

**TECHNICAL REVIEW MISSION
GOL/UNDP/UNCDF
(LAO/96/020;LAO/96/C01)**

"Microfinance & Sustainable Livelihood in Lao PDR"

**Henri Dommel
Peter Kooi
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1. Executive Summary

1. The project LAO/96/C01 - LAO/96/020 "Microfinance & Sustainable Livelihood (hereinafter called "the Project") was designed to enhance the national capacity in Laos to provide sustainable access to financial services for the lowest segments of the market. In 1997, the Project started in an environment in which microfinance was a relatively unknown concept.

2. The prime objective of the project document is to support sustainable microfinance in Laos and to assist in shaping an environment that is conducive to its development. The purpose of the Technical Review Mission is to analyze the present status of the project and the initial experience gained so far on the basis of which the mission will make recommendations for a future strategy in line with the prime objective of the Project.

3. At the national level the Project provided support to the establishment and strengthening of the Microfinance Task Force which has the mandate to supervise the development of a policy for microfinance conducive to an optimal development of microfinance in Lao PDR. The mission welcomes a gradual development of the national policy on microfinance to be developed by the Microfinance Task Force (MTF), based on the understanding of recognized sound practices. The mission recommends that for a proper development of such policy, a participative approach should be adopted whereby government staff, practitioners, specialized consultants, regulators and other key persons are involved to be able to provide input and comments during this process. The mission recommends the Task Force to review all regulation that could hamper the development of a diverse and vibrant microfinance industry. Attention needs to be paid to reforming regulations that make it difficult to practice various forms of microfinance. The mission views that once the microfinance industry matures in Laos, it should consider to transfer the policy mandate entirely to the Bank of Laos. The mission also recommends that the MTF continues promoting coordination among donors involved in microfinance. This coordination should focus on best practices and build on the experience gained internationally and nationally

4. The Project supported the establishment and strengthening of a Micro Finance Training Center which provides training to government, donor representatives and practitioners in the field of microfinance. The mission recommends that the Microfinance Training Center (MTC) continues to develop courses relevant for the microfinance sector and with a focus on disseminating "best practices in microfinance". The mission, therefore, recommends that the project continues to support the MTC within the present budget for the remaining of the project period. In order for the MTC to operate efficiently, the mission recommends that the MTC is enabled to provide its training courses as planned and that cancellation or postponement of training courses is avoided. It is envisaged that, at a certain point in time, MFIs which aim for sustainability will start providing in-house training. The MTC should therefore take into account that, in future, the demand from microfinance institutions and policy makers for their training courses might decline. In line with the objective to aim for cost recovery the mission recommends that the MTC is allowed to conduct their courses, on a fee basis, also for interested individuals or organizations which are not directly related to microfinance. Such

activities would broaden its future income base which is necessary to reach full cost recovery

5. Finally, the Project supported the Government and the Bank of Lao PDR with respect to the initial stages of shaping of a regulatory environment for microfinance. Further to the decision of the previous Tripartite meeting to postpone the development of the regulation agenda, a workshop was organized with the Bank of Laos. During this workshop, general issues on microfinance regulations and a specific case study on the evolution of the drafting of MFI regulations in Cambodia, were reviewed. The presentations highlighted the need to develop a regulatory framework, only once there is a critical mass of microfinance institutions that have reached a certain scale of activities and are considering to start mobilizing deposits from the public.

6. At the provincial level the Project supported the establishment of five Accredited Agents, the establishment of two replications of Sipsacres and Sipsacres itself. The Accredited Agents are in an early phase of operations and have already demonstrated that, on a small scale and with support from the Project and supporting organizations, they possess the operational capacity to manage disbursements of loans and collection of savings in an accountable manner. In the first year of operations the Project has therefore established a very first basis for the provision of microfinance to meet the demand for this service at the lower segments of the market. Preliminary experience has shown that it proved possible to construct financial products at market rates for which there is demand. Across the board the Accredited Agents and Sipsacres in Vientiane reported high repayment rates (the portfolio at risk of loans past due more than one 15 days is 0.56.%). Moreover the project has shown that great efforts have taken place to sensitize the environment of the distinctive characteristics of microfinance.

7. The mission observed that the operational ratios as reported by the Accredited Agents and Sipsacres are overstated because they do not take into account all recurrent cost related to operations and governance which are common to microfinance institutions. The mission views that without substantial consolidation and rationalization of operations the Accredited Agents and Sipsacres Vientiane will not become fully self financing and will not reach significant outreach.

8. In addition, the mission observed that fundamentals of institutional capacity like governance, leadership, strategic management, financial management, internal control, audit, MIS development, human resource management, public relations, operations control, product development etc., as typically provided by a mature microfinance institution's management structure, is lacking. This might be acceptable in the very early stages of the Project but this needs considerable change in order to build a sustainable microfinance institution.

9. Nevertheless, the mission views that at the national level and provincial level the Government of Laos shows strong commitment to create an optimal enabling environment to fuel the growth of a very nascent microfinance industry. Moreover, the Project has demonstrated to be able to establish, in a short period, promising entities which could become a vital part of a emerging microfinance industry, provided they pursue a vigorous strategy which leads to sustainability of their operations.

10. The mission expects that, on the basis of the project's activities, a solid foundation could be build for the provision of sustainable microfinance with prospective high outreach at later stages. Therefore, the mission recommends UNCDF and UNDP, as pioneers in microfinance in Lao PDR, to continue its support to strengthen microfinance in Lao PDR through the Project, provided that the Project adopts the following strategy:

1. To dramatically increasing the financial sufficiency and outreach of the supported entities through a process of consolidation and rationalization;
2. To establish a National MFI with a Supervisory Committee, a Head Office and a branch network, composed of presently supported entities.
3. To expand the branch network with two additional provincial branches in order to reach a minimum critical base for managerial, technical and financial sustainability.

11. It is envisaged that in due course the Head Office will take over the responsibilities of the Technical Assistance presently provided by the Project in the provinces. It is also foreseen that, in time, the project support tasks of the Provincial Project Management Offices will be transferred to the Head Office of the National MFI, while its other facilitating tasks will be gradually absorbed by Provincial Government as integrated part of their duties.

12. The mission learned that representatives from the Government, technical assistance providers and staff from the Accredited Agents welcomed the main points of this proposed strategy and that the combined objective of sustainability and outreach was fully supported. The mission views that, with support of the Government of Lao PDR, a proper implementation of this strategy could result in the first premier National MFI in Lao PDR. The mission acknowledges that a resurge in inflation to extreme levels could undermine the self-financing capacity of the national MFI. The mission views such a resurge as a calculated risk inherent to investing in Lao PDR. However, the mission notes that the Government is determined to bring down inflation and has successfully managed a sharp decline in inflation over the past few months. Therefore, the mission recommends that, as early as possible, a comprehensive feasibility study be conducted to validate the consensus on this strategy, to draft agreements required to implement this strategy, and to prepare a detailed business plan for the National MFI.

2. Context

13. The Project LAO/96/C01-LAO/96/020 "Microfinance and Sustainable Livelihood in LAO PDR was designed to enhance the national capacity in Laos to provide sustainable access to financial services for the lowest segments of the market. The executing agency is the Ministry of Finance of Lao PDR. The total budget amounts to US\$ 6,935,085 (Government: US\$ 150,000; UNCDF: US\$ 5,395,485; UNDP: US\$ 1,389,600, to which should be added the recent contribution from the "Agence Internationale de la Francophonie (AIF) for US\$ 360,000. The project duration is five years. The Project operates in the provinces Vientiane, Oudomxay, Sayaboury. The Project is under the supervision of the National Project Director from the Ministry of Finance. It is managed by the Central Project Manager and has Provincial Project Management Offices based in Sayaboury and Oudomxay.

14. The prime objective of the Project is to support sustainable microfinance in Laos and to assist in the shaping of an environment that is conducive to its development. International experience has shown that large and sustainable microfinance institutions have the potential to continue expansion by attracting large amounts of unsubsidized additional funding which permits massive provision of financial services to the lower segments of the market.

15. The Project's objective consists of a national component and a provincial component. The national component is designed to create optimal conditions for the development of microfinance in Lao PDR. Elements of this component are: establishment of a Government Microfinance Task Force which supervises the development of a policy for microfinance conducive to an optimal development of microfinance in Lao PDR; support to the bank of Lao PDR in the development of a regulatory environment for microfinance; establishment of a training center to provide training to microfinance institutions and which disseminate information on best practices in microfinance.

16. The provincial component is designed to provide technical assistance to microfinance institutions. The Project contracted PACT to provide technical assistance to the establishment of five Accredited Agents in the provinces Oudomxay and Sayaboury and to build their capacity to provide microfinance services. PACT Lao also delivered support to Sipsacres in Vientiane and its replications in Oudomxay and Sayaboury.

17. In 1998, the Project started in an environment in which microfinance was largely unknown concept. Pioneering microfinance is a very complex exercise because clients and local authorities are often not aware of the essence of microfinance. Products and markets need to be developed from scratch. Intensive staff training needs to take place because experienced local microfinance practitioners are simply not available. The project document took this particular situation into account by allowing for a broad range of possible interventions at national and provincial level. The project document permitted a flexible design and large budget, providing the necessary substance to define a more focused strategy at later stage, once initial experience had been obtained.

18. A first technical review mission took place in December 1998. The decision was taken to cancel the “basic needs” component since this was not related to fostering sustainable microfinance. Similarly, the decision was taken to postpone the implementation of a “micro-enterprise” sub-component in light of the lessons UNCDF had learnt from similar approaches in the context of some of its other projects. During the tripartite review in December 1998 it was decided to postpone the drafting of bank regulations for microfinance as it was perceived as premature, given the limited existence of microfinance activities in Lao PDR.

19. PACT completed its training programme for the five entities in April 99. These entities started operations in August 1999, under difficult macro-economic circumstances (the inflation rate topped at 140% in that period). Since August 1999, the 12 month-based inflation rate gradually decreased to less than 70% in February 2000.

20. The purpose of the Technical Review Mission is to analyze the present status of the Project, both at the national and provincial level, and to review the overall strategy of the project. On the basis of its findings the mission will make recommendations in line with the prime objective of the Project.

3. The operations of the supported MFI's

21. In April 1999, the Project and UNCDF approved three year proposals prepared by five Accredited Agents (AA's) in the provinces Oudomxay and Sayaboury. These five AA's are: LWU Oudomxay, LWU Sayaboury, APB Oudomxay, APB Sayaboury and Save the Children Australia in Sayaboury. The proposals included a mission statement, an organization structure and staffing, a description of the products envisaged, targets and a three year workplan including a budget and financial projections .

22. Upon approval, a one year Memorandum of Agreement with each Accredited Agent was signed by the Project, UNCDF and the Accredited Agent. The Memorandum of Agreement stipulates the responsibilities, budget and the ownership of capital and equipment. The staff of these Accredited Agents were trained and supported by PACT in credit and savings methodology, financial and operational analysis, accounting and basic management, planning and budgeting, from November 1998 till February 1999. In June the Accredited Agents established their offices and made the necessary preparations for the delivery of financial services.

23. The Project also supported the cooperative Sipsacres in Vientianne, which started its operations in 1995 With support of the Project Sipsacres started two replications, one in Oudomxay called Xaysac and one in Sayaboury called Sayasac. Sipsacres' staff received training from PACT in accounting and management information systems in September 1999.

