it to be. Is it capable of stimulating monetized informal sector economic activity in the Pacific economies where such activity has been notably lacking so far?

Achieving the transition to commercialized agriculture and creating opportunities to earn income outside agriculture, including informal sector opportunities, remains a primary goal of Pacific economic policy. Indeed, although the point is commonly neglected, the transition from subsistence should be the starting point of private sector development in the many countries of the region where considerable productive resources of land and labour remain tied up in the traditional economy. Increasing access to financial services, including micro-financial services, is certainly part of the solution to achieving the necessary structural changes in these economies.

2. Definitions: from 'microcredit', to 'microfinance', and to 'financial inclusion'

There has been a considerable evolution in thinking about the role of financial services in alleviating poverty. Beginning in the 1960s, State 'development' banks were established in Forum island countries to lend for agriculture and small enterprise. These banks were intended to lift farmers directly out of the traditional economy and into commercial agriculture, or to 'indigenize' the modern urban economy. Their record has not been encouraging, either in terms of achieving these objectives or of their solvency.

From the late 1980s, the success of the Grameen Bank drew attention to the role of 'microcredit' for micro-enterprise. The significance of informal sector activity and the role of women came to be better understood. Lack of access to credit was seen as the binding constraint on the development of an informal sector in Pacific countries. Micro-loans delivered to groups of poor women seemed to offer a simple and direct remedy. Early efforts to replicate Grameen Bank methods of group-based microfinance in the Pacific included the Women's Social and Economic Development program (WOSED) in Fiji from 1993 and the Liklik Dinau Abitore Trust (LLDAT) in Papua New Guinea from 1994. Both of these early schemes failed, despite considerable government (WOSED) and donor (LLDAT) support.

Among the reasons for the appeal of the microcredit idea is that it is politically attractive. Microcredit, as with 'development' credit before it, makes an intuitively satisfying connection between providing credit and removing poverty. Resources for credit can be made available through the political process. State banks or agencies can be directed to lend, resources for lending can be allocated in state budgets, and soft loans or grants for on-lending can be sourced from international agencies (see box 1 for a Fijian example).

Sponsorship of credit by the State offers opportunities for patronage, and this also is appealing. But less well understood is the notion that microcredit has to be sustainable, meaning that the costs of lending need to be covered by the interest rates charged. Also, excessive emphasis on credit to the exclusion of other financial services tends to obscure the need to develop systems of financial intermediation, in which the mobilization of savings within a financial system provides resources for the growth of credit.

Box 1: When Government takes the lead: Fiji's National Microfinance Unit

Government support for microfinance in Fiji is dispensed primarily through a national Microfinance Unit (MFU). Originally a free-standing entity, the MFU is now located within the National Centre for Small and Microenterprise Development, a statutory agency. The Unit represents perhaps the most consistent and substantial case in the Forum island countries of government budgetary support for microfinance as an anti-poverty measure. The impulse originated in a 1998 Cabinet Memorandum arguing for an action plan to develop a microfinance system in Fiji. In 1999 the MFU was set up as the vehicle to progress microfinance, supposedly with an emphasis on systemic issues and on making use of existing institutions as far as possible.

On the face of it this was a good idea and a promising start. However, a change of government and relocation of the Unit to a different host ministry may have contributed to a change of focus. It was decided to allocate substantial funding to the MFU for microcredit lending ($F3.0 Mn, or about USD 1.5 Mn, in its first year of operation, and an additional $F1.0 Mn in each subsequent year) and to set a short time-span for the initial program. These allocations suggested urgency on the part of government to launch the program quickly, and with an almost exclusive emphasis on microcredit rather than on system-building. It is perhaps understandable that in its early years the MFU appeared preoccupied with short-term operational objectives, rather than with systemic issues. It had the awkward task of finding channels through which to arrange the lending of its substantial budget for microcredit. By comparison, its budget for capacity-building seems to have been inadequate.

MFU began by supporting the creation of MFIs replicating the Grameen Bank approach to microcredit and was slow to extend support to existing institutions such as the credit unions. The irony is that, in neglecting systemic issues such as capacity-building and the creation of an enabling policy and regulatory environment, the MFU had difficulty in establishing the conditions in which its initiatives might have flourished. It also found that for NGOs to create new Grameen-style MFIs was a painfully slow and difficult process. The new institutions could not absorb the funds available for lending. Perhaps it was frustration that induced the MFU itself to commence a program of direct lending. Suffice to say that this short-lived experiment endorsed international experience, which shows that government agencies have no comparative advantage in lending money. Lending should be left to financial institutions.

The MFU has continued to develop its capacity to nurture microfinance institutions and to fund their lending programs while contributing to their operating costs. It has broadened its scope beyond Grameen replication to establish a number of village-based financial institutions that commenced with savings programs (in which results have so far been mixed) and has cooperated with credit unions to set up rural savings groups that may graduate to full credit union status. It contributes to a national financial literacy campaign in association with UNDP. Its original Grameen-style MFIs have continued to grow, though they and the village-based institutions experience difficulties with governance and sustainability issues. The MFU has had some difficulty in gaining acceptance as the focal point within Government for microfinance considered as a financial sector activity. Since the tendency to pigeonhole microfinance in the social welfare sector is still strong, MFU has had limited success in drawing attention to the need for an appropriate policy and regulatory environment for microfinance in Fiji.

Reference: World Bank (2003) Fiji Microfinance Policy Review.

Internationally, energetic advocacy of the 'Grameen Bank approach' proved extraordinarily influential. This led to the 'Microcredit Summit' of 1997 and, eventually, to the declaration of 2005 as the 'International Year of Microcredit'. This enthusiasm was echoed in Forum island countries. Over this period, however, there was an increasingly

negative reaction among development professionals to what was thought to be excessive emphasis on credit and the corresponding neglect of other financial services for the poor. Most important among these was access to savings deposit services. It was a great irony that, by 2005 when the 'International Year of Microcredit' was celebrated, virtually all professionals in the field had long abandoned the term 'microcredit'. Most described themselves instead as 'microfinance' practitioners, and would have agreed broadly with the definition of this term popularized by the Asian Development Bank:

> *Microfinance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and their micro-enterprises.4*

This definition encompasses credit, but gives precedence to savings. It also includes newer services that microfinance institutions had been learning to provide, such as micro-insurance, and money transfers (remittances) as well as payments services, enabling people in remote locations to pay government charges and utilities bills, even 'top-up' their mobile phones. This study will describe how a surprising array of financial institutions in Forum island countries, public and private, regulated and informal, are actively engaged in 'microfinance' as defined by the ADB, above. Table 2 sets out a classification of institutions active in certain Forum island countries, a number of which will be examined in detail in this study. It distinguishes between institutions found in the public, private and community sectors, and those established through the intervention of international agencies. It differentiates between those regulated by central banks, those subject to other forms of regulation or legislation, and those not under any form of financial regulation.

