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GOVERNMENT OF THE REPUBLIC OF THE UNION OF MYANMAR

**Formulation and Operationalization of National Action
Plan for Poverty Alleviation and Rural Development through
Agriculture (NAPA)**

Working Paper - 9

RURAL FINANCE

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ACRONYMS

ASEAN	Association of Southeast Asian Nations
CBM	Central Bank of Myanmar
CBO	Community-based Organization
CDZ	Central Dry Zone
Cenfri	Centre for Financial Regulation and Inclusion
CMFS	Community-managed Financial Services
FMT	FinMark Trust
FAO	Food and Agriculture Organization of the United Nations
FIND	Financial Inclusion for National Development
GDP	Gross Domestic Product
GRET	Group de Recherche et d'Echanges Technologiques
HDI	Human Development Initiative
HIES	Household Integrated Economic Survey
IFC	International Finance Corporation
INGO	International Non-government Organization
KIIs	Key Informant Interviews
LIFT	Livelihoods and Food Securities Trust Fund
MADB	Myanmar Agricultural Development Bank
MAP	Making Access to Financial Services Possible
MEB	Myanmar Economic Bank
MFI	Microfinance Institution
MIC	Myanma Insurance Company
MICB	Myanmar Investment and Commercial Bank
MIS	Management Information Systems
MLFDB	Myanmar Livestock and Fisheries Development Bank
MLFRD	Ministry of Livestock, Fisheries and Rural Development
MOAI	Ministry of Agriculture and Irrigation
MSE	Microfinance Supervisory Enterprise
MSMEs	Micro, Small and Medium Enterprises
NGO	Non-government Organization
PACT	Private Agencies Collaborating Together
PGMF	PACT Global Microfinance
POS	Point of Sale
RTGS	Real Time Gross Settlement
SFI	State Financial Institution
SME	Small and Medium Enterprise
UNCDF	United Nations Capital Development Fund

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UNDP	United Nations Development Programme
SMIDB	Small and Medium Industrial Development Bank

EXECUTIVE SUMMARY

The Government of Myanmar has articulated a National Strategy on Poverty Alleviation and Rural Development (NSPARD) and requested the Food and Agriculture Organization of the United Nations (FAO) to formulate a National Action Plan for Agriculture (NAPA), the agricultural component of the NSPARD. The Livelihoods and Food Security Trust Fund (LIFT) operated by UNOPS provided financial support to NAPA. This study of the rural financial service sector in Myanmar presents findings of the preliminary sector diagnosis and identification of priority areas for investigation and analysis with an emphasis on those aspects most relevant to smallholders and poorer rural households.

Poverty in Myanmar is predominantly a rural phenomenon and nearly 75 percent of the total population resides in rural areas and is principally employed in agriculture, livestock and fisheries to sustain livelihoods. The extent of rural poverty varies widely according to principal activities and asset holdings. While the crop sector tends to be the major sector regarding food security and income, the others have an important role in sustaining the livelihoods of the rural poor, both in terms of on- and off-farm support. The resource-poor rural inhabitants are among the poorest segments of the rural population. One of the primary reasons for this high poverty rate is their lack of access to productive assets, including capital. These poor people have high incidence of debt distress and are usually unable to generate sufficient income. They take small short-term loans to make up their income deficit primarily to meet basic household consumption needs. In order to repay the loans, they usually take more loans. This process of taking loan after loan continues for years and years and is often passed along to the next generation. Among the principal coping mechanisms of the poor is incurring debt followed by reducing food consumption, sale of livestock and seeking wage employment elsewhere.

Myanmar's population is thinly served by financial services. The microfinance providers in Myanmar comprise a variety of formal and informal actors. Provision of financial services in rural areas remains a challenge. The financial service providers include commercial banks, unregulated money lenders, other unregulated providers, and pawnshops, the Myanmar Agricultural Development Bank (MADB), unregulated agricultural input providers, cooperatives, microfinance institutions (MFIs) and rice-specialized companies.

Commercial banks dominate the financial sector. They have traditionally been urban-oriented and are generally not interested in providing microfinance services. Commercial banks are neither structured nor geared to extend microfinance. Private Banks are not involved in microfinance, partly for regulatory reasons and partly because of lack of interest. Commercial banks are the biggest providers of regulated credit. While commercial bank branches appear to have the largest retail network, their concentration in urban areas means that most of the population lacks access to them.

Rural outreach is largely driven by State Financial Institutions (SFIs). There are four state-owned banks in Myanmar – the MADB, Myanmar Economic Bank (MEB), Myanmar Investment and Commercial Bank (MICB) and Myanmar Foreign Trade Bank. State-owned banks, such as the MEB) represent the largest provider of deposit services in Myanmar. While it does not engage in microlending, the MEB provides subsidized funding to the MADB at a subsidized rate of 4 percent. SFIs, driven largely by the MADB, have a rural focus as opposed to the urban-focused commercial banks. The MADB has about half of the estimated microclients and is the largest formal credit provider, but it does not meet all demand in its core focus area of seasonal paddy. A significant number of small farmers cannot provide right-of-use documents and therefore are not eligible for such loans. Further, MADB loans are

often not disbursed in time to finance the necessary preparation for the planting season and loan repayment is due when the crop prices are at their lowest (immediately after harvest). Consequently, farmers are often forced to source additional credit, mostly from money lenders at high cost as an interim financing measure. Also, these loans are at times too small to meet the financing needs of farmers. The balance amount is obtained from money lenders.

MFIs operate in more densely populated towns and cities that are not very rural and not considered to be low-income areas. Two notable exceptions are PACT and Proximity (INGOs). PACT, the largest MFI in Myanmar, and Proximity are the only MFIs with a rural focus, largely driven by their donor mandate. Most MFIs lack the financial capacity, management or operating models necessary for the efficient delivery of rural finance. MFIs vary widely in their ability to design and deliver microfinance services. Many MFIs run programmes which are not sustainable and need considerable cross-subsidization. Access to liquidity and institutional capacity remain the two key challenges to sustainable growth and outreach. Achieving scale will require increased capacity of the sector to manage risks, increase efficiencies and renew focus on operational sustainability and commercial viability. A key challenge to MFIs is rising the necessary funding to permit growth. MFIs rely considerably on non-commercial funding. MFIs have a very limited range of products and generally lack the knowledge to diversify their products. Most of the MFIs have restricted their outreach to urban and peri-urban areas and many of them have yet to develop effective outreach services for rural areas or a diversified set of products for poor households. The existing paper-based banking/payment systems are unsustainable and impact on cost and scalability.

The limited reach of regulated financial infrastructure in Myanmar has resulted in significant dependence on unregulated and often informal infrastructure to meet risk mitigation needs, especially amongst the rural population. Due to existing supply constraints, consumers are reliant on informal credit which is expensive. The unregulated financial sector constitutes the largest source of borrowing. According to LIFT's report the total outstanding debt provided by unregulated money lenders is estimated to be as high as US\$3.9 billion. The unregulated financial sector constitutes the largest source of borrowing. Thus, there is a great need to expand financial services in Myanmar.

The evolving investment climate and the rapidly evolving regulatory environment are yet to fully support financial inclusion. Laws and regulations are still being finalized, and in instances are not yet fully supportive of financial inclusion. There is for example a need generally to improve the balance between regulation and commercial decision-making, and to review specific regulations, e.g. credit and interest rate caps. There is also a need to boost supervisory capacity across the board.

Myanmar has a capital-constrained regulated retail financial sector. All financial institutions suffer from a capital constraint that limits their ability to extend credit. There is also lack of sustainable business models to serve rural areas. The public sector relies on subsidies while the private sector is not yet sustainable in rural areas as the cost of doing business is high (low infrastructure base, lack of scale, weak systems.). Regulated credit take-up in rural areas is mostly driven by subsidized credit. Under current circumstances rural outreach depends on access to subsidized funding. Current interest rate caps do not enable or incentivize formal MFIs to enter into new and more challenging markets. MFI capacities are also limited. Their systems and capacity appear to be limited and they appear currently not to have the operational infrastructure to achieve scale. Many institutions and especially SFIs who serve most low-income clients utilize paper-based systems.

Based on the foregoing analysis, there is a need to reduce the extensive poverty in rural areas by providing opportunities for increasing income and improving the living standards of rural communities through provision of income-augmenting opportunities via provision of affordable credit. Increasing access to financial services is a major goal of the government. In line with government policy, the NAPA project, through its rural financial services, will contribute to rural poverty reduction through income-enhancing rural livelihood interventions. Incomes in rural areas are low and poverty is widespread. The poorest groups are the disadvantaged, resource-poor and marginal farmers, especially those with small (usually less than 2 ha) landholdings, the landless who are dependent on livelihoods from farm labour, small businesses, livestock or subsistence fisheries, especially vulnerable female-headed households and particularly vulnerable national ethnic groups.

The major challenge and critical factor at the farm level is the provision of more and *reasonably-priced* credit, as well as the delivery of extension services so that credit can be put to good effect by borrowing farmers. Further, microfinance providers continue to cover only those who have either some extant microenterprise or an asset base which gives a degree of assurance to the lending agency for recovery in case of default. This leaves most of the chronic poor with few skills and no asset base.

There is lack of responsive and sustainable *institutional finance* that will provide rural households with permanent, reasonably priced and accessible financial services for various needs, a key factor to poverty reduction and enhancing rural development. Another major challenge in developing *inclusive* rural finance is the higher risks and costs involved relative to urban financial services. The rural market is largely dominated by an agricultural economy and low-income households that are perceived as high risks. Poor infrastructure and lower population density also result in higher transaction costs. Thus the overall penetration rate of microfinance remains low and the microfinance market is characterized by a high degree of portfolio concentration in and around major cities.

Efficiently and effectively delivering financial services in rural areas is particularly challenging. There is a need to identify an appropriate delivery mechanism that will contain the transaction costs, increase outreach and effectively target the rural poor and women. Community organizations may offer new avenues for microfinance. Village-level community organizations could evolve into more formal credit and savings organizations that could be provided with additional seed funding to extend lending, subject to regulatory issues being resolved and the introduction of appropriate systems and processes. The Community Managed Financial Service (CMFS) model has the advantages of rural outreach, poverty outreach, flexibility, savings and community development. However, the major limitation of this approach is the absence of professional management. Community groups under this model require strong technical support in financial service management.

However, for rural microfinance development to succeed, experience has shown that a stable macroeconomy and a liberalized financial environment are essential. In order to encourage financial intermediaries to enter rural markets the government needs to play an effective role in establishing a favourable or enabling policy environment, infrastructure and information system and supervisory structures to facilitate the smooth functioning of the rural financial market. It is important that various components of the policy, legal and regulatory framework are coherent, consistent and mutually reinforcing in order to develop a vibrant financial market. The guidelines must be consistently applied to all stakeholders to ensure a level playing field that promotes healthy competition and efficiency.

The proposed NAPA microfinance project will support the development of a vibrant, responsive and inclusive rural finance industry that will provide institutional self-sustaining financial services for rural areas. The project will provide strategic interventions as follows:

Policy reform advocacy

Policy reform advocacy targets policy-makers and supervisory bodies through detailed assessment of policy and regulatory frameworks to identify issues, the need for pro-poor innovations and an enabling environment for inclusive rural finance. More specifically it will provide (a) multipronged support for intervention activities for all stakeholders in the following areas:

- (i) **Policy framework:** Three areas need consideration. First the interest rate regime needs to be reviewed to ensure that the banks are able to sustainably lend to the agriculture sector in rural areas. Second, the need to allow the cooperatives and MFIs to mobilize savings from the both borrowers and non-borrowers will have to be reviewed coupled with adequate regulatory measures and deposit insurance. Third, a policy for allowing the MFIs to emerge as a full-fledged microbank under the supervision of the Central Bank of Myanmar will have to be formulated.
- (ii) **Regulatory framework:** The existing regulatory framework for banks (both public sector and private sector), MFIs and cooperatives will have to be reviewed and suitable recommendations for establishing a strong regulatory framework to secure citizens' savings will have to be made.
- (iii) **Outreach expansion:** Outreach expansion is critical for expanding delivery of financial services. Government support for banks to expand into the unbanked areas will have to be worked out. This needs to be coupled with product development to ensure that the rural poor are able to access financial services with minimal transaction costs.
- (iv) **Technology adoption:** Technology adoption is critical to bring about transparency and accountability in the banking sector. Technology in the form of computerization and core banking software is critical for real-time branch performance assessment.
- (v) **Agriculture and microfinance refinance mechanism:** The existing system of refinance by the MEB will have to be reviewed. A sustainable system of refinance provision to the public sector banks for agriculture lending and also to the MFIs and cooperatives for lending will have to be developed.