3.1 The Accredited Agents

24. The Accredited Agents are in an early phase of operations and have already demonstrated that, on a small scale and with support from the Project and supporting organizations, they possess the operational capacity to manage disbursements of loans and collection of savings in an accountable manner. The repayment rates on the first

loans disbursed are almost 100% (Portfolio At Risk of loans past due more than one 15 days is 0.56%).

25. A proper governance structure provides for oversight which serves as a check and balance to safeguard that the management will operate in the best interest of an institution. The mission noted that fundamentals of institutional capacity like leadership, strategic management, financial management, internal control, audit, MIS development, human resource management, public relations, operations control, product development etc., as typically provided by a microfinance management structure, is lacking. Aspects of these fundamentals were provided by different supporting bodies (PPMO, LWU, APB, the TAs and PACT) in an often ad hoc and uncoordinated manner.

26. The underlying reason is that the design of the roles and responsibilities of the supporting bodies were not defined in fully transparent, consistent and comprehensive way to allow for a successful institutional capacity building exercise. This has created a confusing situation from a managerial point of view, whereby it was unclear who was or will be responsible for what. The mission concludes that the present set-up might be acceptable in the start-up phase of a Project but is not designed to allow for effective and efficient institution building. In order to reach the longer term goal of sustainability it is imperative that, in due course, an appropriate and transparent governance structure is put in place, which governs the supported entities in line with generally accepted good management practices for microfinance institutions.

27. Each Accredited Agent is staffed with a manager, an accountant and two to four savings and credit workers. The Accredited Agent's staff appears to be well trained and supported by Pact and the project TA. The staff demonstrates motivation and commitment to focus on a clear strategy which will eventually lead to the provision of microfinance services in a unsubsidized and fully sustainable manner. The mission noted with concern that some staff members are not positioned to be full time on the job due to requirements of "mother organizations" like LWU and the APB. The mission urges that selected Accredited Agent's staff should be fully dedicated to work with the Accredited Agents. The mission also noted with concern that the Accredited Agents do not employ a cashier. It appears that cash collections and disbursements are the tasks of the Credit and Savings Workers implemented during the meetings at the client level. This practice contains considerable security and operations risks. The security risks are heightened through the methodology to have noticeable meetings taking place at regular intervals.

28. On 1 February, the Accredited Agents were operational in 35 villages and provided services to 208 groups with a total of 1227 members. During the first six months of operations between 1 August 1999 till 31 January 2000, the five Accredited Agents disbursed a total of 652 loans with a total value of 150,200,000 kips (US\$ 20,000), resulting in an average loan size of US\$ 30, for the first six month cycle. A consolidated balance sheet, derived from the individual balance sheets of the five Accredited Agents shows that per 1 February a total of 92,575,550 Kip was outstanding while the total savings outstanding amount to 21.462,800 Kip of which 96% is compulsory. Per 1 February the average loan outstanding per AA staff member was 3,192,260 Kip (US\$ 425).

29. The balance sheet shows that the total amount of loan outstanding is only 28,57 % of the total assets mainly because almost 70% is hold in cash or in bank deposits.

Although at this early phase of operations no immediate conclusions can be drawn it should be taken into account that the Accredited Agents strive to a loan asset to total asset ratio higher than 80 percent. The ratio fixed assets to total assets is extremely low, especially taking into consideration that this is a start-up phase, which is due to the situation that the fixed assets required for the operations are in possession and use by the supporting organizations.

30. It is commendable that the Accredited Agents put the savings of clients on bank deposits and do not use these savings for on-lending. The compulsory savings methodology is only intended as an insurance to mitigate the risk of default. It would be irresponsible for these Accredited Agents to use those deposits for financial intermediation.

31. The mission recommends that the UNCDF donated loan fund capital shows the amount of the original US\$ value in Kip with a correction booking which accounts for the loss made due to the devaluation of the Kip to the US\$, especially since the ownership of the originally donated funds will only be determined at the end of the Project.

Balance sheet (January '00)	Total five AA's in Kip	Total five AA's in Kip	Total five AA's in US\$	Total five AA's in US\$	as %% of total assets
ASSETS					
Cash	7,470,942		996		2.31%
Bank	195,157,602		26,021		60.23%
Client savings	21,406,088		2,854		6.61%
Total cash/bank		224,034,632		29,871	69.15%
Loan outstanding	92,575,550		12,343		28.57%
Loan loss reserve	0		0		0.00%
Net loan outstanding		92,575,550		12,343	28.57%
Equipment	7,100,454		947		2.19%
Other assets	285,000		38		0.09%
Total fixed assets		7,385,454		985	2.28%
Total assets		323,995,636		43,199	100.00%
LIABILITIES					
Client savings	21,462,800		2,862		6.62%
Loan fund capital	332,007,776		44,268		102.47%
Retained earnings	-29,474,940		-3,930		-9.10%
Total Liabilities		323,995,636		43,199	100.00%

32. The present financial product provided involves a combination of mandatory savings and credit. The product is designed to target the lowest segments in the market. Wealth ranking exercises are conducted in the villages whereby the villagers classify themselves in different wealth categories. Clients which have been ranked within the lowest category with repayment capacity are eligible to apply for a loan. In order to qualify for a loan it is mandatory to deposit savings up to five percent of the requested loan amount. The savings should increase to ten percent of the loan size before the end of the loan period. The loan can only be obtained if all meetings, organized by the Accredited Agents are attended. Repayment of principle and interest is bi-weekly and collected during a meeting which all customers have to attend. The interest rate is 4%

flat per month. The loan period is six months. The interest given on deposits is 22% per year. Clients have to form groups of 5 to 10 members and elect a group leader. The individual loans carry a group guarantee.

33. Field officers and clients reported across the board that the number of clients would significantly increase in the served areas once some time consuming constraints built within the present product are lifted, while not endangering prompt repayment of these loans. It was also reported that many potential clients would require larger loans than presently provided by the Accredited Agents. Valuable suggestions were made to decrease the number of mandatory meetings; to allow repayments to be made by a group leader instead of each group member during collective meetings, to simplify the loan application process and reduce the number of forms to be filled (this would also bring down the costs of printing and photocopying which appears to be a major cost item). It was also reported by field officers and clients that there is a potential demand for higher loans by existing clients and non-clients.

34. Variations of the present product methodology are successfully implemented in areas with a high population density and strong demand. The strategy followed is to target a narrow segment of the market with a particular product and to expand this approach to other areas whereby sufficient clientbase is obtained to sustain operations. However, the population density in the provinces Oudomxay and Sayaboury is too low to be able to reach the necessary critical mass of clients. In light of this context the mission recommends that the Accredited Agents consider adopting a market penetration strategy in combination with product development strategy.

35. The market penetration strategy would focus on adapting the existing product to become more demand oriented by redefining some requirements which would bring down the transaction costs for the customers, while maintaining high repayment rates. To capture the demand for higher loans, additional products could be developed which allow for up-scaling. The introduction of such strategies assume that 1) sufficient capacity has been build, 2) sufficient knowledge of the market has been obtained and 3) (potential) clients have good understanding of the services provided by the Accredited Agents. If such strategies are adopted the mission estimates that, at present, the demand of a total potential client base, in Oudomxay and Sayaboury, amounts to an active loan outstanding of 8,000,000,000 Kip (US\$ 1,066,000). This estimation is based on the assumption that 35% of the 25,000 households living within an hour and half from the five Accredited Agents would be an active borrower.

36. The mission also recommends the Accredited Agents to study if the need for the present savings methodology, as an insurance to mitigate the risk of default, will remain justified after the start-up phase. The mission views the compulsory savings methodology is an expensive tool for both the microfinance institution and the customer. This tool leads to higher administrative costs for the microfinance institution, which will translate in a higher interest rate in order to increase the income to compensate for these additional costs. The customers will have higher transaction costs in terms of additional time lost. The customers most likely will suffer opportunity costs because this methodology makes it hard to have the right loan size in the right time. Finally, customers pay an higher effective interest rate on their loans with this methodology because they are forced to place deposits at a lower rate with the Accredited Agent than the rate they have to pay on their borrowings to the Accredited Agent. Therefore, it is very questionable if customers are satisfied with this forced savings methodology given

the costs they will have to pay for it. Moreover, it is questionable if savings in monetary form should be encouraged or forced in high inflationary circumstances. In this respect, the mission would like to note that, in general, it has been demonstrated that poor people highly value access to savings services with positive returns provided such services are offered by professional, profitable and regulated financial institutions.

37. With respect to the financial performance the Accredited Agents reported a financial income of 20,868,090 Kip (US\$ 2,782) during the first 6 months while incurring an amount of 119,637,802 Kip (US\$ 15,952) in operational costs during the same period. During the last month the Accredited Agents reported an overall operational self-sufficiency of 43%. It should be noted however, that these financial reports only take into account the actual running expenses made by the Accredited Agents. They do not include depreciation of equipment, the usual management and support costs normally born by a Head Office of a microfinance institution as explained above like costs of training, supervision, audit etc. At present these costs are mostly accounted for by the supporting organizations. The financial statements do not include provisioning and imputed costs of capital.

Income and Expense Account (1 August '99 - 31 January '00)	Total five AA's in Kip	Total five AA's in Kip	Total five AA's in US\$	Total five AA's in US\$	As % of admin. cost	As % of 50% * Loan O/S end of period
Financial Income						
Interest on loans	18,928,534		2,524			40.89%
Fees	1,814,000		242			3.92%
Bank interest	125,556		17			0.27%
Total financial income		20,868,090		2,782		45.08%
Total financial costs		950		0		0.00%
Net financial margin		20,867,140		2,782		45.08%
Administrative costs						
Training	0		0		0.00%	0.00%
Electricity/water supply	900,090		120		0.75%	1.94%
Salaries and benefits	56,095,147		7,479		46.89%	121.19%
Office supplies	13,876,650		1,850		11.60%	29.98%
Rent	4,270,000		569		3.57%	9.22%
Depreciation	0		0		0.00%	0.00%
Communications	462,020		62		0.39%	1.00%
Printing + photocopy	31,622,900		4,216		26.43%	68.32%
Maintenance	835,500		111		0.70%	1.81%
Fees	31,100		4		0.03%	0.07%
Bank charges	110,680		15		0.09%	0.24%
Travel	8,118,100		1,082		6.79%	17.54%
Petrol	3,315,615		442		2.77%	7.16%
Total expenditure		119,637,802		15,952	100.00%	258.47%
Net income		-98,770,662		-13,169		
Grants	65,471,644		8,730			
Translation loss	3,824,078		510			

Total subsidy and translation		69,295,722		9,239		
Net income after grants		-29,474,940		-3,930		

With respect to depreciation of equipment it should be noted that projections made should take into account that the Accredited Agents will evolve into a fully fledged semi-autonomous branches. At present the Accredited Agents only possess desks, chairs and cabinets while equipment as computers, generators, photocopiers, telephone, motorcycles and cars are placed at the supporting organizations. Of course, it is expected that once the supporting organizations have fulfilled their support role, the equipment base of the Accredited Agents will have to be expanded to ensure good performance.

38. It should also be noted that the salaries of the Accredited Agents seem quite low compared to PACT staff. For instance, a PACT assistant accountant earns almost four times the salary of an Accredited Agents accountant and more than three times the salary of a manager. A PACT senior trainer earns twelve times the salary of a Savings and Credit Worker and more than eight times the salary of an Accredited Agent's manager. It is very questionable if the present comparatively low salaries offered by the Accredited Agents can be maintained once the total volume of the portfolio starts to increase to a substantial level and hence, the increasing responsibility and skill base of the staff managing this portfolio.