The importance of 'financial inclusion'

More recently, and perhaps as a negative reaction to the distortion of priorities implied by the term 'microcredit', attention has turned to 'financial inclusion' as an appropriate policy goal. This may best be understood by considering its opposite, 'financial exclusion'. This occurs when particular social groups are excluded from access to the formal financial system. Financial exclusion exists in all economies, developed and developing, and hence in Australia and New Zealand as well as the Forum island economies. Households may be excluded by remoteness from facilities, by inability to satisfy collateral or documentary requirements, or by transaction costs and the service policies of financial institutions. An appropriate definition of financial inclusion for Forum island countries would be 'the condition of having access to relevant and sustainable financial services' such as those described in the ADB definition, above.

The term 'financial inclusion' does not supersede the term 'microfinance'. However the exclusion of people from financial services is a more general problem, to which microfinance is one of a number of possible solutions. A variety of microfinance 'solutions', provided by a wide range of financial institutions, will be necessary to eliminate financial exclusion in the Forum island countries. We need to consider not just

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4 ADB (2000) *Finance for the poor: Microfinance development strategy*. Manila, Asian Development Bank.

Table 2: A classification of institutions providing microfinance services, And support institutions, in Forum island countries

Institutional Categories	Regulated by central bank or monetary authority	Subject to other regulation or legislation	Not subject to financial regulation	Supporting (non-financial) institutions
Public Sector	National Bank of Vanuatu (commercial bank) Treasury 'Cash' offices at district level, with private bank participation (PNG) Rural commercial bank agencies in post offices (Fiji, Vanuatu, PNG)	Samoa Development Bank Rural Development Bank (PNG)	Ni-Vanuatu Small Business Development Fund	National Micro-Finance Unit (Fiji)
Private Sector	Commercial Banks: ANZ (mobile banking in Fiji, Samoa, Solomon Is), Bank South Pacific (PNG), Nat Bank of Samoa. PNG Microfinance Ltd, 'aPex' remittances (Samoa) Finance Companies (PNG)	'Hebridean' Savings and Loan Cooperative (Vanuatu) PKF Credit Union, (Vanuatu) Vanuatu Credit Union League Licensed Moneylenders (Fiji)	Informal moneylenders (Fiji, PNG, elsewhere)	Microfinance Competence Centre (PNG)
Community Sector	Savings and Loans Cooperatives (PNG)	Credit Unions, Credit Union League (Fiji)	MFIs: Aglow MFI, FCOSS (Fiji), VANWODS (Vanuatu), SPBD (Samoa), CDA Bougainville (PNG). Village and Tikina Banks (Fiji) Informal savings clubs and revolving funds (PNG and elsewhere)	Microfinance Pasifika (regional network). Vanuatu MF Task Force (stakeholder consultative body). PNG national MFI assoc'n (Network). WIBF (Samoa) and *Putim na Kisim* (PNG) (Business and/or agricultural development services providers).
International Agencies	Wau Microbank (ADB) Papua New Guinea		Small Business Enterprise Centre (ADB) Samoa	UNDP Financial Literacy training (Fiji)

the creation of new specialized 'microfinance institutions' (MFIs), but also to think about how more orthodox financial institutions, including commercial banks, credit unions and savings and loan cooperatives, might be able to reach out to lower income and isolated households currently suffering exclusion. We need to think in a more 'systemic' manner, to consider how financial *systems* might be made more inclusive.

This brings us to an important distinction: that between microcredit 'schemes' and *systemic changes* designed to increase financial inclusion. Efforts at constructive financial system development are always and everywhere preferable to microcredit 'schemes'. The latter are usually short-term in focus, are sometimes politically-inspired, and are often designed as 'add-ons' to activities in other sectors, such as agriculture or community welfare, rather than as ends in themselves. This distinction is explored in some detail in section 4 as part of a discussion of the criteria for success of microfinance initiatives.

3. The financial service needs of the poor; micro and macro aspects of microfinance

The financial service needs of the poor are simple but their satisfaction can be life-enhancing. Principally, the poor need access to convenient, liquid and safe deposit services which are protected against inflation by positive real rates of interest. With savings in reserve the poor are able to smooth their consumption expenditures in the face of uncertain income streams. Savings provide a shield against catastrophic events, such as cyclone damage or the deaths of family members. Such misfortunes, by forcing the vulnerable to divest productive assets, would otherwise tip them over the dividing line between meagre sufficiency and poverty.

Access to deposit services assists the recipients of 'lumpy' income flows, such as remittances, to manage these more efficiently and prudently. This applies to domestic remittances in Forum island countries where internal migration is significant, but especially in those countries from which significant numbers of adults are absent working overseas. In both cases, access to efficient and reasonably-priced remittance services can provide considerable welfare benefits. Box 2 ('Remittance services in Samoa') contains a description of an innovative private, for profit, approach to providing money transfer services in the eastern Pacific. MFIs with contacts down to village level can partner with formal financial institutions to provide this service.

A related but as yet little-developed service which MFIs are equipped to offer in partnership with formal financial institutions and government agencies is arranging payments for utility fees, government charges and other obligations for persons living in remote locations, thus considerably reducing their transaction costs. As with other services, this can aid MFIs to achieve financial sustainability by diversifying their sources of income. There is also scope for households to receive payments from agencies of government, such as pensions, lease rentals and crop receipts, where applicable.

Micro-insurance is another financial product with potentially profound welfare benefits. Microfinance programs are learning how to pool risks among their clients to offer simple forms of cover against contingencies such as death and illness. Cover may be offered to clients as an element in loan contracts, or arranged for savings depositors upon payment of an additional fee. Earnings from micro-insurance contribute to the financial sustainability of MFIs and enable overhead costs to be spread over a wider range of activities. A number of Pacific MFIs already offer rudimentary micro-insurance services.

Box 2: 'aPex' Remittance Services in Samoa

aPex Remittance Services (not its real name) is an apparently thriving microfinance service provider, operating on a private, for profit, basis in Samoa and elsewhere in the Eastern Pacific. It offers remittance services, principally to and from Australia and New Zealand and uses commercial bank transfer services for this purpose. aPex is associated with a travel agency and its remittance agency appears a natural extension of the services it offers to travelling Samoans and members of the Samoan diaspora. While households in Samoa may wish to remit funds, for example to students in New Zealand, the flow of funds is predominantly inbound. After financial liberalization in 1998 it became possible for firms to operate as licensed foreign exchange and money transfer agents, although since 9/11 their operations have been subject to greater scrutiny and upper limits apply to transactions. aPex claims to report transactions regularly to the Central Bank of Samoa, and the Bank maintains active surveillance of licensed agents. It is aware that some operators are not licensed and is considering whether the current regulatory environment for these activities is appropriate.

aPex in Apia maintains a cash float for daily transactions, replenished regularly by transfers from offshore branches. These transfers, which are the daily aggregate of many individual remittances, are made by commercial bank telegraphic transfer. This enables aPex to economize on transaction costs. In the meantime, aPex branches offshore have emailed the Apia office listing the personal details of recipients (who must show appropriate identification) and the amounts to be disbursed in Samoan currency. (A rival firm uses SMS text messaging to inform clients of the arrival of remittances). No information was available on any spread taken by aPex in making this calculation, but on the face of it the nominal fees are less than half the cost of a bank transfer and considerably less than the costs of a transfer via Western Union. The aPex affiliate in Brisbane charges a flat fee of $A15 for transfers to Apia of less than $A2000, and slightly more if the transfer is to be made to a nominated bank account. Australian clients may deposit money directly to an aPex bank account in Australia if they do not wish to visit the Brisbane office.