It is not possible at this stage to provide budgetary estimates for these interventions as some donors are already working in these areas.

Community-managed financial services (CMFS)

The strategy for CMFS is to efficiently provide a range of affordable financial services to resource-poor rural communities who disproportionately bear the burden of poverty. Services provided at affordable prices will have a significant poverty reduction impact by increasing the incomes of poor households, enhancing outreach (especially to women), building social capital and reducing the risks faced by the poor. In line with the project's gender and development objectives to empower rural women, CMFS is designed to enable women to become full participants in and beneficiaries of the project.

There will be a gradual transition from the MFI-operated microfinance system to microfinance controlled and managed solely by each village organization. Instead of immediately relying on community capacity to manage financial services, an experienced microfinance institution will operate, train and then transfer resources to the communities.

The use of an experienced microfinance provider with an intensive emphasis on capacity development within community groups, considerably lessens the risks of poor financial management at the community level, allows time for confidence building among community executive members and provides an integral exit strategy within the project. Further, CMFS will enable rural women to become full participants and beneficiaries as the loan recipients. The CMFS component has two principal innovative features: the introduction of financial services to the rural poor and the gradual transfer to the community of the control of financial service management, operations and resources, which also provides an intrinsic exit strategy for the project.

MFI/INGOs constitute a potentially vital channel through which financial resources can be channeled to the village organizations for on-lending to the target group. The accreditation of the MFI/INGO under the project will be based on selection criteria. The MFI/INGO will on-lend to the ultimate beneficiaries. It will build community capacity to utilize and eventually manage financial services. The selected MFI/INGO will have the capability to combine microfinance/microenterprise and other rural lending operations to support individual borrower graduation.

Most of the poor live either in the Central Dry Zone (CDZ) – where soils are sandy, rainfall low and density high – or in hill tracts populated by ethnic groups, which are remote, have limited arable land and have been affected by conflict. In line with the government's targeting policy, the NAPA project will target the risk-prone areas in the CDZ. Although the intervention will target the country as a whole in the longer term, initially NAPA will target assistance to the rural poor in the CDZ by providing access to rural financial services. This will be achieved through income-enhancing rural livelihood interventions at the village level that will have direct benefits to the primary target group of NAPA. The approach used in the CDZ may be replicated in other regions. Selection of priority townships and village tracts in the CDZ would be based on the composite poverty profile, livelihood enhancement potential, capacity of the recipient beneficiaries evidenced by prior involvement and exposure and or state of readiness of development plans at the village tract or village levels, low donor density or unserved areas, a conducive security situation and relative ease of market access.

Under CMFS, three interventions are proposed for implementation over the five-year period: (a) seed capital grant of US\$5 million to finance the requirements of resource-poor rural communities in the CDZ; (b) community capacity building focused on strengthening the capacity of the main stakeholders to effectively manage financial services;¹ and (c) management support intervention through which incremental management resources will be provided to enable the MFI/INGO to take on added management responsibilities. This intervention will cost approximately 2 percent of total costs.

The rural financial services will be implemented over a period of five years. It will be divided in two phases. In Phase 1 which covers the first three years, CMFS will be concentrated in the townships/village tracts in the CDZ. Assuming a positive mid-term review the component would be expanded in scope and replicated in other areas in the country. Phase 2 involves an expansion of activities during the remainder of the implementation period.

¹ Although some training would be provided to the concerned staff of the participating MFI/INGO, most of the resources would be dedicated to training and capacity building of community organizations at the village tract level. In addition to training and capacity building, office equipment or motor bikes will be provided to the relevant staff of the INGO. The community capacity building component comprises 15 percent of total costs.

1. INTRODUCTION

The Government of Myanmar has given high priority to poverty alleviation. In this context it has articulated a National Strategy on Poverty Alleviation and Rural Development (NSPARD) and requested the Food and Agriculture Organization of the United Nations (FAO) to formulate a National Action Plan for Agriculture (NAPA), the agricultural component of the NSPARD. The Livelihoods and Food Security Trust Fund (LIFT) operated by UNOPS provided financial support to NAPA. . The NAPA project aims to provide strategic and comprehensive plan to provide guidance for the effective implementation of the NSPARD.

Poverty in Myanmar is predominantly a rural phenomenon. Poverty remains widespread and is twice as high in rural compared to urban areas; as a result rural areas account for almost 85 percent of total poverty incidence. Agriculture is overwhelmingly the largest contributor to rural employment in Myanmar, including poor and vulnerable households, and fosters local economic growth and social stability in rural areas. Agriculture not only provides food security for farmers but is also the backbone of the national GDP. The agriculture sector contributes 34 percent of the GDP and employs 63 percent of the labour force. About 75 percent of the total population resides in rural areas and is principally employed in agriculture, livestock and fisheries to sustain livelihoods. The agriculture sector in Myanmar continues to suffer from major inefficiencies. Agriculture is underdeveloped with most farms generating very low yields. Myanmar's agriculture suffers from a compounded problem of lack of infrastructure and market structure. The resulting inefficiencies impact all market participants and keep the sector from being competitive.

Financial services play an important role in determining the competitiveness and profitability of the agriculture sector and are vital in ensuring that agriculture can generate the incomes for producers and other participants in the value chains that extend from input supplies to retail sales. Access to finance in rural areas has lagged behind the country's growth and development needs and it appears to be an important constraint for further development of the agriculture sector in general.

The government has made significant progress in the last two to three years in developing and reviewing laws and regulations and redefining the financial landscape in Myanmar. It is important that various components of the policy, legal and regulatory framework are coherent, consistent and mutually reinforcing in order to develop a vibrant financial market. The operating guidelines must be consistently applied to all stakeholders to ensure a level playing field that promotes healthy competition and efficiency. There is a need to move towards properly regulated but market-determined rates for savings and lending that will encourage improvements in capital supplies.

This study of the rural financial service sector in Myanmar is one of the studies commissioned by FAO for formulating the NAPA. The mission was conducted during November to December 2014 and the sector study was carried out in a participatory manner by encouraging participation of stakeholders at all levels to ensure diversity of inputs and to foster ownership by a wide range of stakeholders and the government. This report presents findings of the preliminary sector diagnosis and identification of priority areas for investigation and analysis with an emphasis on those aspects most relevant to smallholders and poorer rural households.

2. BACKGROUND

The financial service sector in Myanmar is small and underdeveloped. The financial service providers in Myanmar include commercial banks, unregulated money lenders, other unregulated providers, pawnshops, the MADB, unregulated agricultural input providers, cooperatives, MFIs and rice-specialized companies.

Rural outreach is largely driven by SFIs. There are four state-owned banks in Myanmar (the MEB, MADB, MICB and Myanmar Foreign Trade Bank). However, a large proportion of the MEB's outstanding loan book in 2013 consisted of wholesale funding to the MADB which it uses to fund loans to farmers. State-owned banks, such as the MEB represent the largest provider of deposit services in Myanmar. The MEB provides retail lending as well as wholesale financing to various government-linked initiatives. While it does not engage in microlending, the MEB provides subsidized funding to the MADB. Lending to the MADB makes up just over half of MEB loans at subsidized rate of 4 percent but, at the same time, the MEB only lends out 11 percent of its deposits. It also provides wholesale loans to the Small and Medium Industry Development Bank (SMIDB). The MEB has incurred substantial losses over the last few years due to subsidized funding to the MADB. Given the rapid expansion of the MADB loan portfolio in the recent past, which it has achieved through an increased MEB loan facility, MEB losses are likely to have substantially increased.

Although private banks also cover all 14 regions, SFIs, driven largely by the MADB, have a rural focus as opposed to the urban-focused commercial banks. Similarly, MFIs operate in more densely populated towns and cities that are not very rural and not considered to be low-income areas. Two notable exceptions are PACT and Proximity (INGOs). PACT, the largest MFI in Myanmar, and Proximity are the only MFIs with a rural focus, largely driven by their donor mandate. The limited reach of the regulated financial infrastructure in Myanmar has resulted in significant dependence on unregulated and often informal infrastructure to meet risk mitigation needs, especially amongst the rural population.

Financial service providers in Myanmar are as shown in Table 1.

Table 1: Overview of the credit provision landscape in Myanmar

Provider	Client base as % of adults who currently owe money	Total loans outstanding
Commercial banks	0.3%	39.8%
Unregulated money lenders	31.0%	36.0%
Other unregulated providers	22.9%	16.1%
Pawnshops	16.4%	4.0%
MADB	8.4%	1.9%
Unregulated agricultural input providers	7.9%	0.7%
Co-operatives	4.4%	0.6%
MFIs	3.7%	0.8%
RCSs	0.1%	0.1%
Total	18 907 935 adults	K 10.3 trillion

Source: Supply side data, FinScope 2013, author's calculations

Banks

Commercial banks dominate the financial sector. They have traditionally been urban-oriented and are generally not interested in providing microfinance services. Commercial banks are neither structured nor geared to extend microfinance. Private banks are not involved in microfinance, partly for regulatory reasons and partly because of lack of interest. Commercial banks are the biggest providers of regulated credit. While commercial bank branches appear to have the largest retail network, their concentration in urban areas means that most of the population lacks access to them. Commercial banks are the largest credit providers in terms of volume of loans outstanding, but one of the smallest in terms of number of clients. Many of their clients are commercial clients, not retail. Commercial banks predominantly provide credit for very high-end income.

Excluding commercial banks, the proportion of total loan volumes of financial service providers is given in Table 2.

Table 2: Comparison of credit providers, excluding commercial banks

Providers	Proportion of total loan volumes of selection of providers
Unregulated money lenders	60%
Other unregulated providers	27%
Pawnshops	7%
MADB	3%
Unregulated agricultural input providers	1%
Co-operatives	1%
MFIs	1%
RCSs	0.1%

Source: Supply side data, FinScope 2013, author's calculations

Unregulated money lenders

The rural finance market has traditionally been served by informal arrangements. Such informal sources mainly supply short-term credit at terms that reflect the weak bargaining power of the borrower. Money lenders are present in almost all wards or villages. Money lenders are providing a significant proportion of loans to the market. Credit extended by money lenders exceeds the number of credit clients of the MADB and the estimated loan volume of outstanding loans with money lenders is on a level comparable to commercial banks. A direct implication of this form of unregulated provision, is that much of financial intermediation in Myanmar is individualized (i.e. individuals with savings directly extend credit rather than intermediating savings through a financial institution). This limits the financial sector's ability to aggregate savings and to facilitate large-scale investment. The money lenders as a group are comparable to the commercial banking sector in terms of the size of their total outstanding loan volumes.

In addition to the providers discussed above, there are various other unregulated community-based providers of credit. Community-based assistance groups provide financial and non-financial support. Community-based organizations, such as village revolving funds and village savings and credit groups also exist. Community-based assistance groups like free funeral

societies seem much more prevalent. These groups provide assistance for health, education, the elderly etc. as well as money for various welfare purposes.

Pawnshops

Pawnshops are estimated to be one of the largest categories of providers in terms of both number of clients and loan volumes, but provide no net additional funding (only offers value of gold). The gold held by pawnshops cannot be leveraged or intermediated through the rest of the financial system. There are both regulated and unregulated pawn shops. Unregulated pawnshops are common in most wards or villages.