39. With respect to the pricing of loans, it appears that most villages have a money lender providing loans charging a rate ranging from 15 to 30% flat. Family based money lending is common. Rates are reported to vary but to range from 0 to 30% flat. These rates are well beyond the rate charged by the Accredited Agents which allows for room to raise interest rates if such is required to become fully sustainable. Given the above mentioned observations, the mission views that the recent decision to bring down the interest rate from 6% to 4% flat was questionable. Interest rates should be calculated on the basis of steady state financial projections which include all costs incurred by an MFI on a fully unsubsidized basis.

40. The present management information systems are adequate given the level of operations. The accounting and reporting systems are inspired by the examples provided by the CGAP Handbook for Management Information Systems, and adapted to the requirements of a start-up operation. The systems are manual and spreadsheet based. The present MIS system produces balance sheets, profit and loss accounts, aging reports, clients accounts and subsidiary ledgers.

3.2 Sipsacres and its replications.

41. From September 1995 till October 1997, Sipsacres functioned as a savings and credit scheme under the Sihom Rehabilitation Project. SIPSACRES operates since October 1997 under the Microfinance and Sustainable Livelihoods Project.

42. Sipsacres is governed by an Executive Committee which is composed of two representatives of the villages in which Sipsacres provides its financial services. In general one representative is the Village Chief while the other is a representative selected by the Village Chief. The Sipsacres Chief is also a member of the Executive

Committee. Elected members of the Executive Committee have a term of office of two years. Elections take place every two years. Executive Committee members do not receive any remuneration. At present the Executive Committee has 56 members. Sipsacres is based on the principles of a credit union whereby its elected members participate in the running operations. The members of the Executive Committee are all volunteers. The members of Sipsacres are, however, not the shareholders of Sipsacres, which makes the ownership of Sipsacres unclear.

43. In Vientiane, Sipsacres is staffed with a six paid staff members: a Chief, one accountant and four field accountants. The field accountants function as credit/savings officer. The paid staff is mainly responsible for the operations and financial management and administration of the funds. Sipsacres in Vientiane has made considerable improvements during the past year especially with regard to its accounting and MIS systems, as a result of PACT training. The staff of Executive Committee and the staff of Sipsacres have demonstrated to possess the operational capacity to manage and process loans and savings in an accountable manner. The repayment rates on the first loans disbursed is reported to be 100%.

44. Although Sipsacres does have some form of management structure, the arrangement is weak due to an ever expanding Executive Committee of members who work on a voluntary basis and are hardly in a position to guide the organization towards sustainable delivery of microfinance services. The structure shows weak check and balances by being member governed but not member owned. It is difficult to see how, under these circumstances effective leadership can develop. The mission has not become clear on the future direction of Sipsacres and understands that the strategic orientation and management structure of Sipsacres are, at present, under discussion. Important aspects of management like strategic planning, internal audit, financial management, product development, staff development are still an important function of the technical assistance provided to Sipsacres.

45. In order to qualify for loans a savings group has to be formed consisting of four to ten members. Sipsacres collects savings from members on a monthly fixed deposit days. If members of the savings group want a loan they fill in an application form which needs to be signed for approval by group leader, the Village and the Sipsacres Chief. The loan size requested can be up to twice the amount of the savings of the member. The members have a choice between repayment of principle in equal installments or as a balloon payment at the end of a six month loan period. Interest is paid on a monthly basis. The interest rate is 6% declining per month, although Sipsacres also offers a emergency loan with a rate of 4%. Sipsacres also offers a special loan for one month which does not carry group guarantee.

46. The savings of the members are considered collateral for the loan. Members can withdraw their savings if they do not have a loan outstanding with Sipsacres. The interest on savings is calculated at the end of the year and equals the net annual profit of Sipsacres divided by the total savings. This methodology could represent an incentive for the members to govern Sipsacres in such a way that the return on deposits would be positive in real terms. The mission noted however that interest on savings was paid to its members during 1999, while Sipsacres made a loss. It appears the present interest rate policy on savings is under review by the Executive Committee.

47. Sipsacres also offers a children's savings scheme product for girls and boys up to 18. The product carries the same rules as the savings products for adults with the exception that this product does not give the right to obtain a loan. Sipsacres studies plans to launch a new product called Sawatikaan, which would be designed to provide support to the family of deceased members.

Per 1 January 2000 Sipsacres worked in 28 villages and served 328 savings groups and a total of 1649 clients of which 573 borrowers. The total loan outstanding was 137,919,689 Kip (US\$ 18,400). The average loan outstanding per client is US\$ 32. The total savings outstanding is 109,788,699 Kip (US\$ 14,638). The total savings per member is US\$ 8.80. The average loan outstanding per staff members amounts to 22,986,615 Kip (US\$ 3,065).

Balance sheet (January '00)	Total in Kip	Total in Kip	Total in US\$	Total in US\$	as %% of
SIPSACRES					total assets
Assets					
Cash	0		0		0.00%
Bank	189,112,555		25,215		57.69%
Total cash/bank		189,112,555		25,215	57.69%
Loan outstanding	137,919,689		18,389		42.07%
Loan loss reserve					
Net loan outstanding		137,919,689		18,389	42.07%
Equipment	801,200		107		0.24%
Other assets					
Total fixed assets		801,200	0	107	0.24%
Total assets		327,833,444		43,711	100.00%
Liabilities					
Client savings	197,918,122		26,389		60.37%
Loan fund capital	123,259,100		16,435		37.60%
Remaining surplus/deficit	14,926,433		1,990		4.55%
Retained earnings	-8,270,211		-1,103		-2.52%
Total Liabilities		327,833,444		43,711	100.00%

48. The 1999 annual financial statement shows a total income of 69,296,888 KIP (US\$ 9,239) of which 74% from interest on loans and fees, while 26% was earned by interest on bank deposits. Based on a month end loan outstanding calculation over 1999 the effective interest yield 49.5%. Sipsacres paid a total of 12,197,599 Kip on savings (US\$ 1,626). The total administrative expenditure was 69,795,900 (US\$ 9306). The total loss made in 1999 was 12,696,611 Kip (US\$ 1,692). The mission has the same observations with respect to omission of some cost items as practices by the Accredited Agents. With respect to the administrative expenditure no cost was reported for rent, electricity, water, depreciation of equipment. Also, costs related to essential function like internal/external audit, internal control etc. were provided by the TA and are not included. The statements do not include imputed costs of capital.

Income and Expense Account 1999	Total in Kip	Total in Kip	Total in US\$	Total in US\$	As %% of admin cost	As %% of 60% * Loan O/S end period
SIPSACRES						
Financial Income						
Interest on loans	48,636,600		6,485			58.77%
Fees	2,383,700		318			2.88%
Bank interest	18,276,588		2,437			22.09%
Total financial income		69,296,888		9,240		83.74%
Interest paid on savings		12197599		1,626		14.74%
Net financial margin		57,099,289		7,613		69.00%
Administrative costs						
Training	256,500		34		0.37%	0.31%
Electricity/water supply	164,400		22		0.24%	0.20%
Salaries and benefits	42,160,200		5,621		60.40%	50.95%
Office supplies	2,796,100		373		4.01%	3.38%
Rent	0		0		0.00%	0.00%
Depreciation	0		0		0.00%	0.00%
Communications/postage	2,416,700		322		3.46%	2.92%
Printing+photocopy	17,151,100		2,287		24.57%	20.73%
Maintenance	2,727,100		364		3.91%	3.30%
Fees	0		0		0.00%	0.00%
Bank charges	0		0		0.00%	0.00%
Travel	0		0		0.00%	0.00%
Petrol	1,090,800		145		1.56%	1.32%
Indirect expense	1,033,000		138		1.48%	1.25%
Total expenditure		69,795,900		9,306	100.00%	84.34%
Net income		-12,696,611		-1,693		
Grants						
Translation loss						
Total subsidy and translation		4,426,400		590		
Net income after grants		-8,270,211		-1,103		

49. A one year pilot replication project of Sipsacres in both provinces Sayaboury and Oudomxay commenced at the end of 1998. A US\$ 25,000 UNCDF assistance grant

was made available for that purpose. This Fund has several purposes. The fund is used as a loan fund for all savings groups. The Fund also functions as a guarantee fund for bad loans. Interest on the remaining Fund in the savings Kip account is used to cover overhead and operational expenditure

50. The two Sipsacres replications in Oudomxay and Sayaboury have their own Executive Committee, composed according to the same methodology as Sipsacres in Vientiane. The replications are staffed with one manager and an accountant. The replications use the same product methodology as Sipsacres.

51. Per 1 January 2000 the replication worked in a total of 3 villages each providing financial services to 129 groups with 745 members. The total gross loan outstanding amounts to 14,833,800 Kip (US\$ 1,978) and total net savings of 39,504,200 Kip (US\$ 5,267). During the last six months of 1999 the replications reported a total income of 5,414,740 Kip (US\$ 722) and a total administrative expense of 7,247,700 Kip (US\$ 966).

52. Both replications experience some defaults and it is understood that the practice of rescheduling loans is regularly applied. Although working in the same areas as the Accredited Agents, the replications charge a lower effective interest rate. The management appears weak in the understanding of best practices and sustainability. The mission observed that these pilots do not meet the expectations which were driving this initiative. These replications showed weak management capacity, growing arrears, repeated rescheduling of loans in arrears and non-adherence to basic principles of financial management.

3.3 Prospects for the Accredited Agents' and Sipsacres' future

53. It should be emphasized that the main objective of the Project is to support the development of local capacity in microfinance on a national and institutional level. To maximize the economic and social impact of this large investment, the Project should optimally use its resources to strengthen the capacity of microfinance institutions for them to become fully sustainable and manage a massive outreach. At that stage a microfinance institution will be able to finance its further growth on an unsubsidized basis. The mission views that such focus will have the highest and most lasting economic and social impact.

54. In the first year of operations the Project has established a very first basis for the provision of microfinance to meet the demand for this service at the lower segments of the market. Preliminary experience has shown that it proved possible to construct financial products at market rates for which there is demand. Across the board the Accredited Agents and Sipsacres in Vientiane reported high repayment rates. Moreover the project has shown that great efforts have taken place to sensitize the environment of the distinctive characteristics of microfinance.

55. With respect to the replications of Sipsacres the mission has concern that these replications will prove to be unsustainable and in the worst case scenario could damage a healthy development of microfinance. The mission therefore recommends that any new lending be suspended by the replications and that they focus on recovery of loan arrears, until further notice.

56. The mission expects that, on the basis of the project's activities, a solid foundation can be build for the provision of sustainable microfinance with prospective high outreach at later stages, provided that some critical issues will be addressed. These issues represent (1) the establishment of a management structure proper for sustainable microfinance and (2) an increase in financial self-sufficiency.

3.3.1. Establishment of an MFI governance structure.

57. One of the most important issues to be addressed will be the institutionalization of the governance structure. At present, elements of the Accredited Agents governance are shared on a ad-hoc basis and in a non-institutionalized way by the supporting parties. This might be acceptable in the very early stages of the Project but this needs to change in order to build a sustainable microfinance institution. The mission views that the most appropriate way to address this issue, is to establish a Supervisory Committee and a Head Office at central level to provide proper governance to entities supported by the Project.