Finally, the poor benefit from access to credit, which can increase the productivity of their labour in microenterprise activities. Close knowledge of borrowers and their preferences guides the managers of MFIs in designing loan products suitable to their needs. (Box 3 provides an example from Vanuatu of a loan product reflecting Pacific social values and conditions). Nor should microcredit be necessarily restricted to financing narrowly-defined 'productive' activities. Recognizing the fungibility of money, which makes it difficult for lenders to know exactly how borrowers use the funds they receive, many MFIs are prepared to lend for a wider range of purposes. These may include family needs, including school fees, and the purchase of consumer durables. MFI credit can free poor households from exploitative financial relationships with moneylenders, which are increasingly common in the Pacific region under the pressures of urbanization and social change.

At the macro-level, there are convincing arguments for microfinance as a beneficial influence on both economic efficiency and distributional equity. In terms of its contribution to efficiency, the extension of deposit services to larger numbers of people supports the processes of financial deepening and intermediation, which are positively associated with economic growth. Also, to the extent that access to financial services assists in the growth of informal sector economic activity (filling in the 'missing middle') it may play a helpful role in reducing the international wage-cost disadvantage suffered by Forum island countries (see box 4).

Box 3: 'Hebridean' Savings and Loan (S&L) Cooperative Ltd, Vanuatu

Hebridean Savings and Loan (not its real name) is an anomaly. While registered under the cooperatives ordinance and reporting to the relevant ministry, it may not satisfy governance requirements for a cooperative. Indeed it appears to be a private entity operating in the 'shell' of an S&L. The current management assumed control in 1996 when the S&L was experiencing a financial crisis. It is no longer a membership organization and deals with the public. After almost 10 years it seems to be prospering where conventional S&Ls have not flourished. Its operating methods are unconventional, but they shed light on some interesting aspects of consumer preference in the Pacific context. These may have some wider application in the design of financial products for a particular category of client in the region. While the operations of this S&L may not be replicable (even if that were desirable) it is instructive to consider how it works.

Briefly, Hebridean lends for business, agricultural and personal needs. The latter include school fees, travelling expenses and 'kastom' obligations. Management claims that it operates 'like a bank', but whereas a bank will typically require collateral worth at least 100% of the value of a loan, the S&L requires a savings deposit equal to the amount to be borrowed. In the case of government employees with whom direct salary deductions can be negotiated, a security deposit of 70% of loan value will be accepted. The secured deposit required for larger loans (in excess of Vt.100, 000, or USD1000) is negotiable, and the minimum loan amount is Vt.40, 000 (USD400). Loans bear interest of 16% per annum on a monthly reducing basis, while deposits earn annual interest of 2.75%. The latter is equivalent to bank interest, while the former is probably quite attractive if compared with personal loan rates, especially those of finance companies. Outstanding portfolio at the time of the interview was about Vt.80 million (USD 0.8 million) and deposits held were approximately Vt.50 million (USD 0.5million). Some 20% of loans were said to be in difficulty at the time, but Hebridean's policy is to recover outstandings at law. Loan documentation is adequate for this to be done, by means including garnishee orders against salaries for any shortfall between amount owed and the value of the security deposit.

At first blush, the operating methods of this S&L appear counter-intuitive. Why would customers borrow money when they already possess between 70% and 100% of the needed funds, and why would they accept 2.75% on their own funds while paying 16% for the loan? However, such behaviour is in no sense illogical if one accepts a set of consumer preferences, arising from a particular social environment. First, the behaviour suggests that some customers in Vanuatu place great value on having accumulated a lump sum and that they are reluctant to see it dissipated even in the face of pressing needs. Indeed they may see virtue in having the lump sum put beyond their own reach or that of other persons to whom they may have 'kastom' (that is, traditional) obligations. In order to satisfy the particular need of the moment (perhaps school fees, a chainsaw or an air ticket) they may prefer to enter into what amounts to a forced savings agreement to satisfy that need. They may even regard the subsequent reduction in their discretionary spending as a useful discipline and a further protection against the demands of members of their extended families. Seen in this light, Hebridean's customers behave quite logically in terms of their preference to retain a lump sum once accumulated and to insulate themselves from social pressures. These preferences seem likely to be shared by some people in most Forum island economies. This suggests that savings and loan products could be designed to meet the needs of such people, and that these would be quite profitable for MFIs or other financial institutions operating in environments where legal remedies are available at reasonable cost.

In terms of distributional equity, there is a convincing argument that greater financial inclusion enables the fruits of economic growth to be more widely shared. Access to finance benefits both household production and consumption. With regard to the latter, access and the improvements in 'financial literacy' that it brings can increase the efficiency with which households spend their money. With respect to household production, microenterprise activity stimulated by access to financial services enables the benefits of economic growth to be more widely shared. This applies particularly to female-headed households, which are over-represented among the very poor and are a particular target group of microfinance. It is also possible that growing informal sector economic activity stimulated by financial inclusion may assist in cushioning the shocks of adjustment to a worsening external trade environment forced upon Pacific Forum economies (box 4).

4. Appropriate aims for microfinance interventions, and criteria for their success

As mentioned in section 2, above, this study aims to refocus attention away from microcredit 'schemes' and to concentrate on systemic microfinance interventions in Forum island countries. The primary aim of such interventions should be to increase the degree of financial inclusion. This means that more households will have available to them sustainable financial services tailored to their needs and priorities. This should be the primary aim of 'microfinance', using that term in its broadest possible sense. An appropriate criterion for success of a microfinance intervention is simply this:

> *any intervention should demonstrate a measurable improvement in the inclusiveness of the financial system, in terms of providing sustainable micro-financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and their micro-enterprises.*

This criterion includes two quantifiable elements. The first is the degree of 'inclusion' or outreach to poor and low-income households. While this may seem obvious enough, inquiries in a number of Forum island countries suggest that most do not have good data to indicate what proportions of households actually have access to various financial services, for example passbook savings accounts. The measurement of 'financial inclusion' by monetary authorities or national statistical services is ill-developed. This data deficiency is not confined to Forum island countries and the World Bank is urging governments around the world to improve their data on access5

5 See **http://www1.worldbank.org/finance/html/presentations.html**

Box 4: Financial inclusion promotes economic efficiency and distributional equity

A. Pro-efficiency: Financial inclusion contributes directly to the process of financial deepening, which is an important concomitant of economic development. There is real significance for financial sector development in the extension of savings facilities to increasing numbers of poor householders. This is true no matter how small the average balances of their accounts. The poor can demonstrate a surprisingly high propensity to save, especially if they have access to safe, liquid, deposit facilities bearing positive real rates of interest. Extension of financial services, especially deposit-taking, to the financially-excluded lays the foundation for a cumulative process of financial deepening. This in turn supports 'financial intermediation', by which the growth of savings finances credit growth.