MADB

1. The MADB is the single largest regulated provider in terms of number of clients and is the largest individual regulated provider by loan book value. It also has the second largest branch network (205 branches). The MADB provides loans across three seasonal cycles. It provides two categories of loans – seasonal and term loans. Seasonal loans constitute 98 percent of MADB loans. Around 90 percent of MADB loans are concentrated in paddy. Seasonal loans are structured as group loans with five to 10 farmers in each group. The MADB provides loans to farmers on a maximum amount per acre basis, up to a maximum of 10 acres, and farmers tend to take the maximum loan amount. This maximum amount per acre has increased continuously over the past few years from as low as 8 000 kyat² per acre in 2009 to the current level of 100 000 kyat per acre for paddy and 20 000 kyat per acre for other crops. Farmers are required to have the necessary documentation to verify the farmer's right to use the land for agricultural activities. Loans are approved at MADB branches and the village tract committee is involved in the approval process. Farmers obtain and repay loans in person and in cash at the MADB branch. Loans are repaid immediately after harvest. Both interest and principal are repaid at the end of the loan term (harvest). The MADB charges 5 percent *per annum* interest on their loans. The MADB provides financing for a limited number of crops and does not finance the production of fruits and vegetables. MADB products are designed to support the working capital needs of the customers it serves by covering a fraction of the production cost. Interest rates on MADB loans have been reduced substantially over the last five years. The MADB currently charges 5 percent *per annum* interest on loans, which is a substantial discount compared to loans by other market players. This is made possible by the subsidized finance provided by the MEB. Prior to 2012, the MADB charged interest rates of between 13 and 18 percent on its loans. During this period, the bulk of loans was funded from compulsory savings on which the MADB paid 8 percent interest. The institution managed to generate a surplus during this time and was, therefore, able to operate on a sustainable basis. The term loan is currently provided for farm machinery, sugarcane and plantation crops, salt production, etc. Farmers are to deposit 30% of the value of farm machinery while the remaining 70 percent of the amount is given as a term loan by BADB on 1 to 3 years

² US\$1.00 = 1 164 kyat (April 2016).

term of repayment. Similarly term loan is also provided for solar salt production and for plantation crops like coffee, rubber and sugarcane, etc., on 1 to 3 year term basis.

Agricultural input providers

Agricultural input providers offer small loans to a large number of farmers. There is substantial reach of agriculture input credit. There are numerous companies providing agricultural inputs on credit. This is a sizeable segment of total agriculture credit provision.

Credit take-up of groups involved in farming is given in Table 3.

2. **Table 3: Credit take-up over groups involved in farming** the following table:

	Farming groups	Main income farming	Farming as secondary income	Family dependents of farmers	Total
Number of adults		12 098 928	3 264 502	4 412 523	19 775 953
Number of adults in each group with (loan):	MADB loan	3 748 655	470 286	895 272	5 114 213
	MFI loan	586 761	206 979	97 014	890 754
	Any regulated loan	4 478 014	776 636	1 149 954	6 404 604
	Any regulated or unregulated loan	6 181 984	1 393 378	1 802 184	9 377 546
% of adults in each group with (loan):	MADB loan	31.0%	14.4%	20.3%	25.9%
	MFI loan	4.8%	6.3%	2.2%	4.5%
	Any regulated loan	37.0%	23.8%	26.1%	32.4%
	Any regulated or unregulated loan	51.1%	42.7%	40.8%	47.4%

Source: FinScope 2013

MFIs

The formal MFI sector in Myanmar is made up of a diverse set of institutions including INGOs, domestic NGOs, cooperatives, domestic and foreign for-profit companies. Registered MFIs serve a total client portfolio of 690 000. The bulk of MFI clients is served by INGOs, which have 82 percent of loan clients. MFI cooperatives (including the CCS and its branches) serve about 15 percent of MFI clients, while local NGOs and for-profit MFIs serve only around 3 percent of all MFI clients. Domestic NGOs and for-profit MFIs are all relatively young, as they could only recently enter the market with the adoption of the Microfinance Law in 2011. Very little information is available on them. MFIs are not allowed to take deposits from non-borrowers.

The United Nations Development Programme (UNDP) initiated a microfinance project during the second phase of UNDP's Human Development Initiative in 1997. The project activities were initially implemented by three international NGOs (Grameen Trust from Bangladesh in the Delta Region, GRET from France in Shan State and PACT from the United States in the CDZ. In 2006, project implementation across three regions was consolidated under one management system and PACT was selected as the sole implementing agency. In 2012, PACT started a separate programme in Myanmar called PACT Global Microfinance (PGMF). Before the passage of the Microfinance Law in November 2011, only PACT UNDP was allowed to operate

in Myanmar legally. All others operated without legal status, which essentially prevented them from developing or scaling up their microfinance programmes. Since then, most INGOs and NGOs have received MFI licences. The leading institutions namely PACT, GRET, Save the Children and World Vision have reached over 450 000 active borrowers with an aggregate loan portfolio of over US\$69 million.

PACT is the largest MFI and serves approximately 74 percent of all active MFI clients and contributed to 90 percent of the total INGO clients reported as of March 2013 (PGMF: 16 percent and PACT MF: 74 percent). PACT also held 65.4 percent of all MFI outstanding loans as of March 2013.

PACT Myanmar and PGMF are operating on a near identical basis from the same management structure but focus on separate geographic areas. They both provide uncollateralized productive loans (loans for income generation) to individuals on a group basis (solidarity lending model) where group members are held liable for each individual's loan and have a focus on women and the poor. PACT MFP's main loan product (regular loan) is provided for businesses/SMEs on a group basis. These regular loans are for amounts up to 200 000 kyat with a term of one year and interest rate of 2.5 percent per month. Successful borrowers can graduate to individual microenterprise loans of 500 000 kyat with the same term and interest rate. Some clients have progressed to larger loans overtime. PGMF follows a similar product structure with a slightly lower loan size. PACT MFP provides an agricultural loan to 19 percent of its borrowers. The loan size is 250 000 kyat and interest is 2.5 percent per month with a term of five months. PACT's agricultural loans are therefore seasonal and are mostly monsoon paddy loans, with some loans to pulses and rice. They limit farm size to 5 acres to retain focus on the landless and marginalized farmers. PGMF also offers a similar agricultural loan for up to 200 000 kyat at 2.5 percent interest per month. PACT also extends a variety of personal loans to a smaller number of existing clients. Both PACT MFP and PGMF provide a health loan and an education loan at interest of 2 percent per month. They also provide consumer loans and small and vulnerable loans.

For all categories of MFIs, compulsory deposits contribute a limited proportion of loan funding and they have been unable to attract sufficient volumes of voluntary deposits. As such, INGOs and NGOs are funded by donors and expansion is dictated by donor interests. In a number of cases, funding is tied with a particular mandate or instruction, which may fall beyond the current capacity and experience of a particular MFI (e.g. to lend to a particular region or sector). The remaining MFIs are either for-profit MFIs or cooperatives that have registered as MFIs. Domestic for-profit MFIs are largely funded by owners' capital and stay in areas that they can make profits (urban, densely populated, higher income).

Most MFIs reported strong growth over the last year. Given their inability to raise voluntary deposits as a means of financing loans, MFIs are dependent on owners' capital, donor funding and other wholesale funding to expand their portfolios. Recent growth seems to be driven more by the availability and/or release of funding rather than an explicit expansion strategy. In some cases, the constraint on capital is a result of regulatory constraints on increasing foreign funding or increasing registered capital.

In a number of cases, donor funding comes with a particular mandate or instructions, which may fall beyond the current capacity and experience of a particular MFI (e.g. to lend to a particular

rural region or agriculture sector). In most cases, this will require the MFI to serve new clients, which requires new branches in new locations. Given the shortage of funds, some MFIs have accepted such directed funding without necessarily having the capacity to deliver to those particular regions/states and sectors (e.g. extending loans in particular rural areas where they may not have branches or experience or extending loans to agriculture without any knowledge of or experience in this sector). While it may catalyze innovation, the additional funding also places added strain on the already limited capacity of the MFIs, which can jeopardize their overall operation.

The management information systems (MIS) and system capacity of MFIs is still evolving and staff capacity is a major constraint.

Cooperatives

There are three different types of cooperatives involved in the provision of financial services. Cooperatives licensed as MFIs, financial cooperatives and agricultural cooperatives. There has been a rapid expansion of credit through agricultural cooperatives. Most of these cooperatives have only started lending to their members recently as a result of funding being channeled to agricultural cooperatives, which was obtained from the Export-Import Bank of China. Cooperatives and pawnshops have the largest regulated footprint in Myanmar amongst credit providers. Cooperatives offering financial services have the largest regulated distribution footprint with 7 635 branches. Agricultural cooperatives, which account for 5 222 branches, have a greater reach into rural areas but have only recently started offering credit to their members. Financial cooperatives, which account for 2 268 branches, operate almost exclusively in urban areas.

Rice-specialized companies

Only one rice specialization company remains operating in delta. Although 57 Rice Specialization Companies (RSCs) were registered in 2008, currently only Gold Delta is still operating. RSCs have very limited reach as they usually operate in one township only, with contract farmers farming around a core or nucleus farm owned by the RSC. RSCs were originally created in 2008 as part of a government-initiated regime to improve access to farm inputs (including credit) whereby large investors/registered firms “were encouraged to provide paddy inputs on credit under contract farming schemes in return for rice export permits”. Initially, RSCs seemed to have a positive impact on the rice industry resulting in an increase in rice exports from 2008 onwards. However, according to a United States Agency for International Development (USAID) study, the poor performance of the RSCs in Myanmar was expected because “while contract farming schemes can work well for highly specialized, high value export commodities, they are unlikely to prove commercially sustainable for low-value commodities with broad market outlets, such as ordinary rice.” According to the study, contract farming is not a solution for Myanmar’s “weak rural credit systems and weak input markets”, given the current nature of agriculture in Myanmar. Weather risk has further undermined the viability of production and therefore, credit provision. The failure of RSCs has at least partially been ascribed to the “heavy cost of input finances and poor repayment rates resulting from crop losses, flooding and low paddy prices”. Currently, the largest rice specialization company that still provides credit, Gold Delta, has 2 000 farmers owing (a third of their farmers) who are unable to repay their current loans because of poor harvests caused by flooding.

3. SPECIFIC AREAS/ASPECTS OF THE THEMATIC AREA UNDER REVIEW

The United Nations Capital Development Fund (UNCDF)/LIFT report on The Myanmar Financial Inclusion Roadmap states that there is a need to expand access to financial services in Myanmar. Overall financial sector penetration is low. According to the Making Access to Financial Services Possible (MAP) report of 2013, over 70 percent of adults do not have formal access to credit, deposit and other financial services such as insurance and remittance. The report further states that although 30 percent of the 39 million adults use regulated financial services, only 6 percent of adults use more than one service. Only 5 percent of adults have a bank account in their name.

The outreach of regulated financial service providers in the rural areas is limited. Their reach is concentrated in urban areas. Most citizens rely on unregulated providers, or family and friends to meet their needs for financial services. The costs of services provided by unregulated providers is much higher than those offered by regulated providers. Use of informal providers of credit is widespread despite the high cost (10-20 percent per month).

The crop sector is particularly exposed to credit shortages. Lack of credit prevents producers from borrowing from the regulated providers for inputs and prevents traders from investing in more efficient handling, storage and trading operations. The consequences of lack of credit are cyclical. Endemic problems of major agricultural crops include inadequate and insufficient input use and thus low yields, resulting in high cost of production, significant postharvest losses due to poor storage facilities, weak market information flow and instability in crop quality.

The most significant barrier to credit is the lack of funding to meet demand, but in addition the current unsuitable products (loan sizes, short-term nature, collateral requirements and group based delivery), regulated caps and loan terms limit the effectiveness of what is currently available. The current regulatory environment is not enabling expansion of rural provision, as constraints in regulation deter even mandated and subsidized operations from challenging rural markets (for example the current interest rate caps, loan sizes and capital regulations and the higher cost of rural provision are resulting in withdrawal of certain NGO MFIs from some rural markets).