58. The mission views that establishing a Supervisory Committee and Head Office per province or per Accredited Agent is not a feasible option due to the relatively small scale of (projected) operations per province. The required overhead, to fulfill necessary head office functions like overall strategic management, financial management and control, audit, human resource management, public relations, operations control, product development etc. will prove too great of a burden for the Accredited Agents and Sipsacres to become financially sustainable. The mission therefore views that the Accredited Agents could only become sustainable as part of a larger MFI.

3.3.2 Increase in financial self sufficiency

59. As indicated the mission views that the operational ratios as reported by the Accredited Agents and Sipsacres are overstated because they do not take into account all recurrent costs of operations and governance which are common to microfinance institutions. The mission views that without substantial consolidation and rationalization of operations the Accredited Agents and Sipsacres will not become fully self financing and will not reach significant outreach. The mission views that the Accredited Agents and Sipsacres face the challenge to increase their administrative efficiency considerably in order to become independent of subsidies. However, the mission views that if appropriate strategies are adopted, the Accredited Agents and Sipsacres have the potential to become sustainable. To increase financial self-sufficiency and outreach the mission recommends the Accredited Agents to merge into provincial branches, to adopt a market penetration strategy, to up-scale, to rationalize their product methodologies and allow for a right pricing of products. (see Chapter 5: recommendations for more detail).

3.4 Provincial Project Management Office

60. The Provincial Project Management Office's (PPMO) main role is to support the Project at the provincial level under the supervision of the Central Project Manager. The main objective of the PPMO is monitor and support the Accredited Agents and the

Sipsacres replications. In that respect the PPMO fulfills a project support role and a facilitating role.

61. The PPMO's have been functional in their project support role by monitoring the project activities in the provinces and by regularly reporting to the Central Project Management and UNDP/UNCDF. The PPMO's have supported the Accredited Agents in complying with the procedures established by the Project and have provided support to monitoring visits requested by the Project. The PPMO's have facilitated the Accredited Agents to start providing microfinance services by liaising and coordinating with the local authorities to gain their support and to ensure their understanding of the Project and the nature of microfinance. The PPMO's have played an important role in this respect especially taking into consideration that microfinance is a relatively new phenomena in these provinces.

4. Operations at the national level

62. At the national level the Project provided support to the establishment and strengthening of the Microfinance Task Force which has the mandate to supervise the development of a policy for microfinance conducive to an optimal development of microfinance in Lao PDR. The project supported in the establishment and strengthening of a Micro Finance Training Center which provided training to government and donor representatives and practitioners in the field of microfinance. Finally, the project supported the Government and the Bank of Lao PDR with respect to the shaping of a regulatory environment for microfinance.

4.1 The Microfinance Taskforce

63. In August 1997, the prime Minister's Office approved the establishment of the Microfinance Task Force. At present, the Microfinance Task Force is composed of two representatives of the Bank of Lao PDR and one representative of the Ministry of Finance, the Committee for Investment and Cooperation, The Lao Women's Union, The Agricultural Promotion Bank, and the Ministry of Foreign Affairs and representatives from the Provincial Government, the Project and Sipsacres.

64. The Project has provided assistance during the preliminary phase of the establishment of a Microfinance Task Force. During the project period, members of the Microfinance Task Force have participated in a series of conferences, workshops and study tours. The Microfinance Task Force supports the development of a national policy on microfinance, helps strengthen coordination among donors in this area and supports dissemination of best practices in microfinance at the national and provincial level.

4.2 Microfinance Training Center

65. The Microfinance Training Center was officially inaugurated in June 1999 with the objective to enhance microfinance understanding and managerial skills of people involved in rural development and poverty reduction in Lao PDR by providing training on microfinance at a national level. The target participants are policy makers, field workers, practitioners, NGO's and project staff, bank staff and the Lao Women's Union staff.

66. The training team consists of two national trainers and an administrative assistant. In January 1999, the trainers were trained by the Credit and Development Forum (CDF) in collaboration with the Association of Social Advancement (ASA) from Bangladesh and by PACT-Lao PDR. The trainers received support and training from the UNCDF Microfinance Advisor and Coordinator. The Microfinance Training Center is managed by the Central Project Manager.

67. With support of CDF and ASA a curriculum was prepared which includes sessions on the concept and role of microfinance in poverty alleviation and sessions on key components of microfinance methodology and management as: group formation, savings management, portfolio management, accounting and record keeping, management information systems, sustainability and administrative efficiency.

68. The training center trained a total of 116 participants from March 1999 till November 1999 of which forty eight from Sipsacres, forty three staff members from NGO's and twenty five representatives from provincial government departments and from international organizations. The Microfinance Training Center charges a modest fee for the training and reported that it managed a cost recovery of 38% during its first year of operations.

69. The mission recommends that the Microfinance Training Center continues to develop courses relevant for the microfinance sector and with a focus on disseminating "best practices in microfinance". The mission recommends that the project continues to support the Microfinance Training Center within the present budget for the remaining of the project period. In order for the Microfinance Training Center to operate efficiently, the mission recommends that the Microfinance Training Center is enabled to provide its training courses as planned and that cancellation or postponement of training courses is avoided. It is envisaged that, at a certain point in time, MFIs which aim for sustainability will start providing in-house training. The Microfinance Training Center should therefore take into account that, in future, the demand from microfinance institutions and policy makers for their training courses might decline. In line with the objective to aim for cost recovery the mission recommends that the Microfinance Training Center is allowed to conduct their courses, on a fee basis, also for interested individuals or organizations which are not directly related to microfinance. Such activities would broaden its future income base which is necessary to reach full cost recovery.

4.3 Regulatory framework

70. During the Tripartite meeting of 11 December 1998 it was concluded that it was premature to start developing a regulatory framework for microfinance in Lao PDR and it was agreed to postpone this activity. During 1999 the Project held several meetings on the issue of regulations with the Bank of Lao PDR. The project provided several technical documents on prudential regulations to the Supervision Department of the Bank of Lao PDR to share the latest knowledge on the challenges face by other Central Banks in the development for an appropriate regulatory frame work for the microfinance industry.

71. A very first draft of regulations was prepared by the Bank of Lao PDR. The mission noted that this draft uses a very narrow and highly uncommon definition of

microfinance institutions. The definition excludes types of microfinance institutions which are regarded as highly successful in countries elsewhere, reaching hundred of thousands of clients. The definition includes "revolving funds" and informal mechanisms as "houays". This is highly uncommon. The drafted regulations contains articles which would make traditional practices of rotating savings and credit groups suddenly illegal. The mission views that if these regulations would be approved, the development of microfinance would be seriously damaged and the Bank of Lao PDR will be flooded with requests, statutes and reports, which, from a prudential point of view, does not seem the have a relevant purpose.

72. On 2 March 1990 a workshop was organized for the staff members of the Bank of Lao PDR and the MOF to share experience on general issues related to microfinance regulations, while a specific case study on the evolution of the drafting of MFI regulations in Cambodia was presented. The presentations highlighted the need to develop a regulatory framework, once there is a critical mass of microfinance institutions that have reached a certain scale of activities and are considering to start mobilizing deposits from the public. The presentations demonstrated that it takes time for the microfinance to develop and that it is the challenge to gradually establish a policy and regulatory environment which is optimal for the development of this industry. The presentations concluded that, in the case of Lao PDR, it would be premature to establish regulations because of the very nascent stage of microfinance.

5. Technical assistance

73. PACT developed four training modules as introductory courses in key areas of microfinance. Module 1 provides an introduction to microfinance and spells out the basics of the savings and loan product methodology. Module 2 focuses on the administrative procedures related to this methodology. Module 3 provides material for financial ratio analysis and in module 4 the basis is provided to establishing an accounting system. PACT's training programme for the Accredited Agents in the two provinces was completed in April 99. With support of PACT the Accredited Agents successfully started operations in August 1999.

74. In its role as technical service provider, PACT became increasingly involved in managerial decision making. The overall institutional set-up is rather complex and confusing from a governance point of view. PACT, and in a certain way the provincial Project Management Office, the TA's, the LWU and the APB as well, performed functions which would normally be carried out by departments, units or committees of a Head Office of a microfinance institution. It is, therefore commendable that PACT, as a technical service provider, allowed its role to evolve to be able to fulfill essential managerial functions which where not accurately addressed in the present project arrangements.

75. In addition to PACT's training and monitoring, UNCDF provided technical guidance and assistance through technical advisors (TA's) posted at central level and the provincial level.

6. Recommendations

76. It should be emphasized that the main objective of the project is to support the development of local capacity in microfinance on a national and institutional level. To maximize the economic and social impact of this large investment, the Project should focus its resources on the microfinance institutions which have the potential to become fully sustainable and manage a massive outreach. At that stage a microfinance institution will be able to finance its further growth on an unsubsidized basis. The mission views that developing such a quality microfinance institution will have the highest and most lasting economic and social impact.

77. On the basis of the main objective of the Project the mission recommends a strategy which aims at 1) increasing the financial sufficiency and outreach of the Accredited Agents and Sipsacres, 2) the establishment of a National MFI and 3) the expansion to other provinces

78. This recommended strategy is in harmony with the output related to two other components of the Project, the implementation of which was postponed during the previous Tripartite Meeting i.e (i) Capitalization of Sustainable MFIs, (ii) support to Micro-enterprises.

6.1 Consolidation and rationalization

79. The mission recommends that on the basis of the present experiences the Project, the Accredited Agents and Sipsacres adopt the following strategies to enhance the financial self-sufficiency of the operations.

a) Merger into provincial branches.

80. To increase efficiency and remove unnecessary costs, the mission recommends that a merger takes place between the Accredited Agents to form one provincial branch per province. The mission views that having separate Accredited Agents operating from the same area in both Oudomxay and Sayaboury leads to a duplication of cost items and makes proper oversight more cumbersome. In the case of the Accredited Agent SCA in the Sayaboury province consideration could be given to restructure it into a district branch residing under the Sayaboury provincial branch. The mission noted that there is excellent collaboration between the Accredited Agents within the provinces and that the rationale for a merger was understood and supported.

81. With respect to the replications of Sipsacres the mission has concern that these replications will prove to be unsustainable and in the worst case scenario could damage a healthy development of microfinance. The mission therefore recommends that any new lending be suspended by the replications and that they focus on recovery of loan arrears, until further notice. The provincial branches in both Oudomxay and Sayaboury should, once merged, study the viability of taking over the assets and client base of these replications.

b) Market penetration and up-scaling

83. Especially in an area with limited demand, the challenge is to tap into the potential demand as efficiently and effectively as possible. The mission recommends that the Accredited Agents and Sipsacres adopt a market penetration strategy in combination with a product development strategy necessary to optimize sustainability.

The market penetration strategy would focus on further restructuring the existing product to become much more demand oriented. It is viewed that, elements of the present methodology could be relaxed or abolished, with the existing experience gained in the market place. The objective of the restructuring should be to increase the demand by bringing down the transaction costs for the clients while maintaining high repayment rates. The proposed product development will allow for disbursements of larger loans requested by micro and small businesses, in the same areas of operations (up-scaling). Effective delivery of such a product is expected to substantially increase the administrative efficiency. The introduction of both strategies assume that 1) sufficient capacity has been build, 2) sufficient knowledge of the market has been obtained and 3) (potential) clients have good understanding of the services provided by the Accredited Agents.

c) Increase administrative efficiency.