A second potential contribution to economic efficiency relates to the wage-cost disadvantage typically experienced by Forum island economies. This is inevitable so long as the bulk of the consumption needs of urban wage-earners is sourced from the 'modern' sector, with a high import content. By taking action to fill in the 'missing middle' of informal and micro-enterprises, Pacific economies could provide a growing range of lower cost wage-goods and (particularly) services for the consumption baskets of their urban workforces. This would tend to weaken the linkage between local wage rates and import price levels and increase the political feasibility of policies of wage restraint, designed to lower wage-cost disadvantage in Pacific economies in the longer term.

However it seems likely that financial exclusion is only one of a complex of factors contributing to the slow emergence of the 'missing middle'. The financial inclusion of microentrepreneurs may be a necessary condition for them to flourish, but it is unlikely to be a sufficient one. Microcredit is not a magic bullet capable of creating economic activities for the 'missing middle'. The limited range of skills and microenterprise opportunities of which potential borrowers are aware, and their very limited experience in business, tend to limit the usefulness of credit. On the other hand, greater access to financial services for wage-earners can provide significant welfare benefits, such as lower cost remittance services, reduced dependency on money-lenders and other high-cost credit services, and greater capacity for consumption-smoothing in the face of economic shocks. These benefits would tend to reduce pressures for wage increases and support national policies of wage restraint.

B. Pro-equity: Microenterprise conducted at the household level is a form of economic activity that enables the benefits of economic growth in the broader macro-economy to flow to poor and low-income people, and to facilitate their participation in that growth. Action to improve the productivity of microenterprises, including increasing their access to financial services, will have direct distributional benefits. Microfinance can also assist the sharing of prosperity in growing economies by assisting both wage-earners and poor households engaged in the informal economy to consume more efficiently. Female-headed households are over-represented among the very poor, and stand to gain disproportionately from financial inclusion and microenterprise opportunities.

A further point is relevant to the impact on Pacific island economies of 'market opening' due to trade liberalization, to which they are exposed because of changes in international trading arrangements. To the extent that greater financial inclusion contributes to filling in the 'missing middle' of Forum country economic structures and lowers import-dependence, this will contribute to increasing the capacity of low-income households to withstand the shocks of adjustment to a changing international trading environment.

The second quantifiable element is the degree of sustainability of particular micro-financial services. Where these are supplied by private, for-profit, financial institutions, such as commercial banks, they normally take the form of new 'products' tailored to the microfinance market. By opening new market segments, innovative products increase financial inclusion. In assessing the success of such innovations, bank managers apply normal commercial criteria to calculate returns on the assets employed. Box 5 ('a state commercial bank explores micro-lending') describes such a situation. For the external observer, the fact that a bank continues to offer a new product in the longer run is sufficient evidence of its sustainability. On the other hand, where services are supplied by not-for-profit entities, such as MFIs or credit unions, it is relevant to apply the concepts of 'operational' and 'financial' sustainability as defined internationally by CGAP, the international donor group on microfinance6.

Mention of commercial banks brings up the point that systemic microfinance interventions are not confined to establishing 'microfinance institutions' (MFIs). They may include efforts by *any* financial institution, whether regulated or informal, to expand its outreach to previously unserved population groups. An intervention can be said to be 'systemic' when it is capable of being replicated in the financial system at large, and therefore capable of increasing the system's capacity to serve a larger proportion of households. When rival banks imitate the microfinance 'products' introduced by others, this suggests that a genuine systemic innovation has occurred. In the Forum island countries, innovative financial interventions by a variety of institutions are increasing the capacity of Forum financial systems to 'include' their populations (Table 2).

Microcredit 'schemes' are unlikely to satisfy the goals of increasing 'inclusion' and achieving 'sustainability' unless they are more widely replicable. To be replicable, an initiative must be designed to have relevance to the broader financial system. This requirement rules out most of what were described above (in section 2) as 'add-on' projects. Examples might include those providing credit in association with rural development or livestock projects, or furnishing credit for the self-employment of graduates of vocational training or skills-development projects. Such 'add-on' microcredit schemes are usually implemented by agriculturalists or community developers rather than microfinance specialists, and are seen as a prop to the main goals of their projects, rather than as an effort to put in place sustainable financial sector processes.

Typically, microcredit 'schemes' do not outlast the projects that created them and they seldom leave behind any continuing financial sector capacity. Worse than that, to the extent that they may have been providing subsidized credit or that they were not serious about recovering monies loaned, 'add-on' projects may leave behind a negative legacy in

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6 The definition of 'sustainability' in microfinance adopted by CGAP, the Donor Consultative Group for Assistance to the Poor at www.cgap.org, is relevant here. It distinguishes between two degrees of sustainability for a microfinance institution. 'Operational' self-sufficiency requires institutions to cover all administrative costs and loan losses from operating income. 'Financial' self-sufficiency requires institutions to cover all administrative costs, loan losses, and financing costs from operating income, after adjusting for inflation and subsidies and treating all funding as if it had a commercial cost.

the form of a poor 'credit culture' among the 'beneficiary' population. Such 'schemes' tend to undercut the activities of genuine microfinance institutions attempting to operate on a sustainable basis.

Box 5: A state commercial bank explores micro-lending: National Bank of Vanuatu

After sailing close to insolvency in the late 1990s, the NBV was reconstructed between 1999 and 2001. The process involved getting bad loans off the balance sheet, after which it was possible to begin rebuilding a sound loan portfolio and recovering market share. Since 2003, and reflecting a commitment to rural banking services, this has included a modest but innovative program of micro-lending in rural areas. The ADB has provided technical assistance in developing this lending, which is currently conducted from seven of the bank's 20 branches, and on four of Vanuatu's islands. To end-March 2006 some 475 micro-loans had been made, totalling Vt.104 million (USD 1.04 million), and with a mean loan size just under USD 2200. While this is about 25%, by number, of all loans made during this period, it remains a very small fraction of lending by value, around 2%.

Loans were allocated 23% to agriculture, 5% to fishing enterprises, 44% to retail activities, and 28% to tourist ventures. The micro-loan product carries a flat rate 1.25% per month interest charge, flat (equivalent to around 27% effective) for terms of 12 and 24 months. Prime rates for bank lending range from 11% to 14%, diminishing, with the bulk of normal borrowers paying in the 14% to 18% range. NBV management comments that none of its micro-borrowers would have qualified for loans under standard criteria. Interestingly, in the process of considering micro-loan applications, NBV 'discovered' more than a hundred other persons who qualified for normal loans totalling Vt. 40m. Repayment performance for the micro-portfolio was good; around 130 loans had been paid off, while arrears on the outstanding portfolio stood at close to 1% in March 2006.