For all categories of MFIs, ownership, funding and mandate differ by type of institution. Compulsory deposits contribute a limited proportion of loan funding and they have been unable to attract sufficient volumes of voluntary deposits. As such, INGOs and NGOs are funded by donor funding and expansion is dictated by donor interests. In a number of cases, funding is tied to a particular mandate or instruction, which may fall beyond the current capacity and experience of a particular MFI (e.g. to lend to a particular region or sector). The remaining MFIs are either for-profit MFIs or cooperatives that have registered as MFIs. Domestic for-profit MFIs are largely funded by owners' capital and stay in areas that they can make profits (urban, densely populated, higher income).

Estimated total rural finance demand and provision

According to the LIFT report, the most common sources of loans are money lenders and family and friends. Poorer households borrow mostly for food purchase and health emergencies, whereas higher income households borrow for input purchase and business investments. A large section of the population relies on informal lenders to meet their cash flow needs.

Table 4: Demand for credit

	Number of adults obtaining loans from unregulated providers	Total value of outstanding unregulated loans (range)
Total unregulated lending (proxy for demand)	9.2 million	K 3.6 trillion –K 5.4 trillion
Total rural unregulated lending (proxy for rural demand for credit)	7.1 million	K 1.9 trillion –K 3.5 trillion

Source: *FinScope 2013*

Agricultural production is to a large extent dependent on credit to fund inputs and to smooth consumption between harvests. Farmers represent the largest target segment for credit. Specific uses of agricultural financing include financing inputs (seeds, fertilizers, etc) prefunding of outputs and equipment financing. Farmers in remote areas have limited choice between providers and products. Farmers have high take-up of regulated credit but unmet demand exists. This high take-up is largely driven by the MADB and PACT to a lesser extent. Agricultural credit is the largest regulated credit product. Beyond MADB, the bulk of finances seems to be provided on an unregulated basis by input providers and value chain players. Other regulated agricultural products have limited reach. MFI agricultural portfolios are relatively small. Across all providers, the bulk of loans is for paddy rice. For example, the MADB provides a portion of the loan requirement and farmers often fill the gap by borrowing from informal money lenders who often charge 10-20 percent interest per month.

Six percent of the population obtain credit to start their own enterprises. Supply-side constraint is the main driver to low credit take-up. The demand for microloans is clearly reflected in the large supply of informal services. The main sources of loans for small-scale entrepreneurs are bazaar cooperatives, MFIs, pawnshops and unregulated money lenders.

Consumption is the largest driver of borrowing. A significant number of households borrow to fund living expenses. Consumption smoothing loans are required for individuals with irregular or seasonal income such as farmers, informal traders and the informal consumption credit sector. At present most consumption lending occurs through unregulated lenders. Productive loans are also fully or partially used for consumption smoothing. Inactivity during the rainy season results in increased borrowing for consumption purposes such as food.

Health and education loans are usually obtained from pawnshops, relatives and money lenders. Health and education loans are offered by some INGOs and NGOs. However, one usually has to be an active member, i.e. an existing loanee of the INGO/NGO. A substantial portion of adults

uses credit as a means to manage risk events. Overall, adults who experienced an unexpected event that affects their income borrow to cope financially. Credit is also obtained for on-lending (to on-lend for making profit from the interest rate differential). Credit is also obtained to repay other loans.

According to the UNCDF, the demand for microcredit is high. Unmet demand is estimated at US\$1 billion. While overall demand exceeds supply, according to the MADB there is potential for overindebtedness among farmers in some geographic areas. Based on the limited data available, it estimated that current microfinance outreach is US\$283 million. Relative to the enormous demand, there are few institutions that provide microfinance services that have the potential to reach a large scale while providing their services in a financially sustainable and responsible way.

According to a Finscope survey, demand for credit has been estimated by using total unregulated money lending as a static estimate for the demand for credit currently not met by regulated providers. A total of 9.2 million adults have outstanding loans with unregulated credit providers with an estimated total outstanding loan value of between 3.6 trillion and 5.4 trillion kyat (US\$3.8 billion and US\$5.7 billion). The total unregulated usage, and proxy for demand, thus lies between these two ranges. The same process also allows an estimate of the demand for rural credit as a subcomponent of overall credit at between 1.9 trillion and 3.5 trillion kyat (US\$2 billion and US\$3.7 billion). Unregulated credit take-up can be used as a proxy for latent demand for credit. The substantial proportion of current unregulated provision indicates significant absorption capacity for regulated credit (moving from unregulated to regulated). With the size of current unregulated loan volumes estimated at more than 450 percent of total regulated retail credit, i.e. total regulated credit excluding credit from commercial banks, the regulated market for credit would have to expand substantially in order to absorb unregulated credit clients.

Table 5: Number of adults and estimated outstanding loan book of unregulated loan providers

	Number of adults	Minimum total outstanding loans	Maximum total outstanding loans
Total unregulated borrowing	9.2 million	K 3.6 trillion (USD 3.8 billion)	K 5.4 trillion (USD 5.7 billion)
Total moneylenders	5.9 million	K 2 trillion (USD 2.1 billion)	K 3.7 trillion (USD 3.9 billion)
Total other unregulated	4.3 million	K 1.1 trillion (USD 1.2 billion)	K 1.7 trillion (USD 1.8 billion)

Source: FinScope 2013, author's calculations

Demand for formal savings is difficult to estimate. Past crises in the banking and cooperative sectors have eroded public trust in formal savings products. Only banks and SFIs are allowed to mobilize savings from the general public. Though savings mechanisms with self, family and friends are prevalent, the regulated financial sector – commercial banks, SFIs, regulated MFIs and financial cooperatives also offer savings and deposit facilities. The FinScope survey results indicate that SFIs serve the largest group of adults in terms of savings products (4 percent of adults save with an SFI), followed by MFIs (1 percent), private banks (1 percent) and finally cooperatives (0.5 percent). It is important to highlight that only the banks and SFIs are able to

mobilize savings from the general public, while MFIs and financial sector cooperatives are limited to taking deposits from their members.

4. INSTITUTIONAL ENVIRONMENT

The microfinance providers in Myanmar comprise a variety of formal and informal actors. Provision of financial services in rural areas remains a challenge. Even the expansion of microfinance has not changed this significantly. Most MFIs lack the financial capacity, management or operating models necessary for the efficient delivery of rural finance. MFIs vary widely in their ability to design and deliver microfinance services. Many MFIs run programmes which are not sustainable and need considerable cross-subsidization. Access to liquidity and institutional capacity remains the two key challenges to sustainable growth and outreach. Achieving scale will require increased capacity of the sector to manage risks, increase efficiencies and renew focus on operational sustainability and commercial viability. A key challenge to MFIs is raising the necessary funding to permit growth. MFIs rely considerably on non-commercial funding. MFIs have a very limited range of products and generally lack the knowledge to diversify them. Most of the MFIs have restricted their outreach to urban and peri-urban areas and many of them have yet to develop effective outreach services for rural areas or a diversified set of products for poor households.

Prior to the enactment of the Microfinance Law, many MFIs operated as programmes under specific MoUs with different government ministries without being registered as a domestic legal entity. With the introduction of the law, the interpretation is that MFIs are required to register as domestic legal entities but there is some uncertainty around the exact requirements. A number of MFIs have reported challenges in transforming to one of the registered legal entities permitted under the Microfinance Law. The first challenge relates to uncertainties around the legal identity requirement under it. In addition, there are also challenges relating to the mandates of global institutions and whether they can accommodate the restructuring required for transformation.

The evolving investment climate and the rapidly evolving regulatory environment are yet to fully support financial inclusion. Laws and regulations are still being finalized, and in instances are not yet fully supportive of financial inclusion. There is for example a need generally to improve the balance between regulation and commercial decision-making, and to review specific regulations, e.g. credit and interest rate caps. There is also a need to boost supervisory capacity across the board.

Myanmar has a capital-constrained regulated retail financial sector, which is mainly attributable to policy, regulatory and business model features and the absence of a capital market in Myanmar. As a consequence of the scarcity of capital, institutions without a specific low-income client mandate direct capital to more lucrative opportunities in the high-income and corporate markets. Clients who are unable to access regulated credit are resorting to more expensive services from unregulated institutions. Additionally, given the short-term nature of deposits funding loan portfolios, no long-term credit products are offered.

All financial institutions suffer from a capital constraint that limits their ability to extend credit. There is also a lack of sustainable business models to serve rural areas. The public sector relies on subsidies while the private sector is not yet sustainable in rural areas as the cost of doing business is high (low infrastructure base, lack of scale, weak systems).

Most MFIs reported strong growth over the last year. Given their inability to raise voluntary deposits as a means of financing loans, MFIs are dependent on owners' capital, donor funding and other wholesale funding to expand their portfolios. Recent growth seems to be driven more by the availability and/or release of funding rather than an explicit expansion strategy. In some cases, the constraint on capital was as a result of regulatory constraints on increasing foreign funding or increasing registered capital.

In a number of cases, it was reported that donor funding comes with a particular mandate or instructions, which may fall beyond the current capacity and experience of a particular MFI (e.g. to lend to a particular rural region or agriculture sector). In most cases, this will require the MFI to serve new clients, which requires new branches in new locations (presenting substantial challenges as noted below). Given the shortage of funds, some MFIs have accepted such directed funding without necessarily having the capacity to deliver to those particular regions/states and sectors (e.g. extending loans in particular rural areas where they may not have branches or experience or extending loans to agriculture without any knowledge of or experience in this sector). While it may catalyse innovation, the additional funding also places added strain on the already limited capacity of the MFIs, which can jeopardize their overall operation.

The limited infrastructure constrains business models and product offerings. Severe physical infrastructure inadequacies amplify distribution challenges. Additionally, the lack of electronic infrastructure drives up costs and limits scale (most financial service providers are in the early stages of adopting electronic management systems, and there is limited supporting financial sector infrastructure – credit bureau, payment systems, capital market, Forex market).

The MADB has about half of the estimated microclients. Until recently, its loans were largely funded from deposits but following a collapse in its deposit book the bulk of loans is now funded by a loan facility provided by the MEB at 4 percent interest *per annum*. In addition to the funding subsidy, MEB branches are also used by the MADB for much of its cash handling (as MADB branches are not all equipped to handle cash). This is an additional cost subsidy. MADB's documentation is in paper-based formats and the bank lacks a functioning IT system. MADB's management has in practice limited operational autonomy. All board members are appointed by the government. It has a weak internal control system. It has never been audited by the Central Bank. Its operational infrastructure is rudimentary. All documents in the MADB system including loan documents, customer identification and so forth are paper based. The record keeping system is outdated and inefficient. There is no electronic loan tracking system. Data processing is fully manual. The MADB has a limited MIS system.

The existing paper-based banking/payment systems are unsustainable and impact on cost and scalability: Many institutions, and especially SFIs who serve most low-income clients, utilize paper-based systems that are heavily reliant on low-cost labour to be sustainable. To offer improved products at scale they will have to modernize and recruit higher skills at higher prices.

MFIs operate on a variety of MIS systems ranging from largely paper-based (e.g. GRET) and Excel-based systems (Myanmar Microfinance, STC and PACT who are looking to move to a more advanced MIS system) through to more advanced MIS systems (World Vision installed the Kredits MIS system in late 2012). Some of the domestic MFIs have also noted donor support to implement microfinance MIS systems (Micro Banker Win). Moving to more advanced MIS systems will require substantial investment and also business process engineering that is

presenting challenges to some of the smaller MFIs. While it may require a period of consolidation to embed the more advanced MIS systems, it seems that the MFI sector is moving faster than the banking sector with regard to improving MIS systems, which should provide a platform for future growth. Even with the more advanced systems, challenges will remain to run a distributed branch network given the limited telecommunication connectivity and in some cases electricity only for short periods during the day.

Further, in the above context skills are limited and both the cost and availability of these skills is challenging. Finding suitably qualified and experienced domestic staff is a significant constraint. This relates to both head office management and technical staff (e.g. accountants) as well as branch-level staff. In initial stages of growth, MFIs are able to manage this from centralized head office staff. Beyond this, growth requires more decentralized operations, which requires higher-skilled staff at the branch level. MFIs also need to build up the institutional structure to manage such a decentralized system.