84. The Accredited Agents should develop a sharp focus on increasing productivity. The mission recommends the Accredited Agents to minimize or abolish activities or products which are considered to have a negative net benefit. In this respect, Accredited Agents could review the pro's and cons of the forced savings scheme, the wealth ranking exercises and the participative rural appraisals. The mission recommends to review the product methodology with the objective to bring down the administrative requirements. It is notable that the expenses made for printing and copying is one of the major cost items for both the Accredited Agents as Sipsacres.

d) Right pricing

85. The mission recommends that comprehensive financial projections be made, and that the interest rate be determined based on the "steady state" situation of a fully fledged, unsubsidized National MFI. The mission recommends that until such projections are made no further decrease of interest will occur.

6.2 Establishment of National MFI

86. One of the most important issues to be addressed will be the institutionalization of the management structure. At present, elements of the Accredited Agent's governance are shared on a ad-hoc basis and in a non-institutionalized way by the supporting parties. A microfinance institution can only become sustainable once it adequately fulfills essential functions of overall strategic management, financial management and control, audit, human resource management, public relations, operations control, product development etc. The mission recommends to establish a Supervisory Committee and a Head Office at central level which will manage all potentially sustainable Accredited Agents supported by the Project. The Accredited Agents will report under the management of the Supervisory Committee and the Head Office. In this way the Supervisory Committee and the Accredited Agents form one National MFI.

87. A microfinance institution with a Supervisory Committee, a head office and a branch network is a common organizational structure which is necessary for proper governance. This structure also allows for economies of scale, higher efficiency of operations, enhanced cross-fertilization between branches to develop greater innovation

and better practices, standardization of MIS and management systems, shorter and improved communication lines. Such a structure can build the capacity required to manage massive outreach once a steady state has been reached. A National MFI is much better positioned to attract large amounts of funds from public and private investors to finance its further expansion into other provinces. The mission considers that a national MFI with a provincial branch network is required to reach full sustainability.

88. The mission recommends that once a Head Office of the National MFI is established the Project to enter into sub-contracts directly with the Head Office of the National MFI based on its business plan and projected capital funding required. This consolidated arrangement should lead to a considerable simplification of the present administration which provides for separate agreements for each individual Accredited Agents and Sipsacres and its replications

6.3 Expansion to two provincial branches

89. The mission views that a minimum critical mass is required to strengthen the sustainability of the National MFI through economies of scale while, at the same time, expanding the outreach of microfinance in Laos. The mission recommends to establish two additional provincial branches. The mission proposes expansion in the provinces of Vientiane and Luang Phrabang¹ due to their large potential client base and their relative proximity to the provinces Oudomxay and Sayaboury.

90. The mission views that the establishment of a proper governance structure together with the merger of Accredited Agents into provincial branches and establishment of two additional provincial branches will result in one National MFI, with a Supervisory Committee and a Head Office in Vientiane, and with four provincial branches in respectively Vientiane, Sayaboury, Oudomxay and Luang Prabang. The mission views such a structure as necessary to provide a solid basis for a large and sustainable MFI in Lao PDR, which has the potential to continue expansion to other areas by attracting large amounts of unsubsidized additional funding which permits massive provision of financial services to the lower segments of the market.

91. With respect to Sipsacres in Vientiane, the mission recommends to await the managerial review of its future direction. The mission recommends Sipsacres to focus on the importance of good governance, best practices and full sustainability. The mission encourages the Project and Sipsacres to assess the viability of the option of Sipsacres becoming part of the National MFI as a Provincial Branch.

6.4 Provincial Project Management Office

92. The PPMO's have been functional as a project vehicle to deliver support in the start-up phase of the project in playing their project support role and facilitating role especially taking into account that during the establishment phase the local authorities, the staff of the Accredited Agents and the clientbase were not familiar with the characteristics of microfinance. The PPMO's have coordinated Government support, which has now set a solid base for further institutionalization of the Accredited Agents.

¹ The mission appreciates that the "Association Internationale de la Francophonie" has already committed US\$ 300,000 for such expansion.

93. The mission recommends that the PPMO continues its project support role and its facilitating role. It is not recommended that the PPMO assumes any of Accredited Agents managerial responsibilities or the TA's and Pact's advisory responsibilities. With respect to its facilitating role the mission recommends that the PPMO concentrates on the following issues: 1) liaise with the local authorities to ensure adherence to protocol; 2) introduce and advocate the Accredited agents to local authorities, once they start venturing in new areas; 3) communicate relevant information to Government, UNCDF/UNCDF, Accredited Agents, TA's and PACT.

94. To ensure continuation of these two roles it is important that at this stage these roles will be gradually transferred to sustainable institutions before the end of the project period. It is therefore recommended that the PPMO's continue implementing their project support role until these responsibilities will be fully taken over by the Head Office of the National MFI. At that stage the Project will sub-contract the Head Office of the National MFI directly. The PPMO's will ensure a smooth and gradually transfer of their facilitating role to the provincial authorities. This role should become an integrated part of the responsibilities of the provincial authorities before the end of the Project period. In the meantime the PPMO's will have an additional responsibility in facilitating the process of merging the Accredited Agents into provincial branch offices that will be fully supervised by the Head Office of the National MFI

6.5 Feasibility study

95. The mission recommends the project to conduct a detailed feasibility study on the establishment of the National MFI. This study will include among others : 1) a plan on the establishment of the Supervisory Committee, the Head Office and the two additional provincial branch offices; 2) a detailed analysis which identifies the areas and input required of additional capacity to be built to support the General Manager of the National MFI in the process of its establishment and development into a fully sustainable National MFI; 3) a management plan for merger of the MFI's in the present project areas; (4) a plan for the transfer of management responsibilities to the Head Office; 5) a plan for gradual phasing out of TA and Pact at provincial level (while Head Office and Supervisory Committee become fully operational); 6) a detailed workplan for the structuring the Head office and four provincial branches 7) a business plan and financial projections

6.6 Technical Assistance

96. At this early stage of the project implementation it is advisable that PACT continues its present support to the Accredited Agents. In addition, PACT should support the Accredited Agents in improving the present product delivery with a focus on increasing the administrative efficiency and reduction of the transaction costs for the clients while maintaining a high quality of the loan portfolio. Furthermore PACT should start supporting the Accredited Agents in the development of loan products which target a higher segment of the market. Finally, PACT could play a facilitating role in the merger of the Accredited Agents per province into a provincial branches.

97. In support of the process to establish a National MFI, as explained before, PACT should develop a detailed workplan, under supervision of and in collaboration with the General Manager of the National MFI, which provides for a gradual transfer of PACT's functions in the provinces to the Head Office of the National MFI. PACT could play a supportive role in the initial set-up of the additional two provincial branches until the Head Office has the capacity to supervise and support these new branches. It is envisaged that once a Head Office is established which is able to assume its strategic, supervisory and supportive responsibilities, the activities of PACT at a provincial level will phase out.

98. The mission recommends that the TA at central level, during the present transition process, continue its functions as described in the TOR, in light of the strategic orientation of the establishment of a National MFI. This TA will contribute in the organizational process of consolidation and rationalization and establishment of the National MFI, while continuing its support to the project activities under the National Component (Microfinance TaskForce, Microfinance Training Center and policy dialogue with the Government on the regulation agenda). The TA at provincial level will continue the support to the PPMO in both Oudomxay and Sayaboury and will provide support in the process of merging of the Accredited Agent's into provincial branches. The TA will also provide support in the gradual transfer of the project support responsibilities to the Head Office of the National MFI, to facilitate the subcontracting of the project with the national MFI in future. The mission does not see the need to expand the present TA to support the PPMO's at the provincial level beyond the present TA.

99. The mission recommends that once a Head Office of the National MFI is established PACT and the project TA transfer their technical and managerial responsibilities at the provincial level to the national staff of the Head Office.

6.7 Support at National level.

100. The mission welcomes a gradual development of the national policy on microfinance to be developed by the Microfinance Task Force based on the understanding of internationally recognized sound practices. The mission recommends that for a proper development of such policy, a participative approach should be adopted whereby government staff, practitioners, specialized consultants, regulators and other key persons are involved to be able to provide input and comments during this process. The mission recommends the Task Force to review all regulation that could hamper the development of a diverse and vibrant microfinance industry. Attention needs to be paid to reforming regulations that make it difficult to practice various forms of microfinance.

101. The mission views that once the microfinance industry matures in Laos, it should consider to transfer the policy mandate entirely to the Bank of Laos. The mission also recommends that the Microfinance Task Force continues promoting coordination among donors involved in microfinance. This coordination should focus on best practices and build on the experience gained internationally and nationally.

102. The mission recommends that the Microfinance Training Center continues to develop courses relevant for the microfinance sector and with a focus on disseminating "best practices in microfinance". The mission, therefore, recommends that the project continues to support the Microfinance Training Center within the present budget for the

remaining of the project period. In order for the Microfinance Training Center to operate efficiently, the mission recommends that the Microfinance Training Center is enabled to provide its training courses as planned and that cancellation or postponement of training courses is avoided. It is envisaged that, at a certain point in time, Microfinance Institutions which aim for sustainability will start providing in-house training. The Microfinance Training Center should therefore take into account that, in future, the demand from microfinance institutions and policy makers for their training courses might decline. In line with the objective to aim for cost recovery the mission recommends that the Microfinance Training Center is allowed to conduct their courses, on a fee basis, also for interested individuals or organizations which are not directly related to microfinance. Such activities would broaden its future income base which is necessary to reach full cost recovery.

103. With respect to the regulatory framework for microfinance the mission does not recommend to formulate regulations, at these early stages, without thorough understanding of the nature of microfinance in Lao PDR and without knowledge of the optimal ways in which this industry has the potential to develop. Premature regulatory oversight could, inadvertently, seriously hamper the development of a diverse and vibrant microfinance industry with the result that, without clear reason, many people would be deprived of access to financial services which they need to improve the livelihoods of their families.

104. The mission recommends that the Project supports the Government and Bank of Lao PDR in organizing and financing exposure visits to other Central Banks which have gained experience in microfinance. It is envisaged that this exposure will enhance the understanding of policy makers about the challenge faced by other Central banks to draft a prudential regulatory framework which, within the context of the national legal framework, will be optimal for a vigorous development of microfinance.

6.8 Conditions for UNCDF capital and technical support

105. The mission recommends that the Project will set the minimal conditions required to be met at a certain date (e.g 1 July 2001) for the Accredited Agents and Sipsacres to qualify for the inclusion in the National MFI. The mission considers that the entities which do not meet these requirements should not be included. The mission recommends that direct support from the Project to entities which have not been selected should gradually phase out (See Annex 3).

106. The mission recommends that the provincial MFI's be adequately informed by the Project on these conditions in combination with an intensive training on ways to increase productivity and enhance sustainability.

107. The mission notes that credit funds remain under UNCDF ownership until their final disposition is determined at later stage. In line with the objective of the project these UNCDF funds will be utilized for the benefit of the national MFI if full sustainability (organizational, managerial, financial and technical) is reached on within reach.

LAO/96/C01 Microfinance and Sustainable Livelihoods in Laos

Terms of Reference for the Technical Review Mission - February 2000

I General information and context of the mission

1/ Project background:

a/ Budget.

Executing Agency: Ministry of Finance

Budget: Total : US\$ 6,935,085 (UNCDF: US\$ 5,395,485; UNDP: US\$ 1,389,600
Government: US\$ 150,000)

Duration: 5 years

Provinces: Vientiane, Oudomxay, Sayaboury

b/ project components:

The project has two immediate objectives, reflecting respectively a national and a provincial components. The initiatives under each component are mentioned below:

National Component:

Objective: "create optimal conditions for the emergence of an enabling environment for the development of Microfinance in Lao PDR"

- Establishment of a Government Microfinance Task Force (BOL, MOF, LWU, APB, CIC, MOFA) – with quarterly meetings (started June 97).
- Improvement of regulatory environment for Lao microfinance institutions (started Oct 99)
- Sensitization and national training (Microfinance Training Center- started Dec 98)
- Capitalization of sustainable MFIs (not started)

Provincial Component:

Objective: "Reduce poverty through the provision of small financial services by sustainable Microfinance Institutions."

