. On the positive side, it would provide greater flexibility to the IPs to operate and manage services as they wish (within the parameters specified in the grant documents) and may provide, therefore, a greater opportunity of testing new ideas not considered in the initial design. On the negative side, however, such an approach would run the risk of duplication and overlap of services by different MFIs and would require careful monitoring, including the establishment of some form of loan registry in order to avoid borrowers taking multiple loans and thereby increasing their indebtedness or defaulting.

The provisional costs presented below are estimated based upon the establishment of a stand-alone financial services provider, and are broken down into various projected forms of credit line, including crop production loans (USD3.2 million), livestock purchase loans (USD 3 million), village enterprise loans (USD 245,000), and emergency loans (USD 73,440) as well as related training costs for community groups (USD 140,000). However, such allocations should be viewed as indicative and the M&E process within the programme will permit allocations to be adjusted, or even new categories to be introduced, according to demand. It should be noted that some grant funding is proposed for community thematic groups (e.g. livelihood protection, community health and education) under the Community Development and Social Protection activities. These are described in Annex 5.

Provision is made for personnel and operating costs for the component; all costs are paid for the first two years, one half of costs in the third year and none in the fourth year. The proposed staffing structure would include a Manager, an Accountant and an M&E officer in each Township, as well as six loan officers and a Small Enterprise Specialist. Allowance is also made for an Activity Manager, Assistant Manager, Accountant and M&E Supervisor who would be responsible for overseeing activities in all six Townships selected.

If the selected MFI to lead the component is already active within one of the target Townships, and hence has reduced start-up costs for the target communities, negotiations would be undertaken to either extend the amount of loan funds made available and/or increase the number of loan officers per Township.

The rural finance costs would also include resources to undertake studies on the feasibility of establishing financial linkages between MFIs and the formal banking system and how these might be best achieved, if considered useful in increasing the availability of loan funds to MFIs.

9. Associated Studies

The principal study recommended under **finance** is to assess the feasibility of linkages between MFIs and the commercial banking sector, particularly with respect to the provision of capital to expanding MFIs and the conditions under which such resources might be made available by commercial banks. Key aspects to consider would be the likely cost and duration of funds provided, the nature and extent of any guarantees which would be required by the banks, and the volume of funds which the banks may be prepared to make available. Other linkage aspects which might be considered would include: (a) the establishment of a national credit reporting bureau, in order to monitor borrowers and their repayment histories, and the benefits and costs of MFI participation in such an agency, and; (b) the potential for MFI commercial bank collaboration in developing a funds transfer system, as is used so successfully in East Africa and some other countries.

10. Outstanding Tasks for the Design Mission

Given that much of the Scoping Mission was spent visiting potential target communities within the six identified Township for further analysis, there remain a number of issues which must be addressed in considerably more detail during the design mission. These would focus on discussions with potential Implementing Partners (IPs) as to:

- The implementation modality to be selected for microfinance activities within the targeted communities;
- The cost structures of existing active MFIs, their required margins to meet operating costs and the level of subsidy requirements for initial operations costs;
- Recommended staffing requirements within each Township finance office;
- The procedures to be followed in developing matching grants to community based groups to support their development of community-based loan funds;
- A more detailed definition of study and research needs.