The major difference in the new product, other than the small size of loans, lies in NBV's reliance on character rather than collateral (which borrowers are unable to provide according to conventional criteria). Instead, the bank relies on customary authority figures ('chiefs') who command respect in the communities served and are willing both to vouch for the character of the loan applicant and to agree to exert pressure on individuals should they fail to honour commitments. Thus far this appears to have proved effective as a means of screening applicants and assuring repayment. However where traditional authority structures have been weakened by social change and internal migration this method may not be so effective. The micro-loan product has yet to be rolled out in Port Vila, the capital.

At present loan volumes, the micro-loan product does not break even; a five- or six-fold increase would probably be necessary. Calculations suggest sustainability would require each loan officer to administer from 100 to 125 loans and for the staff engaged to increase to 45 full-time officers (from the present 7 fulltime-equivalents) in 12 to 15 branches and main centres. However there are considerable barriers to achieving this; recruitment of suitable staff, prepared to work in the relatively isolated agencies offering the product, would be difficult. The bank is actively tracking advances in IT and mobile technology being trialled by microfinance institutions in Africa and Latin America that may offer cost savings for fieldwork in remote areas.

Social benefits of microfinance initiatives

The choice of language reveals much about the differences between 'schemes' and genuine financial sector initiatives. 'Schemes' have 'beneficiaries' while financial institutions aiming for sustainability have 'clients' or 'customers'. The term 'beneficiary' is drawn from the vocabulary of social welfare, and such schemes often have multiple objectives, including reducing poverty and the vulnerability of participants to economic shocks. Typically, women are chosen as the target 'beneficiary' group and their empowerment is seen as a particular aim.

In no sense does this study wish to denigrate such objectives, which are wholly legitimate. But this study argues that, if financial services are chosen as the tool for the job, these qualitative objectives can only be achieved on a continuing basis by sustainable financial sector initiatives. Financial inclusion (which is likely to secure both social and financial benefits) must be increased on a sustainable basis. This means that services must carry fees, charges and (especially) interest rates sufficient to cover the costs of efficiently-delivered services. In other words, the intervention must be primarily *financial* in nature rather than *social***.**

A well-designed financial sector initiative can indeed achieve broader social and economic objectives. It can contribute to alleviating poverty among its clients, can reduce their vulnerability to income swings and can achieve qualitative improvements in their lives by increasing their confidence and financial literacy. It is legitimate for a microfinance initiative to define its client population so as to target particular vulnerable groups, such as female-headed households. Even where targeting of female clients is not explicit, experience shows that where savings requirements are sufficiently stringent, loan sizes appropriately low for the poverty group, and other program requirements sufficiently demanding, it is almost inevitably the case that women predominate among qualified applicants for micro-financial services. It is also common for programs to apply poverty-targeting criteria. For example, Grameen Bank replications in many countries apply a 'housing index' as a measure of the poverty levels of households seeking access to microfinance facilities. This aids program managers in selecting the genuinely poor for participation.

A relevant distinction here is between the class of programs that aim to create micro-financial institutions, and those that see microfinance as a necessary element in a package of business development services. The former include initiatives such as VANWODS MFI in Vanuatu, SPBD in Samoa and Aglow MFI in Fiji (see box 6, below). These have in common a focus on creating sustainable MFIs and concentrate on achieving scale in their operations, recognising that reducing transaction costs is essential to the viability of their financial services.

At the other end of the spectrum (although not to be dismissed as 'schemes' or 'add-ons') are programs directed to developing the potential of the human being as a self-supporting and resilient micro-entrepreneur. A leading example is the Women in Business Foundation (WIBF) in Samoa, which provides comprehensive training programs and

actively explores business opportunities and market development. It also provides some credit, after exhaustively preparing its clients for borrowing. A corollary of this intensive process is that the numbers of women who can benefit from training is quite limited and the number who access credit is smaller still. This is not necessarily reason for criticism; what we have is a contrast in philosophical approaches. It is best to conclude that WIBF and like programs are not operating within the scope of microfinance as defined for the purposes of this study.

Some disabilities of Pacific microfinance

Microfinance in Forum island countries suffers from some quite daunting disabilities. Distinct features of Pacific island demography (low absolute populations, low population densities) and geography (remoteness and high transport costs) decisively influence the scope for microfinance. These disabilities place limits on the application of principles and practices originating from other regions, such as Monsoon Asia. This is because microfinance provision is a labour-intensive activity. Higher population densities, other things being equal, permit higher client-loads per field officer and/or lower time and transport costs per client. (These two variables are virtually the reciprocal of one another). Hence low population densities are associated with high transaction costs of service delivery. Population densities in the Pacific region, with limited local exceptions, are in general lower than is desirable for sustainable microfinance. For example, in Monsoon Asia, Bangladesh is the laboratory where the Grameen Bank and a number of other world-leading microfinance institutions were developed. With a total population of 144 million and density of around 1,000 per Km2, Bangladesh provides an acute contrast to the Pacific population densities recorded in table 1, above. The extreme contrast is with PNG, about three times the size of Bangladesh, with a density of 11 persons per Km2.

However, a summary measure such as a low national population density may hide the existence of concentrated pockets of population. If transport and communications infrastructure for such sub-populations is adequate, it may be possible to assure economical service delivery. Unfortunately the highest population densities in the Forum island countries are found (table 1) in those with low total populations, for example Nauru and Tuvalu, where the problem of the ‘missing middle’ is also extreme. This limits the number of potential ‘pockets’ suitable for microfinance in these small island states.

Absolute population size in even the most populous Forum island countries (Papua New Guinea, Fiji, Solomon Islands, Samoa) is still much lower than in countries where labour-intensive models of microfinance (such as Grameen and its variants) have flourished. This does not rule out the possibility that some sufficiently dense pockets of humanity may exist. (See, for example, the discussion below of the choice of Upolu Island by SPBD as the site for its operations). But it does suggest there may be scope for only a small number of viable institutions in the region. A checklist of criteria for setting up MFIs under Pacific conditions, to be used in feasibility studies, would be a useful tool for potential ‘investors’ and for agencies wishing to support microfinance development. The experience of Grameen Bank replication in the Pacific is reviewed in Box 6.

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Box 6: replicating Grameen Bank in the Pacific

Early attempts in the Pacific to set up MFIs proved disappointing. LLDAT in PNG and WOSED in Fiji died lingering deaths. It appeared that high unit costs in the Pacific must prevent MFIs from achieving sustainability. However experience of some newer MFIs may give reason to re-examine that conclusion. VANWODS MFI in Vanuatu and the South Pacific Business Development Foundation (SPBD), in Samoa, appear to be operating at levels of efficiency not previously seen in the region. They are transparent and able to produce timely operational and financial reports. Both operate on islands (Efate and Upolu) with relatively high population and good transport, so they may benefit from access to suitable 'pockets' of humanity. VANWODS rides the usual NGO merry-go-round of dependence on the goodwill of donors and government agencies for annual grants while trying to build for sustainability. SPBD, by contrast, relies on the deep pockets of a key donor/investor. His financial commitment and business-like approach have attracted support from 'social investors' (foreign financial entities that specialize in taking equity in promising MFIs or otherwise supporting their operations).