- Building sustainable Microfinance Institutions (MFIs) to provide services to 15,000 households (training by Pact started Sept 98 – operations of MFIs started in August 99)
- Replication of the Sipsacres credit union model in the two provinces (started Oct. 98)
- Special programme for small entrepreneurs (not started)

2/ Progress of project implementation:

a/ Activities undertaken under the national component:

- **The Government Microfinance Task Force:** it has been set up since 1997, and has benefited from training on microfinance, including through study tours (in Bangladesh). It is to play an advisory role on policy issues and help set the ground for sound microfinance practices in Laos, as well as support coordination among donors.
- **The development of the Microfinance Training Center:** it started its activities in December 1998. Its main challenge is to expand its activities with high quality curricula, and answer the needs of its main clients (donors and NGOs).
- **Regulation of microfinance institutions:** During the last TRM in December 1998, it was agreed that the implementation of the project's agenda on microfinance regulation would be postponed, in consideration of the very incipient stage of the microfinance industry in Laos, and the potential damage that a premature legislation may inflict to that industry. The issue of regulation was however moved forward by the Government in October 1999, and a draft text of a legislation was issued by the government.

b/ Activities undertaken under the provincial component:

PACT's training programme vis a vis the 8 selected MFIs (called Accredited Agents in the project agreement) in the two provinces was completed in April 99. The MFIs started operations in August 1999, under economic conditions that had become by that time much less favorable, with an inflation rate of more than 100%. In October 1999, the total number of members was 3,200 (1,800 in the two provinces and 1,400 in Vientiane), and that number reached 3,636 as of 01/01/2000 (with 1,123 borrowers). The table below provides a breakdown of that figure as of January 1, 2000.

Summary of Piloted MFIs: as of 1 January 2000

Name of MFI Start date	Province	Type	Members	Borrowers	
1. Sipsacres	VTE	Credit Union	1,649	425	Sept 95
2. AA APB	SAY	SCG MFI ²	194	76	Aug.99
3. AA LWU	SAY	SCG MFI	105	76	"
4. AA SCA	SAY	SCG MFI	153	95	"
5. Sayasac	SAY	Credit Union	289	94	Dec.98
6. AA APB	ODX	SCG MFI	374	101	Aug.99
7. AALWU	ODX	SCG MFI	337	198	Aug.99
8. Xaysac	ODX	Credit Union	535	58	Dec.98
Total:			3,636	1,123	

II Purpose of the Technical Review Mission

The overall goal of the technical review mission is to analyze the progress of project activities, both at the national and provincial level, review the overall strategy of the project, and provide recommendations about the future orientations of the project.

It is important to note that the project was finalized and designed prior to the joint review of UNCDF portfolio with CGAP in 1998, and the subsequent major re-orientation of

² Saving and Credit Groups

UNCDF policy in that area. This joint review has enabled UNCDF to learn from past mistakes, both on the level of project design and operations in the field. During the technical review mission of December 1998, a number of project activities were already re-evaluated, taking into account the new UNCDF microfinance policy. Decision was taken to cancel the “basic needs” component (for US\$ 175,000) since this was not related to fostering sustainable microfinance. Similarly, decision was taken to postpone the implementation of the component on “micro-enterprise” (for US\$ 790,000), in light of the lessons UNCDF had learnt from similar design / approach in the context of some of its other projects.

The present mission will therefore not only review the status of on-going activities, at the national and provincial levels, but also review the overall project strategy (including the components that have not been implemented yet), and provide recommendations for re-orientations, if necessary. More specifically, the team will review the following issues:

1/ Review of project activities:

a/ At the provincial level, the mission will review:

Operations of the 8 MFIs:

- the operations of the 8 MFIs supported by PACT, in the areas of : institutional capacity and organization, lending practices and outreach mechanisms, portfolio quality, financial performance, information system, product development, management systems, human resources, ownership and governance structure. A simple and standard evaluation format will be used to assess those MFIs.
- the prospects of future development and sustainability for those 8 MFIs.
- mechanisms and conditionalities under which the MFIs could access UNCDF funds for loanable capital and technical assistance.

Project institutional arrangements:

- the role of the Province Project Management Offices: How their support role to the project implementation has been fulfilled. What is the rationale of their intervention in the future, in the context of the project strategy and MFI development.
- What has been the role of PACT during this first stage of project implementation, vis a vis the trained MFIs as well as other project activities. How may its role evolve, from this initial stage of project development, and what type of institutional support mechanism should be put in place to best help those MFIs become sustainable.
- The mission will review the TORs of the PPMOs, PACT and the TAs, and the manner in which those various partners operate and interact with each other, and will propose amendments to the existing institutional arrangements as needed.

b/ At the national level:

The team will review the development of the project's activities regarding

- The Microfinance Taskforce: its composition, its mandate and role vis a vis the Government and donors, and the technical training it was given through the project.
- The creation of the Training Center: organization and staffing, curriculum developed, its customers (NGOs, incipient MFIs, donors etc...), the prospects of its cost recovery in the future.

- The technical assistance provided through the project activities, both at the provincial and national levels, will be assessed, and possible scenarios for an exit strategy in relation to this technical assistance will be analyzed.

2/ Review of the project's overall strategy

a/ Geographic and institutional focus

Geographic focus: The project was designed to be developed in two specific provinces, Oudomxay and Sayaboury (plus the Sipsacres operation in Vientiane) Those two provinces are characterized by low population density and difficult communication that are likely to make the pursuit of sustainability more difficult than in other regions. The mission will review the conditions of operations in those two provinces, and will provide recommendations regarding the issue of the project's geographic area of intervention. The mission will in that context explore the possibility for project expansion into other provinces.

Institutions supported: the assumption of the project design has been to train a number of incipient microfinance institutions (called accredited agents in the project agreement) and to create a nascent market of microfinance institutions. Examples of successful UNCDF interventions in other countries have however shown that concentrating donor support to one or very few institutions may have a stronger long-term impact in allowing such institution(s) to reach scale and provide in some cases a national coverage of branches. The mid-term evaluation of the MicroStart programme also provides valuable insights on this issue. The mission will review the project strategy in that regard, and provide recommendations on possible scenarios for future project re-orientation.

b/ Regulation

The mission will review with the government the regulation agenda. It will provide recommendations about the way to implement this agenda, including the appropriate conditions to make the introduction of regulation most effective and supportive for the microfinance industry in Laos. In that respect, the mission will organize a one-day workshop with the Government on this issue, and will use as a resource person an external specialist in that field. Separate terms of reference will be finalized for that workshop.

c/ Other project components

The mission will review the project activities that have been postponed so far, and provide recommendations regarding the opportunity whether to pursue those activities, and if so the modalities under which they should be implemented. The mission will review specifically in that context the project components related to (i) Capitalization of Sustainable MFIs, (ii) support to Micro-enterprises and (iii) Village Savings Groups, in light of the new UNCDF microfinance strategy and lessons learnt from the joint review with CGAP. It will make propositions, as needed, about the possible re-allocation of related resources in a way that support the objective of helping sustainable microfinance in Laos.

III Composition and organization

The mission will be composed of a senior consultant, M. Peter Kooi, and the UNCDF Programme Manager Henri Dommel.

The mission in Laos will take place between the 19 February and 4 March, 2000 (total of 15 days). It will start with briefings in Vientiane, meeting with partners and reviewing the operations of Sipsacres. This will be followed by a field trip, reviewing the MFIs operations and project activities. The mission will then return to Vientiane for 4 days, during which period the workshop on regulations will be organized. The consultant will be given 10 days for report writing in Cambodia. A two days debriefing will be organized in New York, after UNCDF receives the draft report from the consultant.

The overall number of days for the mission will therefore be 27 days.

In order to prepare for the mission, the following documentation will be made available to the consultant: the project agreement, the various activity reports prepared by the technical advisor on the project (M. Duflos), the various exchanges with the Government on the theme of regulation, as well as the UNCDF Joint Portfolio Review with CGAP, and the UNCDF new Policy Paper on Microfinance.

An Aide Memoire will be prepared by the mission. It will be presented to UNDP, and the mission's main findings and recommendations will be presented and discussed with UNDP and the Government during a Tripartite Meeting, prior to the mission departure. Since the mission's conclusions and recommendations will have to be presented at UNCDF Headquarters during the debriefing session in New York that is planned for 20 and 21 March 2000, UNCDF's final position on those conclusions and recommendations will be communicated to UNDP Vientiane and the Government, after the mission debriefing at UNCDF Headquarters.

Within two weeks after the mission's completion, the consultant will submit his draft report, including a summary. The draft report will be discussed during the mission debriefing at UNCDF's Headquarters, after which the final version of the report will be distributed.

**Technical Review Mission from UNCDF and TPR-meeting
Mr Henri Dommel and Mr. Peter Kooi**

Schedule for the Mission

Saturday 19 February

- AM: Arrival in Vientiane of Mr. Peter Kooi, UNCDF Consultant
- PM: Informal meeting and dinner between Mr. Peter Kooi and Mr. Eric Duflos, Microfinance Advisor and Coordinator.

Sunday 20 February

- AM: Arrival of Mr. Henri Dommel, UNCDF Microfinance Portfolio Manager
- PM: Meeting with Ms Helle Buchhave, UNCDF Programme Officer, Henri Dommel, Peter Kooi and Eric Duflos to refine the mission's programme

Monday 21 February

- 08:30 Short visit at UNCDF office and introduction of the mission to Mr Francois Obein, UNDP/CDF Assistant Resident Representative
- 09.00 Meeting with Mr. Gana Fofang, Deputy Resident Representative, UNDP
- 10.00 Meeting with the Madame Thipakhone Chantavongsa, Central Project Manager
- 11.45 Courtesy call to the Mrs. Kari Nordheim Larsen, Resident Representative
- Wrap-up and discussion at the UNCDF office

Tuesday 22 February

- 08.15 Meeting at Sipsacres office: review of activities and introduction to some executive committee members by Mr. Bounsouane, Chief of the Executive Committee and Mrs Nild Van den Brink, Sipsacres Advisor
- 13.30 Presentation at the Microfinance Training Center organized by Mrs. Vansy Chindavong and Mr. Somphone Sisenglath, National Trainers.
- 16.00 Meeting with Mr. Francois Obein

Wednesday 23 February

- AM: Review of project documentation
- 12.10 Departure for Luang Prabang (Helle, Henri, Peter, Eric and Ms Chansouk Thammavong, Deputy Central Project Manager)
- 15.00 Departure for Oudomxay
- 19.30 Arrival in Oudomxay
- 19.30 Dinner with Mr. Kurt MacLeod, Senior Microfinance Technical Advisor for Pact and with Ms Yupaporn Boontid, Technical Advisor for the Provinces of Oudomxay and Sayaboury
- 20.30 Presentation by Pact's Oudomxay team (see list of names attached)

Thursday 24 February

- 08.00 Meeting with PPMO hosted by Mr. Bounpheng Souphatone, Provincial Project Manager in Oudomxay
- 09.30 Review of AA APB at their office, organized by Mr. Suksavanh, AAAPB Manager and his staff
- 12.30 Lunch
- 13.30 Review of AA LWU at their office, organized by Mrs. Kamphone, AA LWU manager and her staff
- 16.30 Visit of clients of AA APB and LWU
- 19:30 Dinner arranged by PPMO for the mission, PPMO, AA staff, Pact and Xaysac.