5. KEY OPPORTUNITIES AND CONSTRAINTS TO SECTOR DEVELOPMENT

Myanmar's population is thinly served by financial services. There is a high level of informality throughout the economy and a capital-constrained regulated retail financial sector. Limited infrastructure constrains business models and product offerings. Constrained product offerings undermine value to customers and the current regulatory environment is not enabling expansion of rural provision and may discourage delivery of financial services in rural areas.

Regulated credit take-up in rural areas is mostly driven by subsidized credit. Under current circumstances rural outreach depends on access to subsidized funding. Current interest rate caps do not enable or incentivize formal MFIs to enter into new and more challenging markets. MFI capacities are also limited. Their systems and capacity are limited and they have yet to build operational infrastructure to achieve scale. PACT is an exception. PACT also has an outreach to rural areas.

Generally, microfinance operators offer products designed to help micro- or small enterprises, meet production needs or enable poor households to meet primary needs. Products include income-generating loans, agricultural loans, consumer loans, health care loans, education loans, client welfare schemes and voluntary savings. Micro savings remain underdeveloped due to the limited number of suppliers and lack of savings culture.

Constrained product offerings do not meet consumer needs, and mismatches lead to an unmet need or a higher cost. An important shortcoming is inappropriate and inefficient products and services. These include inappropriate features, e.g. loan size, collateral, repayment timelines, cost; inflexible products when compared to informal products; arbitrage where money lending is highly profitable when compared to a savings account; limited service delivery points; inconvenient opening hours; and even unavailability, e.g. lack of savings opportunities/products, limited insurance product sets.

At the product level, each product faces unique barriers. Savings are particularly impacted by the lack of deposit and withdrawal points, and low interest rates which result in gold and private intermediation offering better value (8 vs 36 percent +). Regulatory constraints also limit savings growth. The most significant barrier to credit is the lack of funding to meet demand. Regulated

caps and loan terms limit the effectiveness of credit. The payment market is affected by the lack of electronic infrastructure. The insurance sector lacks a full range of suitable products. The business model limitation and culture lead to low quality and diversity of services, especially due to limitations in information systems and skills; the time required to develop new skills required e.g. risk assessment; and the prevalence of the old culture still in place (both in regulation and also in business).

The MADB has about half of the estimated micro clients. It is the largest formal credit provider, but it does not meet all demand in its core focus area of seasonal paddy. A significant number of small farmers cannot provide right-of-use documents and therefore is not even eligible for such loans. Further, MADB loans are often not disbursed in time to finance the necessary preparation for the planting season and loan repayment is due when the crop prices are at their lowest (immediately after harvest). Consequently, farmers are often forced to source additional credit, mostly from money lenders at high cost as an interim financing measure. These loans are also at times too small to meet the financing needs of farmers. The balance amount is obtained from money lenders.

Due to existing supply constraints, consumers are reliant on informal credit which is expensive. The unregulated financial sector constitutes the largest source of borrowing. The total outstanding debt provided by unregulated money lenders is estimated to be as high as US\$3.9 billion. The unregulated financial sector constitutes the largest source of borrowing. An estimated 9.2 million adults have a loan from an unregulated financial services provider, with an estimated total outstanding debt as high as 5.4 trillion kyat (US\$5.7 billion). The total outstanding debt provided by unregulated money lenders is estimated to be as high as 3.7 trillion kyat (US\$3.9 billion). There is a positive consumer perception of unregulated institutions and pervasive use of cash.

There is a great need to expand financial services in Myanmar. The Myanmar population is thinly served by financial services. The key opportunities in sector development include significant demand for credit and other financial services.

The largest priority market in Myanmar is the farmers. The financing needs of the agriculture sector in Myanmar are huge. Although a growing number of MFIs and informal lenders are serving farmers, they have limited capital and the demand for credit in the agriculture sector remains largely unmet. Moreover, informal lenders usually lend at interest rates of 6 to 10 percent or more per month or 72 to 100 percent per year, creating a trap for many debtors who have become highly indebted and are unable to repay their loans. Reportedly many farmers actually borrow from the MADB simply to roll over debt or pay off the high interest loans provided by informal lenders. The rural credit market is larger than the urban credit market both in terms of absolute and relative number of loan clients. This is due to the larger rural population as well as the higher percentage of rural residents obtaining credit. Credit take-up is significantly higher in economic groups that are based in rural areas. Credit is used for multiple purposes. Myanmar's agriculture production is to a large extent dependent on credit to fund inputs and to smooth consumption between harvests. Farmers represent the largest target segment for credit. These farmers are often in remote areas with limited choice between credit providers and products. Consumption lending mainly happens through unregulated lenders. Inactivity during the rainy season results in increased borrowing for consumption purposes such as food. Farmers have a high take-up of debt but unmet demand still exists. High levels of unregulated credit

usage indicate demand for additional credit and credit products. Farmers report a high need for regulated insurance products. Farmers save in cash at home, save in livestock as well as gold to manage the impact of unusual risk events.

There are other critical (if comparatively smaller) markets in Myanmar that also require access to credit in order to facilitate important aspects of development. The creation and development of small enterprises for instance is critical to facilitate the long-term transformation from an agriculture-based economy to production. Informal enterprises are in fact the next largest economic group (although informal consumers are the largest target group) after farmers consisting of 4.7 million adults, 52 percent of whom are in rural areas. Regulated credit take-up among informal enterprises is only 11 percent while 36 percent borrow from unregulated sources or from family and friends. MFIs can also offer more advanced and longer term agricultural finance to complement that of the MADB. Even though the largest segment of the population is rural, and any major attempt to accelerate the expansion of access should also include a rural focus, some providers are unlikely to serve the rural market soon due to several factors. Within current constraints, MFIs are unlikely to provide rural credit at scale. Although the government's intention is for the MFIs to focus on rural areas, most MFI clients are reported to be urban. This is in part due to regulatory constraints, as the current interest rate and loan caps do not enable or incentivize formal MFIs to enter into new and more challenging markets (even those with developmental mandates). However, MFI capacities are also limited. As noted, most MFIs are in the process of implementing MIS systems or considering this. Combined with strengthening of operations and business processes, this may over the medium term put them in a position to accommodate further expansion. Even if feasible, expansion of capacity needs time and can only be achieved through intense and extensive capacity-building efforts the availability of which is also limited and further constrained by generally low levels of education. Given the current regulatory and market situation, initial indications are that MFIs are unlikely to rapidly expand credit provision on a large scale, not only in urban areas, but more so for rural areas which is more challenging. PACT is the exception. PACT seems to be an exception when constraints noted by other MFIs are considered. PACT is much closer to self-sustainability than other INGOs/NGOs, although it is still dependent on its current subsidized donor funding and the transformation of the investment will have a significant impact on its ability to operate and expand. PACT also has an extensive footprint, which includes outreach to rural areas. Furthermore, PACT believes it can rapidly increase scale and has plans to do so.

PACT MFP provides an agricultural loan to 19 percent of its borrowers (71 600 borrowers). The loan size is 250 000 kyat and interest is 2.5 percent per month with a term of five months. PACT's agricultural loans are therefore seasonal, and are mostly monsoon paddy loans, with some loans going to pulses and rice. They limit farm size to a maximum of 5 acres to retain focus on landless and marginalized farmers. Using take-up figures as well as the loan size, estimated loans disbursed for agricultural loans are 17.9 billion kyat. PGMF also offers a similar agricultural loan for up to 200 000 kyat at 2.5 percent interest per month, but take-up figures have not been obtained for this product. PACT MFP's main loan product (regular loan) is provided for businesses/SMEs on a group basis. These regular loans are for amounts up to 200 000 kyat with a term of one year and interest rate of 2.5 percent per month. Successful borrowers can graduate to individual microenterprise loans of 500 000 kyat with the same term and interest rates. As of March 2013, 361 027 members had individual loans and 11 262 members (3 percent

of their borrowers) microenterprise loans. Some clients have progressed to larger loans over time and it is estimated that 10 percent of their clients have loans in excess of 50 000 kyat (Interview, May 2013). PGMF follows a similar product structure with slightly lower loan sizes. Regular loans of 150 000 kyat are offered on a group basis and successful borrowers are able to graduate to individual microenterprise loans of 300 000 kyat. Both of these have a term of up to one year and interest is charged at 2.5 percent interest per month. The breakdown of clients to loan categories is not available for PGMF but as of March 2013, it reported 74 194 active borrowers.

Proximity Designs provides a standard crop loan and a premium crop loan to 32 percent (4 320) and 64 percent (8 640) of its borrowers on an individual basis via village organizations. It also provides a standard crop loan on a group loan basis to 4 percent (540) of its borrowers. Ninety-six percent of its borrowers are paddy farmers, and all farms are smaller than 30 acres, with a median farm size of 5 acres. While expanding in other parts of the country, it has a strong Delta area focus. Although Proximity indicated about 13 500 loan clients as of May 2013, loan data received for the 2012/2013 financial year indicated about 23 500 for that period, suggesting multiple loans per client per year. In addition to providing crop loans, Proximity also provides loans for financing its irrigation products. The structure and terms of these loans are unclear, but it seems that farmers may also take out “extra cash” (sic) with these loans “to be used in agriculture” (sic). Data provided by Proximity indicated that about 16 000 of these loans were provided in the 2012/2013 financial year. Its irrigation products (pumps, drip and storage systems) cost between 15 000 and 40 000 kyat and a full set costs about 70 000 kyat (Proximity, 2012).

World Vision has a limited agricultural portfolio consisting of 2 084 seasonal loans provided on a group basis. It reported that local authorities in some of the areas where it operates did not want WV to penetrate agriculture. WV provides commerce loans ranging between 75 000 and 300 000 kyat to 89 percent (16 800) of its members on a small group basis. Successful clients can migrate to individual commerce loans that could range up to 1 750 000 kyat with most currently ranging around 800 000 kyat. WV’s average loan disbursed (on its total book) is 230 000 kyat but its commerce loan should be close to this amount due to the large proportion of its book being in this category. Interest is charged at 2.5 percent per month and while the term is up to one year, the typical term of the current loan book is reported to be six months. Payments were initially on a weekly basis but they have recently moved to fortnightly payments.

Save the Children provides agricultural loans to 3 746 farmers in the form of seasonal group loans, mostly for paddy in the rainy season and for beans in summer. STC reports that it operates in the same areas as the MADB but it focuses on smaller farmers of between 1 and 5 acres. This is perceived as the first phase exploration of the agriculture sector in which it has limited experience. Given STC’s limited experience and the absence of a detailed loan assessment in the first phase, it is limiting loans to 50 000 kyat over four months, with bi-weekly interest payments and the principal due at harvest time. As of March 2013, 27 percent of its loans (by number of clients) was in this experimental area. Given earlier discussion on likely production cost, these loan sizes are likely to fall short of the value required by farmers. The loan term and repayment frequency also does not seem to match the agricultural production season. STC offers a general loan for productive purposes to individuals on a group guarantee basis. Seventy-three percent of its clients (or 10 000 borrowers) have the general loan; 100 percent of its borrowers are female and 55 percent are located in Yangon. Their loans range between 50 000 and 250 000 kyat and

the general loan has a term of six months, with weekly repayments (including principal and interest).

Group de Recherche et d'Echanges Technologiques (GRET) provides group microenterprise loans ranging between 80 000 and 120 000 kyat to an estimated 6 400 members. Successful clients are able to migrate to individual loans (requiring two guarantors) ranging from 120 000 to 600 000 kyat. An estimated 550 of GRET's members currently have individual loans. Interest is charged at 2.5 percent per month and the term is up to one year.

6. POVERTY AND SOCIAL INCLUSIVENESS

The target group, including gender issues

The NAPA target group will be resource-poor rural inhabitants, including small, marginal and vulnerable farmers as well as ethnic groups, rural women – female-headed households including women from ethnic groups and the landless and poor rural households including ethnic group households as shown in Table 6.