At end-February 2006, VANWODS MFI reported outstanding loan portfolio of Vt. 14.5 Mn (USD 145,000) to 1500 borrowers at a mean loan size of Vt. 9,544 (USD 95). Portfolio at risk was reported at a very low 0.7% for loans overdue 30 days or more. VANWODS calculated operational sustainability at 103.8% and financial sustainability at 84.6%. These figures appear creditable but do not account for subsidies (including the salary of the UN Volunteer manager) and inflation. A striking feature of the balance sheet was that savings of clients were more than double the value of loans, at Vt. 35.4 Mn. These were held by some 1700 savers, with a mean balance of USD 205.

SPBD Foundation does not spring from Samoa. Its founder, having decided to start a Grameen institution, surveyed market prospects in the region. He looked for 'an island' with the right combination of economy, infrastructure, population density and political stability, before settling on Upolu and commencing operations in 2000. SPBD made more than 10,700 loans, totalling cumulatively almost USD 3.4Mn at an average of USD 313, by March 2006. The Foundation incurred losses in each year of operation, although these are diminishing. Management claims the ratio of operating income to operating expenses in 2005 was better than 100% for the first time and is confident SPBD will be in the black in 2006. Unlike VANWODS, this calculation includes the costs of an expatriate manager hired at local rates. However financial sustainability does not appear to be an early prospect. Accumulated losses have substantially depleted the Founder's initial investment, but soft loans and 'quasi-equity' from social investors have maintained working capital at adequate levels. Accounts are kept in NZD and at end-2005 loans outstanding totalled NZ 0.77Mn, with portfolio at risk 2.97% (more than 30 days). This is a somewhat problematic figure, compared with VANWODS at 0.7%. SPBD does not require compulsory savings as part of loan contracts and voluntary savings facilities were offered for the first time only in 2004. The amount saved is insignificant, certainly by comparison with VANWODS. As a condition of a loan from Planet Finance, a European social investor, SPBD agreed to undergo a rating by the Indian microfinance rating agency, M-CRILL, in April 2006. Results were not available at the time of writing. The rating exercise, involving detailed scrutiny of the Foundation's operating procedures and financial accounts, is a rigorous procedure. Its outcome will enable a more informed judgment of the performance and potential of SPBD.

There is much to admire in the performance reported by these two MFIs. One reason for concern relates to the sustainability of the microenterprises they finance, especially in Samoa where remittances may underpin repayment rates. However the value of the VANWODS savings services is obvious, and SPBD would do well to expand this aspect of its activities. More time is needed to see how much further these MFIs can advance towards sustainability.

A ray of hope comes from managerial and technological advances occurring around the world. Innovative approaches to cost-sharing and new electronic technologies applicable to microfinance in the Pacific context may permit the unit costs of delivering conventional microfinance services to be lowered to acceptable levels. Unfortunately the 'Pacific impediment' of high costs due to geography is not compensated by any wage-cost advantage in the region, vis-à-vis countries in Monsoon Asia and elsewhere where microfinance has thrived. Although the point about high relative wage-costs in the Pacific is well-known in relation to export and import-competing industries, it should also be remembered when considering the prospects of microfinance in the region.

Aside from demographic aspects of disability, the problem of the 'missing middle' remains as a formidable barrier to the effectiveness of microcredit. The limited range of skills and microenterprise opportunities of which potential borrowers are aware, and their very limited experience in business, tend to limit the usefulness of credit. However, given that microfinance includes a range of other services (savings, insurance, remittances, payments) these may not be subject to the same disabilities. They can provide a development stimulus in circumstances where the physical barriers to service provision are surmountable.

5. Some practical findings

Diversity is desirable

Table 2 sets out a classification of institutions actively providing micro-financial services in the Pacific Forum island countries, and others that provide support services. One of the objects of this study is to show that a wide range of institutions can 'do' microfinance. Specialist MFIs in the voluntary sector (such as VANWODS in Vanuatu, Aglow MFIin Fiji and SPBD in Samoa) are dedicated to microfinance and may offer a range of services, typically including savings, credit and perhaps insurance). But other institutions may offer microfinance services which are less well understood, such as 'aPex' in Apia (box 1) which offers a competitive remittance service, or 'Hebridean' S&L in Port Vila (box 2) which offers an unusual savings and loan package attractive to many Ni-Vanuatu.

Even conventional financial institutions such as commercial banks can develop microfinance 'products' that have a place in their corporate strategies, as well as tapping a new market segment. Good examples are National Bank of Vanuatu and its drive to develop a microcredit loan portfolio (box 5) or ANZ Bank's innovations in mobile banking (box 7). In a somewhat different category are central bank experiments in banking regulation, done to permit small specialized commercial banks to be created for the microfinance market segment (PNG Microfinance Ltd and Wau Microbank, both in PNG, see box 8).

Different again are some public/private experiments in setting up service points in rural and remote areas at which financial services can be offered. These may not involve innovation but rather the rediscovery of services that had been abandoned after Independence. For example, commercial banks are opening 'windows' in rural postal

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Box 7 Mobile banking services in Fiji and Samoa

According to UNDP, some 340,000 of Fiji's population of around 825,000 remained 'unbanked' until recently. In Samoa, an ANZ banker estimates perhaps 100,000 of that country's 180,000 residents lack access to bank accounts. However, mobile service initiatives by a commercial bank in both countries, as well as in Solomon Islands, may change these ratios in coming years. In Fiji, ANZ aims to capture 140,000 of the unbanked as depositors within three years. It has invested in a fleet of 6 mobile banks serving 150 villages and settlements on a regular schedule. Twelve staff, recruited and trained specifically for this service, travel the main islands of Viti Levu and Vanua Levu and visit some smaller islands.

The bank offers 2 savings products and requires accounts to be operated for at least six months before credit may be accessed. The service also extends to rural schools. By January 2006, after 15 months of mobile operations, ANZ Fiji claimed more than 52,000 new accounts. Around F$3.0 Mn (USD 1.5Mn) was mobilized in savings accounts, with an average balance close to F$60. Some 98% of these new account-holders were said to be 'first-timers'. In addition, the bank made a modest start to micro-lending, advancing some F$260,000 to around 400 borrowers (an average loan-size of F$650). A UNDP observer comments that the mobile banks have potential to facilitate microfinance more broadly. They assist rural MFIs to manage their cashflow and to open group deposit accounts on behalf of clients. The mobile bank has also attracted the attention of other service and financial institutions (such as the national provident fund, native land leasing authority and Fiji Telecom) which are considering its potential as a conduit for making payments to, or collecting charges from, rural households.