Appendix 1. Finance Activity Costs
Myanmar
Dry Zone Programme

	Unit	Quantities 2014	2015	2016	2017	Total	Unit Cost (US$)	Base Cost (US$) 2014	2015	2016	2017	Total
I. Investment Costs												
A. FINANCE												
1. Loans												
a. Crop Production Loans /a	loan/comty	144	96	-	-	240	13,325	1,918,800.0	1,279,200.0	-	-	3,198,000.0
b. Livestock Purchase Loans												
Cattle /b	loan/comty	144	96	-	-	240	10,152	1,461,888.0	974,592.0	-	-	2,436,480.0
Small Stock /c	loan/comty	144.96	-	-	-	144.96	3,280	475,468.8	-	-	-	475,468.8
Subtotal								3,856,156.8	2,253,792.0	-	-	6,109,948.8
c. Village Enterprise Loans												
Individual /d	loan/comty	144	96	-	-	240	510	73,440.0	48,960.0	-	-	122,400.0
Group /e	loan/comty	144	96	-	-	240	510	73,440.0	48,960.0	-	-	122,400.0
Subtotal								146,880.0	97,920.0	-	-	244,800.0
d. Emergency Loans /f	loan/comty	144	96	-	-	240	306	44,064.0	29,376.0	-	-	73,440.0
Subtotal								4,047,100.8	2,381,088.0	-	-	6,428,188.8
2. Market												
a. Training on market, credit and income generation /g												
Training (5 days) /h	training/person	225	450	225	225	1,125	125	28,125.0	56,250.0	28,125.0	28,125.0	140,625.0
3. Studies												
a. Feasibility of Establishing MFI/Commercial Bank linkages									90,000.0			
Total Investment Costs								4,075,225.8	2,527,338.0	28,125.0	28,125.0	6,568,813.8
II. Recurrent Costs												
A. Activity Management & Operation												
1. Annual Personnel Costs												
Finance Activity Manager	pers/yr	12	12	6		30	1,020	12,240.0	12,240.0	6,120.0		30,600.0
Finance Activity Assistant Manager	pers/yr	12	12	6		30	816	9,792.0	9,792.0	4,896.0		24,480.0
Finance Activity Accountant	pers/yr	12	12	6		30	816	9,792.0	9,792.0	4,896.0		24,480.0
Finance Activity M&E Manager	pers/yr	12	12	6		30	766	9,192.0	9,192.0	4,596.0		22,980.0
Support Saff (secretary, guard, etc) - 3	pers/yr	36	36	18		90	178	6,408.0	6,408.0	3,204.0		16,020.0
Township Manager (6)	pers/yr	72	72	36		180	460	33,120.0	33,120.0	16,560.0		82,800.0
Township Bookkeeper (6)	pers/yr	72	72	36		180	357	25,704.0	25,704.0	12,852.0		64,260.0
Township M&E Officer (6)	pers/yr	72	72	36		180	280	20,160.0	20,160.0	10,080.0		50,400.0
Loan Officer (36)	pers/yr	432	432	216		1,080	255	110,160.0	110,160.0	55,080.0		275,400.0
Small Enterprise Expert (6)	pers/yr	72	72	36		180	255	18,360.0	18,360.0	9,180.0		45,900.0
Support Staff (secretary, guard, etc.) (18)	pers/yr	216	216	108		540	153	33,048.0	33,048.0	16,524.0		82,620.0
Subtotal								287,976.0	287,976.0	143,988.0		719,940.0
2. Annual Operating Costs												
Activity Office Operations	Office/year							10,200.0	10,200.0	5,100.0		25,500.0
Activity Office Equipment	Office/year							3,061.0	3,061.0	1,530.5		7,652.5
Vehicles - 4WD	No.	2	-	-	-	2	15,306	30,612.0	-	-		30,612.0
Vehicles - Twincab Pickup	No.	6	-	-	-	6	11,224	67,344.0	-	-		67,344.0
Township Office Operations /i	Office/year							7,653.0	7,653.0	3,826.5		19,132.5
Staff training	Office/year	6	6	3		15	4,081	24,486.0	24,486.0	12,243.0	-	61,215.0
Community Training	Office/year	6	6	6	6	24	3,061	18,366.0	18,366.0	18,366.0	18,366.0	73,464.0
Equipment (computers, telephones, copiers etc.)	Office/year	6	6	3		15	2,551	15,306.0	15,306.0	7,653.0	-	38,265.0
Subtotal								177,028.0	79,072.0	48,719.0	18,366.0	323,185.0
Total Recurrent Costs								465,004.0	367,048.0	192,707.0	18,366.0	1,043,125.0
Total								4,540,229.8	2,894,386.0	220,832.0	46,491.0	7,611,938.8

\a MMK75,000 per acre - 175 acres/ community - 40 communities/township.
\b MMK500,000 per unit - 20 unit/community - 40 communities/township
\c MMK40,000 per unit - 80 unit /community - 40 communities/ township
\d MMK100,000 per individual - 5 individual/community - 40 communities/township
\e MMK250,000 per group - 2 groups/community - 40 communities/township
\f MMK100,000 per loan - 3 loans/community - 40 communities/township
\g OISCA Agricultural and Forestry Training Centre in Yesagyo. It includes accommodation (USD10), tuition fee (USD10) and transportation and compensation for missed work day (USD5).
\h 5 trainees per village.
\i Mileage allowance, electric, telephone, etc.

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