Table 6: The NAPA target group

Poor and marginal farmers
Farmers with small (less than 2 ha) landholdings
Landless dependent on livelihoods from farm labour, livestock or subsistence fisheries
Communities dependent on food security and livelihoods from use of natural resources such as forests and fisheries
Female-headed households that are especially vulnerable
National ethnic groups which are particularly vulnerable

Myanmar has four diverse geographic and agro-ecological regions, namely the Delta, the CDZ, coastal and mountainous regions. The farming and livelihood systems in these regions are a complex mix of systems where the major sectors – crops, livestock, fisheries and forestry – are all closely linked into a range of integrated systems. The relationships between these sectors vary considerably across the country. While the crop sector tends to be the major sector as regards food security and income, the others have an important role in sustaining the livelihoods of the rural poor, both in terms of on- and off-farm support.

Farming systems differ across the country with predominantly monocropped rice cultivation in the Delta Region. In the Delta, inland fisheries and small-scale livestock production (pigs and poultry) are quite common. In the CDZ rice is produced where water is available but other crops most importantly pulses and oilseeds are cultivated. Livestock is an important and integral part of the farming systems, more especially oxen for draught purposes, and sheep and goats for income generation. The farming/livelihood systems in the CDZ areas which are not dependent on paddy production and located in non-irrigated rainfed areas are characterized by a mixed farming system in which crops and livestock are closely integrated and interdependent. In the hilly areas of Myanmar, maize is the predominant crop grown together with legumes and vegetables and a range of fruit trees, and some plantation crops (tea and coffee); shifting cultivation is still practised in the more isolated mountainous areas. In the coastal regions small-scale farmers cultivate rice and other annual crops and in more accessible areas maintain orchards; large-scale

cultivation of industrial crops (rubber and oil-palm) on a commercial basis is common. In coastal areas, people are directly or indirectly involved in the fisheries sector.

Most of the poor live either in the CDZ – where soils are sandy, rainfall is low and density is high – or in hill tracts populated by ethnic groups, which are remote, have limited arable land and have been affected by conflict.

Targeting strategy and gender mainstreaming

In line with the government's targeting policy, the NAPA project will target the risk-prone areas in the CDZ. Income-enhancing rural livelihood interventions will directly benefit small, marginal resource-poor farmers, women, the landless and national ethnic groups. Such disadvantaged people have high incidence of debt distress and are usually unable to generate sufficient income. They take small short-term loans to make up their income deficit primarily to meet their basic household consumption needs. In order to repay what they owe they usually take more loans. This process of taking loan after loan continues for years and years and often is passed along to the next generation. Vulnerability in rural areas is caused by several factors, the most important of which is poverty. Among the principal coping mechanisms of the poor is incurring debt followed by reducing food consumption, sale of livestock or seeking wage employment elsewhere.

Rural women are among Myanmar's most marginalized groups, with high vulnerability to food insecurity and poverty. They are not well represented in the political and higher-level administrative sphere outside of the traditional areas of social services, health and education. At the local level, there are few women representatives in decision-making bodies. There are two categories of women-headed households: women and women-headed households, especially poor and marginal farmers from national ethnic groups and women and women-headed landless households, especially those dependent on livelihoods from small businesses, livestock or subsistence fisheries. Women bear a disproportionately high share of the burden of poverty due to: (i) low social status; (ii) fewer endowments of land and productive assets; (iii) limited access to economic opportunities and social services, (iv) lack of participation in decision-making bodies at local (village and village-tract) levels; (v) lack of participation in elected bodies at regional and national levels; (vi) lack of access to formal and informal credit facilities; (vii) the heavy burden of collecting water and fuelwood; and (viii) lack of opportunities for off-farm income-generating activities. Women are poorer, less healthy and less educated than men, especially in rural areas. Even though economically active, the contribution of women is inadequately documented, understood and appreciated.

Myanmar is ethnically diverse, with eight major ethnic groups, 135 subgroups and 108 different ethnolinguistic groups. As the ancestral lands of ethnic groups typically contain valuable mineral resources, they have been exploited by outsiders, leading to conflicts. Ethnic groups suffer from physical, social and economic isolation because of difficult topography and political neglect.

The availability of finance is an essential requirement for improved livelihoods and employment, but the poor in rural areas lack access to affordable credit. Informal financial markets continue to meet the credit needs of the rural poor and farmers, the cost of which is much higher than formal sources of finance. However, to fully realize the poverty reduction potential through financial services, substantial continuing resources are required to meet the magnitude of demand. Efficient institutional and market support mechanisms are also needed along with appropriately

designed and priced services to enable the poor to profitably invest in agriculture, livestock, microenterprises and fisheries.

The intervention will target the country as a whole in the longer term, through better access to financial services by building on the existence of the village development committees at village and village-tract levels. Initially the NAPA will target assistance to the rural poor in the CDZ by providing access to rural financial services. The priority intervention is a grassroots intervention based on a community-driven development approach aimed at stimulating economic activities in high poverty incidence areas in the CDZ. This will be achieved through income-enhancing rural livelihood interventions at the village level that will have direct benefits for the primary NAPA target group.

Finally, through the new government initiative on rural development, via the MLFRD, communities at the local level will be provided with funds for a range of interventions in support of village development and to enhance farm family livelihoods. The approach used in the CDZ may be replicated in other regions.

7. RECOMMENDED AREAS OF INTERVENTION AND INVESTMENT

For the NAPA project, selection of priority townships would be based on the composite poverty profile, livelihood enhancement potential, capacity of the recipient beneficiaries (evidenced by prior involvement and exposure and/or state of readiness of development plans at the village-tract or village levels), low donor density or unserved areas, a conducive security situation and relative ease of market access.

Review of the rural finance sector indicates that microfinance providers continue to cover only those who have either some running microenterprise or an asset base which gives a degree of assurance to the lending agency for recovery in case of default. This leaves most of the chronic poor with few skills and no asset base. The overall penetration rate of microfinance remains low and the microfinance market is characterized by a high degree of portfolio concentration in and around major cities.

These resource-poor rural inhabitants are among the poorest segments of the rural population. One of the primary reasons for this high poverty rate is their lack of access to productive assets, including capital. There are very few avenues of formal credit available in the area. The dominant source of credit in the area is a very usurious and exploitative system of informal credit operated by informal channels which provide credit for productive and consumption purposes. The credit practices of informal channels vary considerably. The level of interest and flow of payments is dictated by the needs of the borrower and the requirements of the money lender. If the borrower is unable to pay by a specified date, a frequent occurrence, the time and rate are increased. As credit at affordable rates is not accessible to most of the resource-poor rural communities, their income-producing capacity is severely constrained.

Preferred institutional mechanism for microfinance

Based on the foregoing analysis, there is a need to reduce the extensive poverty in the rural areas by providing opportunities for increasing income and improving the living standards of rural communities through provision of income-augmenting opportunities via access to affordable credit. Efficiently and effectively delivering financial services is particularly challenging in the

project area due to the geographic dispersion of clients and less-developed transport and communication infrastructure. There is a need to identify an appropriate delivery mechanism that will contain the transaction costs, increase outreach and effectively target the rural poor and women.

Community organizations may offer new avenues for microfinance. Village-level community organizations could evolve into more formal credit and savings organizations that could be provided with additional seed funding to extend lending, subject to regulatory issues being resolved and the introduction of appropriate systems and processes.

There will be a gradual transition from the MFI-operated microfinance system to microfinance controlled and managed solely by each village organization. Instead of immediately relying on community capacity to manage financial services, an experienced microfinance institution will operate, train and then transfer resources to the communities. The use of an experienced microfinance provider with an intensive emphasis on capacity development within community groups considerably lessens the risks of poor financial management at the community level, allows time for confidence building among community executive members and provides an integral exit strategy within the project. Further the Community-managed Financial Services (CMFS) will enable rural women to become full participants and beneficiaries as the loan recipients.

MFIs/INGOs constitute a potentially vital channel through which financial resources can be channeled to the village organizations for on-lending to the target group. The accreditation of the MFI/INGO under the project will be based on the following criteria:

- Proven track record in community organization and social preparation;
- Competence in social and development work at the grassroots level;
- Outreach capacity to service project areas;
- Extensive experience in microcredit management and microenterprise development;
- Continuous operation over the last two years in the project area;
- Capacity and resources for sustainable operations with or without the project; and
- Agenda or constitution in line with project goals.

The proposed model for CMFS

Rationale

The rationale for the proposed component stems from the need to address the key issue of pervasive poverty and social disadvantage of the resource-poor rural communities through the introduction of livelihood initiatives to raise the income levels and improve the living conditions of the rural poor.

Objectives and scope

The objective of the component is to reduce poverty in rural areas by providing opportunities for increasing incomes and improving the living standards of the rural poor. The scope would include activities to increase incomes and improve the living conditions of poor communities through the provision of income-augmenting opportunities. To support microenterprise development and augment/supplement the livelihoods of such communities, there is a need to promoting savings mobilization, involve grassroots organizations as financial intermediaries on the basis of their outreach capacity, analyse the effective potential of potential borrowers, closely supervise lending systems and strengthen the capability of grassroots community-based organizations serving as financial intermediaries.

The CMFS model has the advantages of rural outreach, poverty outreach, flexibility, safeguarding savings and community development. However, the major limitation of this approach is the absence of professional management. Community groups under this model require strong technical support in financial service management.

Strategy

The strategy for the CMFS is to efficiently provide a range of affordable financial services to resource-poor rural communities who disproportionately bear the burden of poverty. Services provided at affordable prices will have a significant poverty reduction impact by increasing the incomes of poor households, enhancing outreach, especially to women, building social capital and reducing the risks faced by the poor.

In addition to providing financial resources, the component aims to promote and support the development and long-term sustainability of microfinance through capacity building of village organizations (VOs). The VOs could thus form the nucleus for developing self-sustaining rural financial intermediaries which would significantly empower the rural poor, especially women.

Key design elements of CMFS

CMFS will provide financial resources in the form of seed capital grants to finance the requirements of resource-poor rural communities, especially women. In addition to providing financial resources, CMFS aims to promote and support the development and long-term sustainability of microfinance through capacity building of village organizations.

The major limitation of VOs is the absence of professional management. Their inability to immediately assume responsibility for managing credit operations raises two choices: delay the provision of credit until the VOs are able to effectively manage it or use an alternative management system on a temporary basis until such time as responsibility can be transferred to the community. Given the lack of formal sources of credit in rural areas, except for the very usurious and exploitative system of informal credit operated by money lenders at very high interest rates, the alternative of waiting for the development of adequate financial management capacity to develop in VOs is not an attractive one.

CMFS will initially be operated by an MFI/INGO. This approach is seen as a temporary measure which would be accompanied by major support to develop the experience, capabilities and coherence of the VOs with the objective of transferring the financial resources to effectively-managed VOs at the end of the project. Thus instead of immediately relying on community

capacity to manage financial services, an experienced MFI/INGO will operate, train and then transfer resources to the communities. The use of an experienced microfinance provider with an intensive emphasis on capacity development within community groups considerably lessens the risks of poor financial management at the community level, allows time for confidence building among community executive members and provides an integral exit strategy within the project.

There will be a gradual transition from the MFI/INGO-operated microfinance system to microfinance controlled and managed solely by each VO. The transfer process is expected to commence – for those VOs showing sufficient institutional maturity – after three years. This will permit a period of up to three years during which as individual VOs achieve sufficient capacity, responsibilities for such activities as loan applicant selection, loan disbursement and collection, and funds management can be passed from the MFI/INGO to the VOs.

Financial resources would be channeled through the MFI/INGO to eligible VOs/clusters of VOs in the form of a seed capital grant after they have achieved institutional maturity. Eligibility criteria will be established at the start of the project and formally notified. The criteria would include, among other things, institutional maturity of the VO, number of poor members, capacity and probity of the office bearers, track record of own savings and their utilization, performance against other project interventions and so forth. These grassroots institutions would use this grant along with their savings and other contributions for internal lending for income-generating activities. In addition to increasing the income of the rural poor, the other outcome of CMFS is the nurturing of human capital in the form of community accountants, book-keepers and credit extension managers at the community level.