The Fijian experience is echoed in Samoa, where a single banking van is in operation. The mobile service handles payment of remittances from workers in American Samoa, and ANZ is negotiating with authorities to handle electricity bills and pension payments. The mobile service is described as appealing to 'senior citizens, the less educated and the shy' (the latter being people intimidated by the formality of normal banks). The Samoan service, while smaller in scale than the Fijian, is technically more advanced. Benefiting from access to good telecom services on the compact landmass of Upolu, Samoa's main island, it is equipped with mobile phone and fax facilities and an EFTPOS terminal. Two laptop computers are used for data entry and account queries can be handled on the spot by calling the Apia office. The van is airconditioned, enabling staff to serve clients from inside, and equipped with purpose-built furniture and security features. Profitable sideline activities (money-changing on the wharf for cruise ships and Saturday morning banking at Apia market) assist in making the service viable.

A notable feature of the Fijian experience has been collaboration with UNDP, which took part in planning and monitoring the service and has designed and supported a 'financial literacy' training program in communities visited by the bank. This 4-hour module in the vernacular will be extended progressively to all 1,200 rural villages and settlements in Fiji. The banking van is only part of a caravan of vehicles carrying staff, trainers and security personnel on the schedule of visits. Social conditions in Samoa allow security precautions to be confined to the physical design and alarming of the vehicle, but in Fiji the presence of police is judged necessary. This cost is borne by government, which has also facilitated the mobile service by allowing a 150% tax writeoff on the initial investment in vehicles.

Reference: Liew, Jeff (2006), 'Banking the unbanked in Fiji: the ANZ and UNDP partnership'.

agencies in a number of countries, and in Treasury district cash offices in PNG. Such arrangements enable cost-sharing and allow government to assume risks that may otherwise prevent commercial banks from offering rural services. Such initiatives are likely to tap into substantial funds that are 'hoarded' in the countryside; the commercial bank collaborating with PNG Treasury has been agreeably surprised at the volume of savings mobilised via rural cash offices.

Private and public sectors have their roles, aside from the voluntary sector

Visits to a number of Forum island countries reveal an interesting variety of private, for profit, entities offering microfinance services. For too long a narrow understanding of microfinance has encouraged the assumption that it is an activity conducted by MFIs in the voluntary sector, with perhaps some token involvement by commercial banks. But instances of innovative microfinance products introduced by private sector entities (including those of ANZ, "Hebridean' S&L and 'aPex') should serve to banish this stereotype. To this list one could add the creation of the PKF Credit Union in Vanuatu by an accounting firm. PKF has created software and administrative procedures for setting up and running a credit union and is prepared to 'franchise' these processes to any interested party, on a cost-recovery basis.7 Another example, a work-in-progress, is the tentative adoption by private finance companies in Papua New Guinea of microcredit lending methodology under the guidance of the Microfinance Competence Centre, a training and support facility set up as a joint venture by the ADB and the Bank of PNG (the central bank).

If private sector innovations are applauded, what then is the future for public sector initiatives in microfinance? While unfashionable, there is still merit in the view that a state bank operating under Pacific island conditions can, if insulated from political influence, continue to pursue both efficiency and a community service mandate. It is difficult to see private commercial interests taking on the task of developing the micro-lending market in rural Vanuatu, as the NBV is doing. And it is worth remembering that publicly-owned institutions in Indonesia, at national level (Bank Rakyat Indonesia, or BRI) and local level (the LPDs of Bali) are world-leading microfinance institutions. The value of the BRI experience for the Pacific is often overstated, but it is useful in showing that public ownership is not an automatic disqualification for effective provision of rural- and micro-finance services. The key appears to be effective protection of the institution from political pressures (which has certainly been the case for BRI's village units, the micro-banking wing of BRI) and the benchmarking of performance against industry standards. But since state banking institutions in Pacific Forum countries have a rather

7 A detailed discussion is not possible here. Briefly, new legislation for the Credit Union movement in 2000 seems to have been the last straw for the ailing Credit Union movement and its Credit Union League. They were unable to manage the procedures for registration under the new ordinance and in fact PKF is the sole registered Credit Union in Vanuatu. It was set up to provide for the welfare of staff of the accounting firm and has expanded to serve staff of a number of private sector entities. PKF also found it necessary to create a new Vanuatu Credit Union League to satisfy the governance requirements of the legislation. Thus an infrastructure and intellectual property now exist for the re-emergence of the CU sector, created by private sector initiative. As a caveat, however, PKF comments that compliance with the revised legislation is a demanding task.

chequered history, scepticism is understandable. The worst outcome, and one that governments need to avoid, would be for failed state institutions to attempt a comeback by jumping on the microfinance bandwagon.

Governments may provide direct support for microfinance or otherwise provide an enabling environment for it

Leaving aside the ownership of banks by government, there is the larger question of the role of government in relation to microfinance. Assuming they wish the sector to flourish, governments may take action to promote it directly, and/or act to put in place a policy and regulatory environment that facilitates the growth of appropriate institutions and processes.

Direct action by governments to stimulate microfinance would include support for financial system-building at the grassroots. Government would encourage savings mobilization among 'financially-excluded' households by supporting expanded outreach of deposit-taking institutions. Public-private partnerships using state infrastructure are one means by which this might be supported. These would require cost- and risk-sharing arrangements. It is more difficult for government to encourage the 'intermediation' (or on-lending) of savings by deposit-taking institutions in these areas, but the discovery of savings capacity in a district sends a market signal to commercial institutions that lending opportunities also exist. MFIs can expand the frontier of lending and for this purpose, it might be appropriate for governments to support MFI capacity-building. Campaigns to increase the 'financial literacy' of rural and low-income populations are another positive measure to which governments can contribute.

Aside from direct measures, governments can take steps to create an 'enabling' environment for microfinance, in which government policies and regulations are either directly supportive, or at least do not inhibit microfinance without good reason. On the other hand, heavy-handed attempts to compel 'good behaviour' by regulated financial institutions can prove counter-productive. For example, it is unrealistic to expect that all savings mobilized in a particular district will be lent back within that district. There are often good commercial reasons why this is not feasible and it may furthermore not be in the interests of depositors in the region concerned.

In this context it is necessary also to consider how a central bank (for those Forum members that have one) might influence the environment for microfinance. Central banks in some Forum island countries have taken positive measures to promote microfinance. In PNG in the late '90s the Bank took responsibility for reviving and restructuring the Savings and Loan movement, partly because of the historical accident that its colonial predecessor was responsible for setting up the movement in the first place. More recently it partnered the ADB in a microfinance project, among the outcomes of which have been a 'Microfinance Competence Centre' attached to the country's banker training institute and the creation of the Wau Microbank (box 8).

In Fiji in the early part of this decade the Reserve Bank initiated discussion of measures to extend banking services into rural areas. Its proposals for involving the commercial banks in this enterprise may have been pre-empted by the ANZ mobile banking initiative (box 7) or, alternatively, might be credited with forcing ANZ's hand. However, the more closely central banks in the region conform to the modern consensus on central bank functions, the less likely they will be to intervene directly in matters affecting microfinance. One exception is the recent exercise of regulatory discretion by the Bank of Papua New Guinea to permit the licensing of two specialist microfinance institutions under central bank supervision (box 8). This is an interesting experiment, since it is notable that countries (such as Indonesia and the Philippines) whose regulatory regimes permit the operation of small specialized microfinance banks show some of the most promising developments in microfinance. However central banks in the region are likely to be less interventionist in future.