Friday 25 February

- 08.00 Meeting with PPMO continued
- 08.30 Visit of Village Saving and Credit Group meeting in the morning
- 09.45 Review of Xaysac with Mr Chansai, Chief and Mr Viengkam, Accountant, and the executive committee
- 12.45 Lunch
- 14.00 Leave for Luang Prabang

Saturday 26 February

- 08.30 Leave Luang Prabang for Sayaboury
- 12.00 Arrival in Sayaboury and lunch with Ms Winona Dorschell, Technical Advisor for Pact in Sayaboury
- 13.00 Presentation by Pact team at their office (see list of names attached)
- 14.30 Review of AA SCA activities with Ms. Tongkeo, Manager, and her staff

Sunday 27 February

- 08.30 Visit of AA SCA clients/preparation of Aide Memoire
- 13.00 Review of AA APB, with Mr. Tavone, manager
- 13:30 (- Arrival of Mr. Chea Sok, responsible for the proposed mini-workshop, in Vientiane, 13.00)
- 19:30 Dinner arranged by PPMO, for PPMO, AA staff Pact and Sayasac.

Monday 28 February

- 08.00 Review of PPMO activities and responsibilities, hosted by Mrs Ithmany Chantakhone, Provincial Project Manager.
- 09.15 Review of AA LWU with Mrs. Bouchat, Manager
- 12.30 Lunch
- 13.30 Review of Sayasac with Mr. Bounmy, Chief and Ms. Vanasith, accountant with members of the executive committee
- 16.20 Visit of clients of AA LWU and Sayasac

Tuesday 29 February

- 07.20 Breakfast and debriefing for PPMO
- 09.00 Departure for Luang Prabang
- 12.30 Check-in

15.40 Arrival in Vientiane
Continue preparing the workshop

Wednesday 1 March

08.30 Meeting with CPM for debriefing and preparation of TPR
12.00 Lunch and debriefing with UNDP DRR
13.00 Meeting with HE Liane Thykeo, Vice Minister of Finance
PM Preparation of the workshop on regulations

Thursday 2 March

08.00 Registration for the workshop on Microfinance regulations.
12.00 End of Workshop
14.00 Preparation for the TPR
15.00 Meeting between Henri, Peter and the CPM

Friday 3 March

08.00 TPR meeting, chaired by Mr. Bounsamack Sayaseng (NPD) and Mr. Gana Fofang, DRR
18.30 Baci at Eric Duflos' house for the mission and all project participants at the TPR.

Laos workshop on MFI Regulations

General stages in the development of microfinance industry

Given an improving enabling environment and a strengthening microfinance industry, the development of this industry could be envisaged to move through the following phases:

In the start-up phase, microfinance activities are introduced on a very small scale. Some activities aim at delivery of sustainable micro-finance services which concentrate on finding the right areas, staff, systems and products. In this phase other activities start projects which aim at bringing direct relief to population whereby the population is often unclear whether cash disbursements are loans or grants. These projects do not applying sound microfinance principles, they do not build local capacity to deliver sustainable microfinance services and should not be confused with microfinance. The local organizations however, which do apply sound microfinance services will be gradually on their way towards sustainability. In this phase they will especially focus on strengthening the internal capacity and developing the products which are demand oriented but at the same time guarantee high repayment rates. Sound microfinance principles means that you deliver the type of products which the customers really need, that you have professional staff, good administrative and internal control systems, low default and an interest rate which is sufficient to cover the administrative costs, provisioning, inflation, cost of capital and sufficient additional capitalization. It is envisaged that at the end of this stage some of the projects which focus on sound microfinance principles start showing some outreach.

In the expansion phase some of these organizations will continue to develop along the lines of best practices and will increase their levels of sustainability and growth. These projects will start developing and implementing plans for expansion to other areas or with other products. These organizations can expand very rapidly because it has now tested its products and knows its clients. Expansion, at this stage, merely means copying of what the organization already knows and branches are set-up in other provinces to reach a much higher number of clients. In this phase this organization will spend time to further upgrade overall management, the management information systems, internal audit and will refine its credit policies, financial management, staff regulations and human resource management. In this phase the transaction costs for the customers are likely to come down because more successful local institutions will start competing with other microfinance operators to continue increasing their market share. Gradually industry norms start to be accepted nation wide and some “unsustainable” programmes will be discontinued as it becomes generally perceived that these projects are undermining a healthy development of the microfinance industry.

In general, markets shape the regulations. Regulators and policy makers will be encouraged to formulate an appropriate legal framework and regulations once the micro finance industry shows signs of becoming a larger player in the financial market. It is expected that these regulations will:

- shape a conducive environment for a healthy growth of this industry in scale and scope
- allow for fair competition
- define prudential requirements necessary to protect depositors and to safeguard the integrity of the financial system.

At the end of this stage one or more industry leaders will have emerged, prepared to transform into a licensed formal financial institution.

In the integration phase, a fully fledged legal frame work is in place which encourages microfinance institutions to formalize and expand their activities, both in scale and scope. The main motive for MFI's to become licensed MFI's is to guarantee full institutional self-sufficiency and further expansion. As a licensed and regulated MFI, the MFI will be able to attract additional funding to fuel further growth and to reach higher economies of scale and scope through: 1) raising additional equity. 2) access to financial markets to attract loans 3) mobilizing deposits from the public for the purpose of on-lending. 4) provision of other financial services (for instance foreign exchange, savings (time-,savings-, or demand deposit services) At this stage, investors, lenders and depositors will require an established legal and regulatory framework, appropriate for MFI's, and direct supervision (and regulation) of MFI's by the Bank of Laos.

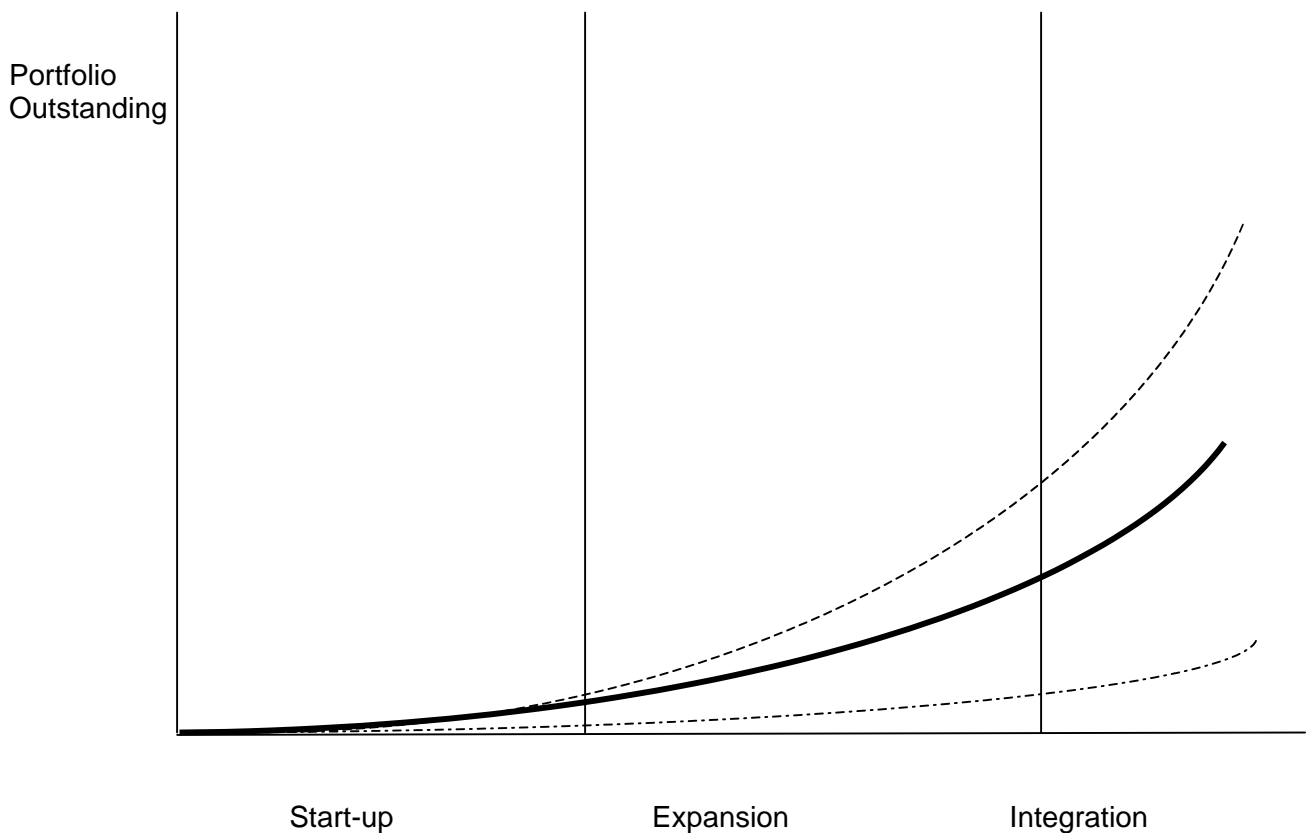


Figure 1. Phases of development of the microfinance industry

These phases are shown in figure 1. The development of the microfinance industry in terms of the total number of clients and portfolio outstanding is highly depended on the enabling environment. If for instance the policy environment is optimal for the development of microfinance the growth and development of microfinance can be rapid. On the other hand regulations and policies could exist which hamper the development of a diverse and

vibrant microfinance industry with the result that many people will not obtain access to financial services which they need to improve their livelihoods.

These institutions will further expand their scale and scope of services at the lowest segments of the market. The institutions will gradually provide also larger loans to be able to grow with their most successful customers (up scaling). This process of up-scaling is much desired because successful expanding businesses have the potential to create employment for people that cannot enter even the lowest segments of the financial market due to their persistent lack of repayment capacity. The growth of these institutions will be financed through capturing domestic savings from the public and equity and loans from investors. These institutions form an integral part of the domestic financial system on a unsubsidized, fully self-sustaining basis

Some Banks which are specialized in targeting the highest segments of the market could become interested to develop products meant to reach lower segments of the markets, to increase their own sustainability and growth (down scaling). Figure 2 shows the process of gradual down scaling of financial institutions which serve the higher end of the market and up scaling of financial institutions, specialized in serving the lowest segments (Examples of countries in this phase are Bolivia, Philippines, Indonesia)..

To reach this stage is an enormous challenge for most developing countries. To reach this stage is the way for microfinance institutions to be able to access the capital needed to provide financial services to the population at large in a sustainable and manner thereby not requiring subsidies from Government or Donors anymore.