The MFI/INGO will on-lend to the ultimate beneficiaries. It will build community capacity to utilize and eventually manage financial services. The CMFS component has two principal innovative features; the introduction of financial services to the rural poor; and the gradual transfer to community of the control of financial services management, operations and resources, which also provides an intrinsic exit strategy for the project.

Funds will be provided to VOs that have member savings (a strong saving history) and members committed to the VO who have invested in its success through savings. In addition, the VO should be committed to a vision of sustainable microfinance for the poor and be willing to implement policies that support that vision, such as pricing loans at interest rates that enable them to fully cover their costs and strict repayment enforcement. Village-level umbrella organizations could provide an opportunity to extend microfinance, provided they are focused towards microfinance and have the necessary management systems and staff to supervise their member community organizations and ensure good lending practice. VOs have a potentially large outreach and they could also form the nucleus for developing self-sustaining rural financial intermediaries which would significantly empower the rural poor, especially women.

The MFI/INGO will institutionalize good record keeping, careful follow up on loan repayments and sound financial management. It will ensure the quality of external non-financial support for the VO and direct supervision of the VO operation. It will provide technical assistance to develop the capacity of VOs to manage their own resources. These resources include savings interest on loans made from member savings, membership and other fees. Once they have demonstrated success with management of their own funds, they would potentially receive the seed capital grant funds and be linked with banks or professionally-managed MFIs.

The proposed mechanism is expected to build on sound financial management practices and saving and interloaning discipline and in the process enable the poor to become credit worthy/bankable clients for the commercial banks and other financial intermediaries. Similarly, the amount of the seed capital grant will be set at an amount that will enable viable and sufficient livelihood activity for the borrower. No interest subsidies will be extended. The MFI/INGO will also receive funds for capacity building and training of community organizations and their clusters, which will be administered transparently for the targeted groups.

Interest rates for on-lending amongst members of the organizations will be determined by the members, however, they will not be lower than commercial rates. The interest rate charged will cover the cost of funds and transaction costs, which will depend on the nature of the basic unit of community organization and how this unit delivers the loans. The project does not envisage any subsidy on either the interest rates or capital.

The VOs should eventually be capable of managing the funds allocated to their community from the MFI/INGO. The amount will depend on the size of the village and will be additional to the share of interest income received by the VO over the period of the project. For this transfer to take place, however, each VO must have in place, and operate, a sound accounting system as well as an effective savings and credit methodology. Procedures for this must be in place, training be given and experience gained by both the executive and the general membership in taking decisions on the control and use of these funds. As no regular savings programme will operate at the VO level, it is considered important to also provide the VO executive with on-the-job experience in managing credit prior to handing over such a large sum of money.

The CMFS mechanism inherently includes an exit strategy. If real VO capacity and community involvement can be attained during the first three to four years of implementation, the long-term sustainability of project benefits will be greatly enhanced, and will be further strengthened through community accumulation of savings and credit interest which will finance an ever increasing share of local economic activities. In order to ensure efficient utilization and transparent management of the CMFS grant, the MFI/INGO will develop appropriate risk management strategies.

The fund will remain a trust fund with the MFI/INGO on behalf of the government and its retention with the MFI/INGO during the project period and any undisbursed amount will be returned to the government at the end of the project period. By the end of the fifth year, all the recipient VOs would be required to be registered as cooperatives or similar associations according to the law. The VOs would be required to report to a regulatory body and submit annual statements on their revolving fund operations.

Once the VO is considered adequately prepared to manage the revolving fund operations, the seed capital grant funds would be transferred to the VO. The MFI/INGO will enter into an agreement with the VO to manage CMFS efficiently and effectively on a sustainable basis. The VO will retain the funds and revolve them as long as it does not breach the terms and conditions of the agreement. In case of breach of contract, the VO would return the seed capital grant to the MFI/INGO which will be distributed to other communities.

8. RELATION TO OTHER RURAL SECTORS

Access to rural financial services has the potential to make a difference in agricultural productivity, food security and poverty reduction.

Access of finance is a crucial issue in the productivity of agriculture. Most smallholders and marginal farmers remain without access to financial services that they need to improve their livelihoods. Despite the significant demand for financial services in rural areas, institutions offering financial services, including MFIs, are typically reluctant to serve in rural areas due to the precarious nature of agricultural production. As a result, the sector continues to suffer from major inefficiencies. Agriculture is underdeveloped with most farms generating very low yields. Myanmar's agriculture sector suffers from a compounded problem of lack of infrastructure and market structure. The resulting inefficiencies impact all market participants and keep the sector from being competitive.

Financial services play an important role in determining the competitiveness and profitability of the agriculture sector and are vital in ensuring that agriculture can generate the incomes for producers and other participants in the value chains that extend from input supplies to retail sales.

ANNEX 1: COMMUNITY-MANAGED FINANCIAL SERVICES

The Community Managed Financial Services would enable the target group in the rural areas to access financial services that respond to their needs. The component will pursue its objectives through two initiatives. The seed capital grant and resources for capacity building activities.

On completion of all disbursement conditions, and the signing of operations agreements, the seed capital grant will be transferred to the MFI/INGO.

The MFI/INGO will be contracted by the project to build the capacity of VO's to manage financial services, as well as internal savings and credit at the CO level.

Resources would be provided to the MFI/INGO for capacity building activities. The resources would be dedicated for training and support for VOs. The objective is to prepare the VOs to assume management and control of all funds at completion of the six-year project implementation period. In order to allow a gradual transition from an MFI/INGO operated microfinance system to a community managed microfinance controlled and managed solely by each Village Organization, the transfer process is expected to commence – for those VOs showing sufficient institutional maturity – after three years. This will permit a period of up to three years during which, as individual VOs achieve sufficient capacity, responsibilities for such activities as loan applicant selection, loan disbursement and collection, and funds management, can be passed from the MFI/INGO to the VO. However, most CMFS disbursements would occur within the initial three-year period, with only transition support activities continuing after this point.

The MFI/INGO will develop key performance indicators for VOs and monitor them on a regular and ongoing basis. All VO's, would submit monthly report to MFI/INGO field staff and through them to project management on the monthly progress of savings and credit including repayment. This means a simple MIS has to be introduced to VO's. The MFI/INGO will train them in this aspect and obtain such monthly reports and check for accuracy.

The MFI/INGO has considerable experience of microfinance operations. The MFI/INGO shall commit to the objectives of the project and shall maintain separate designated Bank Account. Reports should be generated on the status of loans and repayments by Village Organizations.

Funds received by the Government of Myanmar will be transferred to the MFI/INGO to finance credit to the rural poor belonging to VOs. However, credit would also be possible for microenterprises in rural communities especially for women, landless and ethnic groups.

Credit will be given only to members of Community Organizations in VOs which have fulfilled the initial criteria such as registration. The MFI/INGO will start the process of VO formation after formation and maturity of COs at the village level. These village level umbrella organizations (VOs) will initially register with the concerned department and going forward will be encouraged to evolve into co-operatives and register themselves as a Co-operative with the Co-operatives Department.

Credit applications will be submitted by COs. The CO must submit all requests for loans in the form of a Resolution. The Resolution will include relevant information about the intended client, the loan amount and purpose, the time period of the loan, and the mode of repayment (instalment or lump-sum). It will also include a testament by the members that they can be held responsible

for the timely repayment and appropriate utilization of the credit. The Resolution to be signed by at least 75% of the CO members. The MFI/INGO field staff are required to attend the community meetings at which point they also collect any resolutions for onward transmission to the MFI/INGO credit staff. The COs are also able to send the request for a loan to their VO in case an urgent need arises before the scheduled meeting.

The application would then be forwarded to the MFI/INGO in the district. The credit officer of the MFI/INGO will appraise and approve the loan. Endorsement of the application by the VO does not necessarily commit the MFI/INGO to offer a loan. Credit funds will be disbursed by the MFI/INGO through the VO bank account, who will then allocate the funds to the approved borrowers.

Experience practicing microfinance shows that unless a carefully designed loan appraisal system is put in place, influential people within a group or in the area may take the credit instead of the intended client. Therefore, the MFI/INGO should adhere to a thorough system that ensures that the credit reaches the intended client and that the client acknowledges its receipt.

Credit risk and losses due to poor repayment will be borne by the MFI/INGO while any losses due to major 'force majeure' events such as earthquakes, other natural disasters or a significant and serious deterioration in the security situation will be reinsured where feasible.

Once the VOs have achieved maturity, financial resources would be channelled through the MFI/INGO to eligible VOs in the form of seed capital grant. However, these grass roots institutions would use this grant along with their savings and other contributions for internal lending for income generating activities. In addition to providing financial resources, the component aims to promote and support the development and long term sustainability of microfinance through capacity building of Village Organizations.

The seed capital grant would finance the requirements of the target group. In accordance with objectives of the project, seed capital grant would be provided by the MFI/INGO to eligible VOs against a pre-established eligibility criteria involving institutional maturity, representation of poor, track record on own savings and implementation of other project funded activities, repute of office bearers and activists etc. The VO will utilize this grant to provide micro credit to the poor members of the community organizations for various income generating purposes. Social mobilization process would prepare a base for proper targeting and women inclusion.

To implement this procedure each VO must appoint office bearers e.g. an accountant, credit coordinator etc from the income of the CMFS and monitor their performance. This person's principal responsibility will constitute the operation of the revolving fund. The MFI/INGO will train the key persons. Some basic training must also be given to Chairman, Secretary and other executive committee members. It is proposed that a monthly stipend must be paid to the accountant and credit co-ordinator from income derived from loan repayments.

The MFI/INGO will build the capacity of VO's to manage financial services as well as internal savings collected at CO level. The MFI/INGO will develop key performance indicators for VOs and COs and monitor them on a regular and ongoing basis. All VO's and COs would submit monthly report to MFI/INGO staff and through MFI/INGO staff to project management on the monthly progress of savings and credit including repayment. This means a simple MIS has to be

introduced to VO's. The MFI/INGO will train them in this aspect and obtain such monthly reports and check for accuracy.

Interest rates

Initial interest rates for the operation and management of seed capital will be decided by MFI/INGO management.

In any transition period thereafter (in which decisions on loans are made jointly by the VO and MFI/INGO, the interest rates will be jointly determined by the VO and MFI/INGO. Once full control of funds is passed to the VOs, the full membership will decide in an annual vote the rate to be applied but this rate must, at minimum, generate enough income to meet the needs for agreed compensation of the VO executive, the cost of any insurance cover (e.g., life, credit-life, health, calamity) approved by the VO membership, and to cover average annual loan losses over the past three years.

Flow of funds

- The Project/ Government of Myanmar will enter into a contract with the MFI/INGO for management of CMFS including capital and capacity development of VOs to manage seed capital grant.
- Funding will be provided to the MFI/INGO by project in line with the agreed phasing on annual basis, based on approved annual work plans and budget of the project.
- Resources would be provided to the MFI/INGO for capacity building of VOs and duly reflected in AWP/B.
- The MFI/INGO in collaboration with the project will develop key performance indicators for VOs and COs and monitor them on a regular and ongoing basis
- The MFI/INGO will transfer funds to eligible VOs based on an assessment of their meeting the eligibility criteria and signing of agreement between the MFI/INGO and VO.
- The VO will disburse micro credit to the members of COs from the grant and other sources pooled with the CMFS.
- The repayment period will be a maximum of 15 months;
- The VOs will retain the funds as long as they do not breach the terms and conditions of CMFS provided by the MFI/INGO.
- A CMFS funds recovery mechanism will be put in place and shall be part of the agreement between the MFI/INGO and VOs. In case any of the VO breaches agreed terms and conditions for the use of funds, the VO will return the funds to the MFI/INGO. These funds would be transferred to other communities.
- The MFI/INGO will return any undisbursed funds at the end of project to Government of Myanmar. The recipient VOs will be registered as cooperatives and made subject to regular audit in post project period. Retention of funds at the end of project by VOs will be subject to full assessment of the performance of the programme during Project Completion Review.