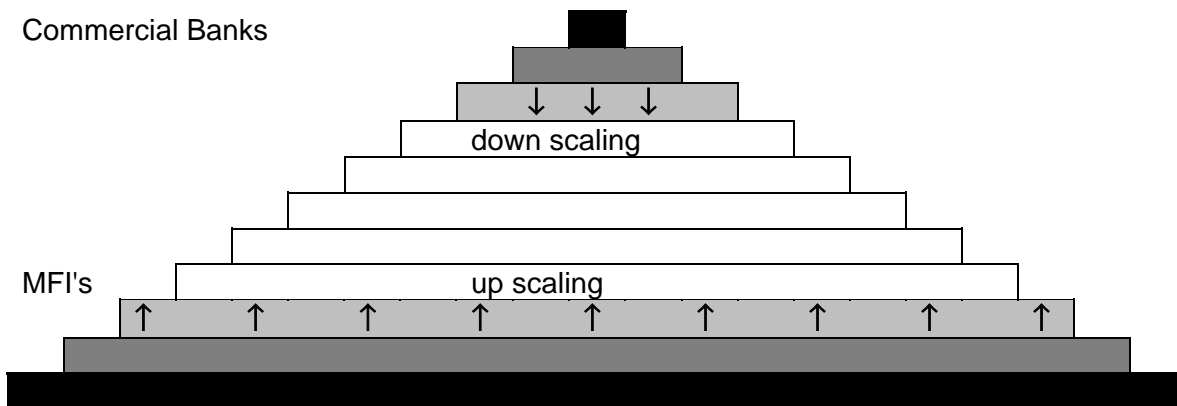


Figure 2 The market for demand for financial services

ACLEDA: An example in Cambodia

**1 st phase: small and micro enterprise development:
UNDP/ILO SEISP Project**

**2 nd phase: sustainable microfinance institution:
UNDP/ILO Alleviation of Poverty through ACLEDA's Financial Services Project**

**3 rd phase: regulated financial institution:
UNDP/USAID/IFC: ACLEDA Transformation Project**

	1993	1995	1997	1999	2001
No. of branches	5	11	27	30	34
No. of professional staff	28	100	228	278	363
No active borrowers	1,475	6,539	44,533	61,575	86,272
Average loan size	147	177	132	224	282
Portfolio o/s end period	216,556	1,157,093	5,898,486	13,781,545	24,323,869
Av portfolio O/S per staff	3,867	7,541	20,312	44,676	62,462
Av. no clients per staff	53	65	195	221	238
Admin.costs/ av. port. O/S	290%	80%	37%	24%	18%
Portfolio yield	13.67%	15.53%	45.51%	42.71%	43.02%
Operational self-sufficiency	6%	23%	124%	185%	237%
Financial self-sufficiency	6%	21%	79%	133%	146%

2. Shaping the regulatory environment

2.a. Why prudential regulations?

Three main issues why, at certain stage, prudential regulation is necessary for microfinance.

1. Prudential requirements to safeguard the integrity of the financial system, in particular the protection of depositors.
2. Enabling policy environment for optimal development of the capacity of the financial market in general and the microfinance industry in particular
3. Fair competition among financial institutions

Ad 1) Prudential requirements are required to safeguard the integrity of the financial system and to protect deposits from the public. An important question to ask is when the microfinance industry will be regarded by the public and major actors as an integrated part of the financial system. In the early phases of development the volumes of activities of the MFI are small while MFIs are supported through projects. In such phase the MFI industry is nurtured and not yet an integrated part of the financial system. Once, however, the microfinance industry starts to enter development stage three a licensed environment could be required. Licensing allows these institutions in this phase to start taking deposits from the public in a prudential way. Also a professional and sustainable MFI which is licensed will find easier access to the international capital market once potential investors

know that the MFI is supervised by a Central Bank, which should guarantee the financial soundness of the MFI

Ad 2) With respect to development of the microfinance industry the institutions and projects, we understand that, given that microfinance in Laos is at its very early stages as an emerging industry, continued support is required to further upgrade the level of the individual players to strengthen their governance, their systems and sustainability.

In most developing countries today the absence of special licensing regimes for MFIs is not the serious constraint to the development of microfinance. The bottleneck for the development is usually that most MFIs are still dependent on subsidies and are not able to raise capital through equity, loans.

. Non-prudential regulation needs to be distinguished from prudential regulation. Prudential regulation is required to certify the financial soundness of the microfinance institution. Non-prudential regulation also influences the development of microfinance. For instance these regulations could involve a severe limitation in the legal form of microfinance institutions; interest rate ceilings, limits on portfolio growth, limits in areas where they can operate, requirements of targeting specific types of customers, are examples which will seriously hamper the development of the industry and will only lead to weak institutions

Ad 3) With respect to fair competition, it is recommended that regulations on microfinance institutions take into account that licensed MFI's will upscale and will start providing a broader range of financial services. Regulations should take into account the unique characteristics of MFI's as compared to Banks, but should on the other hand be designed to allow for fair competition between MFI's and Banks

2.b For whom prudential regulations?

It is generally accepted that credit-only operators (retailers) do not need to be regulated. In general, it is only necessary to regulate MFI's that mobilize voluntary savings for the purpose of on-lending.

An exception to this rule could be made for savings mobilized within common bond groups (village Banks, tontines etc.). These community-based intermediaries, for instance, small financial cooperatives should not be prohibited from taking deposits simply because they are too small or remote to supervise effectively. Also MFIs whose savings deposits are mainly compulsory compensating balances for loans, should not be subjected to prudential regulation. However, as soon as savings do not remain within these groups but are used by an apex for on-lending purposes to other groups, prudential regulation should be considered to protect the depositors and safeguard the integrity of the financial system. In such cases the apex acts like a financial intermediary between depositors and borrowers. Bank supervision might be required to protect the depositors.

It is generally agreed that a Central Bank should regulate MFI's that (plan to) provide full financial services, which include deposit taking from the public for the purpose of on-lending. The main reason for regulating these MFI's is to protect the depositors and to safeguard the integrity of the financial system. It is therefore important not to license MFI's which do not have the capacity to meet prudential requirements because a Central Bank

cannot guarantee or enforce the financial soundness of the MFI. Licensing such MFI's could hurt the trust the public has in the Central Bank and hence the trust the public has in the integrity of the financial system.

2.c When prudential regulations?

Once more experience has been obtained and pending the development of the microfinance market, consideration could be given to develop special categories of law appropriate to the unique characteristics of microfinance institutions (this model has been adopted in many countries like: Bolivia, Peru, Indonesia, Cambodia). The legislation could be gradually developed based on a growing experience of both the Central Bank and MFI's. This emphasizes the importance of a transparent and open relationship between MFI's and the Central Bank, so that a mutual learning process can shape appropriate and more detailed regulation, in order to stimulate the development of the emerging microfinance sector without compromising prudential supervision.

The creation of special regulatory windows for MFIs is probably premature in countries where there is not yet critical mass of licensable MFIs, which have shaped the microfinance industry. Regulation and supervision entail significant costs. To regulate prematurely could unnecessary drain the available resources of the Central Bank while it could seriously hamper a healthy and rapid development of microfinance because the industry is only in its early stages to develop within the country specific context. Again, it could be very risky for a Central Bank to assume the responsibility to regulate while in practice such regulation not possible, due to weak capacity of MFI's or insufficient resources at the BOL.

It is not advisable to just copy regulations from other countries because these regulations fit the stage of development and the actual state of the microfinance industry in these countries. It is recommended however to study the regulations of other countries to review what could be applicable for in the case of Laos once its microfinance industry matures. Once the microfinance market matures, the Central Bank should have obtained profound knowledge of the state of the microfinance industry in Laos and, in addition, study regulatory frameworks elsewhere to obtain more information in order to be able to define a regulatory frame which is optimal in the context of Laos.

2.d What prudential regulations?; Understanding the differences with commercial banks

Because MFI's differ, in purpose and methods, from commercial Banks which target the higher segments in the market, it is important for the regulating authorities to have a good understanding of this difference when designing a regulatory framework and in the execution of its supervisory tasks.

Some examples of differences which are important from a prudential point of view are:

- 1) MFI's secure most loans through peer group pressures, personal guarantees instead of the traditional legally registered securities. Experience shows that, together with sound business plan assessments and in-built repayment incentives, such approaches can show continuous high repayment rates.
- 2) MFI's operate in close proximity to their customers to maintain high repayment rates and to bring down the administrative costs. The result is that MFI's have often higher degree of decentralization of managerial and operational functions than most Commercial Banks. This will put extra emphasis on their internal control systems (MIS, financial policies, internal and external audits)
- 3) Areas of operations. Financial institutions can only have branches in areas where the client base is sufficient to be able to sustain operations. Successful MFI's will often have a much denser network of branches compared to commercial branches because of the proximity requirement and the difference in client base. An MFI could have branches which are remote from the major urban centers which could make it more costly to supervise.
- 4) MFI's are characterized by small loan sizes, short loan periods, high volume of loans and therefore a high portfolio turnover. This puts an even higher emphasis on quality management and a strong management information system.
- 5) The microfinance industry is rapidly emerging world wide. As said, this industry is just starting in Laos. Hence it will be difficult to get experienced people, products and methodologies are in its first experimental development phase, there is a growing knowledge of the market and how this market will develop; institutions are mostly pioneers.
- 6) The operational efficiency ratio's of MFI's are high compared to Banks. The main reason is that the administration and provision of small loans is very labor intensive. This is the main reason why the interest rates charged by successful MFI's are much higher. These higher rates are essential to ensure the survival and growth of the MFI industry and thereby to ensure the continued access to financial services to its customers. We should note however that the interest rates of MFI are considerable lower than the interest rates charged by money lenders. And the money lender rate is the market rate through the eyes of the customers because they do not have easily access to loans from Banks, which charge lower rates.
- 7) In the early development stages most MFI's are still dependent on subsidies or public investors. This makes it more difficult for these MFI's to attract additional capital. In case of difficulties (for instance a rapidly rising PAR, writeoffs etc.) these MFI's will be vulnerable because of their dependence on subsidies.
- 8) Commercial Banks are vulnerable for concentration of risks (large loan to a single borrower, to within one particular sector). Insider lending is also an area of concern. In practice, due to volume of transactions these risks are not significant for successful and large MFI's.
- 9) Inspection visits from the superintendent will be different in nature. MFI's will not have files of registered collateral on their clients. Successful MFI's will have tens of thousands of clients. Supporting documents will remain in the field branches of the MFI

with a branch network and not in their Head Office. Clients with very small loans will not have business plans etc.

- 10) Examples of very successful MFI's worldwide show that their ownership structure of typically differs from a conventional Bank. Owners could include a mix of for instance national and international public investors, former donors, local private investors, socially motivated investors, the NGO parent and an MFI staff association. Many of the leading MFI's in the world are a spin off of a local (parent) NGO. After transformation, the NGO-parent is an entity which acts as one of the shareholders. It is therefore important that an NGO, trust or association, can be seen as a legal entity acting as a shareholder.
- 11) The diversity of institutional forms is often higher among MFI's than banks. To ensure an optimal development and competition is advisable that legislation allows for the development of this diversity of institutional forms of MFI's (for instance: projects, NGO's, corporate form, varied forms based on the credit union approach, village banking with apex, wholesale MFI). It has been demonstrated that more intense competition among MFI's is by far the most effective way to put downward pressure on the transaction costs for their customers and to stimulate the MFI's to provide the type of financial services the people need.

These differences should be taken into account when developing a regulatory framework for MFI's to address the unique risk profile of MFI's and to ensure

- 1) appropriate prudential requirements to safeguard the integrity of the financial system
- 2) to protect depositors
- 3) an optimal development of the microfinance market and
- 4) fair competition once microfinance integrates into the commercial financial market.

Mr. Chea Sok will explain the process of the evolution of the regulatory framework on MFI's, the way it happened in Cambodia. He will also speak in more detail on specific regulations the way it was adopted in Cambodia like minimum capital requirement, capital adequacy ratio, reserve requirements, provisioning and write-off requirements, reporting requirements etc.

Peter Kooi 02-03-2000 Vientiane