- The MFI/INGO will provide specialized training in financial services management, accounting and loan tracking. Setting up, maintaining and controlling the quality of financial records is a significant challenge in most cases. Therefore, training material, guidelines and forms for the accounting, loan tracking and monitoring system should be developed at an early stage so that there is adequate time to impart these skills.
- Establish a monitoring system that collects and analyzes information on a set of quantifiable performance indicators: a small set of indicators well understood to all stakeholders and key performance indicators measuring outreach (number of active clients), client poverty level and loan collection performance
- COs will mobilize savings. VOs as an umbrella group will not collect regular savings. VOs will receive a portion of interest charged on all repaid loans extended by the MFI/INGO over the course of the project.
- The Project will provide resources to the MFI/INGO to provide training in savings and credit as well as bookkeeping
- Interest rates charged on loans will be determined by the MFI/INGO till the MFI/INGO provides loans directly to the borrowers. In any transition period thereafter in which decisions on loans are made jointly by the VO and the MFI/INGO, the interest rates will be determined jointly by the VO and the MFI/INGO. Once full control of funds is passed on to the VOs, the full membership will decide in an annual vote the rate to be applied but this rate must at minimum generate enough income to meet the needs for agreed compensation of the VO execution and cover average annual loan losses over the past three years (however the interest rate will cover the financial intermediation cost). Many of the costs that the MFI/INGO would normally assume in undertaking lending operations, such as community mobilization, training and supervision, incremental staff will be covered separately under the Community mobilization and Livelihoods support component.

Role and responsibilities of the MFI/INGO

- Employ competent staff in Central Dry Zone to manage and administer CMFS and existence of a clear plan to build up capacity of VOs.
- To form COs and VOs in the rural communities.
- To negotiate and sign Terms of Partnership (contracts/agreements) with the VO to manage the CMFS efficiently and effectively on a sustainable basis.
- To train office bearers of COs and VOs.
- To assist the VO in preparing their credit product and Standard Operating Procedures.
- To assist the COs and VOs in opening bank accounts;
- To develop books of accounts, appraisal and collection formats and reports for the VO;

To receive funds from the Project and transfer the funds to the VO after assessing the institutional maturity of VO. For this purpose, the MFI/INGO may disburse the CMFS in instalments or as a single transaction depending on the assessment;

- To develop computer based software or manual management information system for tracking the loans;
- To assist the VO in the first three years in loan processing as on job training;
- To collect data from VOs and prepare a parallel data bank for tracking all loans;
- To do field monitoring to ensure the VOs manage the funds as per their SOPs;
- To do field level evaluation to ensure proper utilization of loans and to give feedback to VOs and Project office on the CMFS management and its utilization;
- To help the VOs develop risk mitigating strategies to keep the CMFS grant intact;
- To get the reports from VO and compare it with the data bank established by the MFI/INGO accountant;
- To provide analytical reports to the Project office on the loans disbursed and recovered by the VOs.

Role of COs

- The Community Organization opens a bank account;
- The CO collects savings from its members and pools it in a CO bank account;
- The CO helps the members identify need for credit;
- The CO screens the members for credit and assesses their behaviors;
- The CO requests the VO to provide credit to the persons identified by the CO;
- The CO coordinates with VO on all matters;
- The CO maintains records of individuals who avail credit from the VO.
- The CO monitors the performance of the individuals who get credit;
- The CO either collects the recovery from the members or guides the members to deposit the recovery as required by the VO.

Definition of a VO eligible for CMFS

- The VO refers to either an individual VO or a cluster of VOs to manage the CMFS;
- In case it is a cluster of VOs, the individual VO will screen all requests received from the constituent CO for credit before sending those to the cluster VO.

Role of VOs

- The VO with MFI/INGO's help prepares Standard Operating Procedures, Books of Accounts, Forms and Credit Product to manage the CMFS grant.
- The VO forms a credit committee comprising representatives of VOs to manage the CMFS and do final approval of the requests forwarded by the/COs;

- The VO establishes a bank account to receive CMFS grant and to pool other sources for credit disbursement;
- The VO disburses micro credit as approved by the Committee;
- The VO arranges to collect recoveries;
- The VO appoints office bearers e.g. accountant, credit coordinator etc from the income of the CMFS and monitors their performance;
- The VO provides all reports to the MFI/INGO and coordinates with the MFI/INGO for its audit.

Selection criteria

- In each Village Tract a CMFS will be established.
- Community Managed Financial Services will be managed through the VOs but the beneficiaries will be the members of the COs
- A VO for CMFS shall comprise a minimum of 10 COs. In case the number of VOs in the Village Tract is more than 2, these VOs will be required to form two clusters;
- The VO will be entitled to receiving the CMFS fund only after it has organized a minimum of 40% of the target household majority who are poor and very poor. At least 60% of the CO members will be women;
- Savings at the CO level will be mandatory;
- VO will be entitled for the CMFS after three months of its formation;
- The VO/Cluster of VOs must have managed an internal lending programme before it requests for a CMFS facility;
- The VO/Cluster of VOs must have developed credit product and SOPs.

Microcredit product

- The VO will use the CMFS for any income generating activity in agriculture, livestock or small business etc;
- The VO will determine the loan size. It is expected that it would not exceed 50,000 kyat;
- The target beneficiaries would be women and poor and vulnerable poor households;
- A household will not access more than 4 loans in five years;

Future maturity indicators

- Targeting is appropriate for poor and vulnerable poor;
- Focus on women;
- Ability to maintain proper records;
- Ability to produce timely reports;

- Ability to monitor utilization of loans;
- Ability to recover costs;
- Readiness for audit.

Estimated credit volumes

It is only possible to provide estimated credit volumes once the survey has been undertaken, village profiles are available and the scope of the project is known.

Strengthening VO capacity for CMFS

The costs of all training and community organization supervision tasks undertaken by the MFI/INGO under the agreement with the Project, beyond those normally undertaken for loan processing, monitoring and repayment collection purposes, would be compensated at agreed upon rates and levels.

If members of a VO have a repayment rate of 100%, the interest sum after paying the handling charges of the MFI/INGO will be passed to the VO. These funds would be expected to be used by the VO primarily for social credit (health, emergencies, etc) to members. These funds will be placed in a dedicated bank account and may be loaned to any VO member upon the approval of the VO executive. Withdrawal of funds will require signature of the treasurer and one other nominated executive member (normally the President). Conditions of loans (e.g., maximum size of loan, duration, scheduling of repayment, purpose and interest rates) will be proposed by VO executive and approved by the full membership, but interest rates will in no case be lower than 10% per annum.

In consultation with the project, the MFI/INGO will draft a credit procedures manual for VO's which would come into effect as the VO accumulate funds for lending. The VO executive would be expanded from President, Vice-President and Secretary, to include the position of Treasurer, as well as one representative from each constituent CO.

Two VO members, including the Treasurer, will be trained in the maintenance of record books, in credit issue and in the collection of repayments, recording and monitoring. The MFI/INGO will provide follow up, on-the-job training and supervision to VO executive members at least monthly to ensure that proper records and systems are in place and are followed.

The project will pay a monthly allowance to the VO Treasurer for the duration of the project. The payment will be paid by the project. However, payments will commence only after the credit program is initiated. Once the seed capital grant fund is transferred to the VO, the monthly payment would be replaced by a percentage of the loan repayment being allocated to the treasurer (and possibly other VO executive officials on a lower rate).

The MFI/INGO will provide data to the project on a monthly basis showing the quantitative progress of VO credit. Each VO has to report these figures to the MFI/INGO. The MFI/INGO will develop an appropriate MIS system and train the VO's to follow the required procedures. The project may provide technical assistance in designing such a system for the MFI/INGO.

Strengthening CO capacity for managing savings and credit programme (in all the village tracts)

The MFI/INGO will train COs to commence savings at a minimum of 250 kyat per month per member. A lower monthly savings amount may be acceptable for women's and other low income groups. CO members will have to meet at least monthly for savings contributions and credit applications and repayments.

All savings will be retained at CO level during at least the initial 3 years and credit from savings will be issued at CO level in accordance with the decisions of its members. The MFI/INGO will draft procedures for CO level savings and credit.

The MFI/INGO will train the VOs to initiate credit operations (primarily for emergency or social purposes) from savings after a period of 6 months. It is recommended that loans to members do not exceed three times the amount saved by that member except in special cases (approved by all CO members). For this purpose, adequate training will be provided to 2 persons in each VO/CO including the member responsible for the savings and credit program. Further on-the-job training will be provided by the MFI/INGO during the monthly CO meeting.

VO by-laws

VO by-laws will be drafted. Introduction of mandatory savings programmes for all CO members and adoption by VOs of the revised by-laws will be a condition of funds disbursement to individual communities. The Project Implementation Manual will provide the details.

Exit strategy

The exit strategy has been built in the core design of the project, through a planned and gradual transfer of responsibility for financial services operation and management from the MFI/INGO to VOs over the last two to three years of the implementation period. If real VO capacity and community involvement can be attained during the first 3-4 years of implementation, the long term sustainability of project benefits will be greatly enhanced, and will be further strengthened through community accumulation of savings and credit interest which will finance an ever increasing share of local economic activities both for rural communities. It is anticipated that a minority of VOs and their communities will fail to develop sufficient institutional maturity to enable them to effectively take over fund management. Where this is the case, it is considered better to transfer their funds instead to other communities which have developed such capacity, than to face the real risk of loss of the resources in poorly managed communities.

The project will attempt to achieve a number of distinct goals through the above strategy: It aims to ensure that VO members themselves take over management of their own financial services as soon as possible and operate it in a sustainable manner. For this to be achieved the recommendations provide for a strong 3-year capacity building program which will allow VOs to gain practice through the management of small funds as well as benefiting from regular on-the-job and class room training from experienced microfinance providers supplied by the MFI/INGO. Introduce a savings habit amongst the poor, even if it is as low as 100 kyat per month. The proposed project structure also permits urgent emergency social credit needs of the poor to be met from internal resources, without creating a dependency on traders and money lenders;

Most importantly the proposal ensures the full participation of NAPA's target group including small and marginal farmers, landless, women and national ethnic groups both as members of VOs and as credit and savings beneficiaries.

Periodically, and at the close of the initial three-year implementation period, the financial management capacity of the VOs in each community will be assessed through an analysis of the lending history of their members and the training and performance of VO executives, as well as through the judgement of the MFI/INGO field staff. Those VOs considered adequately prepared would then commence to play a joint role with the MFI/INGO in managing all credit operations, including assessment of loan applications and joint control of bank accounts. The transfer period until full control is passed to the VOs will depend upon the abilities and performance of each VO, but it is expected that no more than two loan cycles would be required. Members of those VOs considered not yet ready to assume control after three years would continue to access loans through the MFI/INGO for a further year, with the transfer process starting at the end of the fourth year. Those few VOs still judged unable to effectively operate a credit programme by the completion of year five would not receive the outstanding MFI/INGO seed capital grant funds, which would instead be distributed to other communities as determined by the MFI/INGO at that time and agreed to by the Project.

Resources and staffing requirements

Resources would be provided to the MFI/INGO for capacity building of VOs. The objective is to prepare VOs to assume management control of financial services.

In order to strengthen training and oversight support to VOs, a new staff position of one CMFS manager and CMFS accountants will be created within the MFI/INGO. The CMFS Manager will take overall responsibility for the component, including preparation of work plans, and reports and will provide guidance and oversight to all training activities undertaken by the MFI/INGO. These accountants will provide regular supervision of VO, saving and credit activities, including presenting periodic training courses for executives and members and ensuring adequate record keeping and transparency in decision making in relation to all lending activity.

Office equipment, vehicle, motor cycles, travel allowances would be provided to the above MFI/INGO staff. Financial and Technical progress reports would be periodically prepared by MFI/INGO staff in accordance with the requirements in their agreements with the project

Beneficiaries and benefits

The main beneficiaries will be the small, marginal and vulnerable farmers including ethnic groups, female headed households including ethnic groups and rural poor landless including ethnic groups. The CMFS activities would be implemented in the Central Dry Zone.