In terms of the overall policy and regulatory environment, Forum island countries have largely avoided interest rate controls, directed bank lending and the use of central banks for 'quasi-fiscal' purposes that have distorted financial systems in other parts of the world. But in some Forum countries there are still interest rate subsidies and government grants that undercut the operations of microfinance institutions attempting to operate sustainably, or inhibit their emergence. There are legislative environments that are outdated (as for credit unions in Fiji and PNG) or too complex (as for credit unions in Vanuatu). There is a relatively new cloud on the horizon, in the shape of anti-money laundering measures that may inhibit the development of economical solutions to the demand for remittance services. Governments need to consider whether in yielding to external pressure to regulate money transfers they do not unwittingly stifle innovation in this sector. Overall, however, the relatively liberalized financial sector environments of most Forum island countries are conducive to microfinance.

Government's role is not to lend, nor to fund lending

The discussion (in box 1) of Fiji's national Micro Finance Unit (MFU) suggests that allocating resources for lending without making complementary investments in capacity and without giving attention to systemic issues is a mistake. It certainly shows that government agencies are not good lenders. Instead of attempting to kickstart microcredit by providing resources for lending, governments would do better to support capacity-building for lending institutions, especially MFIs, but not excluding commercial institutions.

Governments should avoid the rush to regulate

This issue is relevant to MFIs in the voluntary sector, rather than to regulated financial institutions that may be offering microfinance products. In the microfinance literature, the expression, 'the rush to regulate' describes a common response on the part of finance ministries when they become aware of growing numbers of MFIs. Their instinctive reaction to this unfamiliar phenomenon is to regulate it. However, there are compelling reasons for caution in the approach to regulation of microfinance activities. As was

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argued above in the case of remittances, the principal objection to microfinance regulation is that it is likely to stifle innovation in an industry that is rapidly changing and developing.

The principal argument for regulation is prudential, to protect savings entrusted to an institution by poor people. Thus any institution accepting deposits from the public should be regulated. But in the case of an MFI whose principal business is lending, and which accepts savings from its members as an element in the loan contract (as is common) the case for regulation is much less compelling. In some jurisdictions collection of savings by an MFI is tolerated so long as the net balance of transactions shows loans outstanding to be substantially greater than savings held. In some Forum countries, savings mobilization is tolerated so long as the MFI deposits the funds immediately with a regulated institution, on behalf of its members. This seems a reasonable requirement for a young institution, but perhaps in time well-established MFIs could be permitted to operate on a 'net balance' basis. Where this is permitted, as in the Philippines, it is because MFIs have proved themselves capable of self-regulation on the basis of agreed standards. In the meantime, regulation of MFIs that deposit their members' savings in banks seems quite unnecessary and indeed counterproductive. In general, while central banks may see a need to bring deposit-taking MFIs under regulatory control, they are also acutely aware of the costs of supervising numerous small institutions. They may be more prepared to regulate if they can see an effective means of 'outsourcing' the supervisory function to another agency, perhaps an 'umbrella' organization of the MFIs themselves.

The importance of savings is commonly neglected

In a number of Forum island countries (including Fiji and Samoa, at least) conventional wisdom holds that the indigenous people 'do not have a savings culture'. This is a dubious proposition, contradicted in contemporary society by the behaviour of the clients of 'Hebridean' S&L (described in box 3) and by other examples to be discussed below. But it is not even clear how true this generalization is of 'traditional'cultures.

Put simply, saving is the postponement of consumption. It involves a decision not to spend income immediately but instead to defer present satisfaction in favour of future consumption. Even in cultures in which money is not used and therefore is not saved, as in traditional Pacific island societies, important examples of savings behaviour can be found. For example, Pacific agriculture is based on the production and consumption of tuber crops. These have the characteristic that they may be harvested over a period of time. They may be consumed now, or they may be left in the ground for future consumption, even though this entails forgoing present satisfaction. A pig may be slaughtered at maturity, or later, as circumstances dictate. And for traditional reasons, often involving the desire to present feasts to other significant parties, households will defer consumption of food stocks in favour of the prestige to be gained from a lavish display of food on some future occasion. This is saving behaviour, although in a non-monetary context. In a monetary and non-traditional context, especially where greater elements of individualism are emerging, households may find it both possible and desirable to save if appropriate services can be devised for them. That element of design,

Box 8: Regulatory innovation: specialized microbanks in Papua New Guinea

New banking legislation in PNG in 2000 redefined the role of the central bank (Bank of PNG) and revised the regulatory framework. The *Banks and Financial Institutions Act 2000* set a minimum capital of K.15Mn (USD5 Mn) for a bank and K.1.5Mn (USD 0.5Mn) for a 'licensed financial institution'. The latter are essentially finance companies, but include two microfinance entities. PNG Microfinance Ltd is a fully licensed financial institution under the Act, whereas Wau Microbank (WMB) is licensed under exemption and is subject to additional prudential conditions. They are the only authorized deposit-taking 'microbanks' in Pacific Forum countries.

WMB was established in 2004 as a pilot project in a remote location. It is a partnership between Bank PNG (as executing agency) and ADB (as funding agency), intended to apply new savings and loan products and delivery mechanisms in PNG. In licensing WMB, Bank PNG devised special prudential conditions for it. Implementing agency for the project is IBBM, a training facility owned jointly by Bank PNG and commercial banks. ADB seems to be the ultimate owner, although IBBM holds the license. The Wau market proved too small for viability and WMB moved its locus of operations to the city of Lae in 2005, though maintaining an office in Wau. IBBM is the location of another component of the BPNG and ADB project. This is the 'Microfinance Competence Centre' (MCC), a training and technical assistance facility which supports WMB and other microfinance service providers. MCC reports that, at end-March 2006, WMB had almost 5,900 savings accounts totalling more than K2.8Mn (USD 0.94Mn), averaging K480 (USD160) per account. It had released some 1580 loans totalling almost K2.0Mn (mean loan size K1265, or USD420). Loans outstanding at end-March were K0.642Mn, so that the ratio of deposits to outstanding loans was more than 4 to 1. This is one of many instances pointing to great demand for deposit services in the Pacific. Portfolio at risk stood at 9.47% (more than 30 days), suggesting good reason for a cautious approach to the further expansion of credit.

PNG Microfinance Ltd (PML) is 60%-owned by PNGSDP. A private commercial bank, BSP, is a 40% shareholder. As owner of the assets of the former State commercial bank, BSP may see its investment as fulfilling a community service obligation. But it may also have a commercial interest in learning from the experience of PML. In addition, negotiations are said to be at an advanced stage for the IFC, a member of the World Bank group, to take a shareholding and to supply technical assistance. PNGSDP benefited from the divestiture by BHP Billiton of its 52% shareholding in Ok Tedi Mining Ltd (OTML). OTML operates a mine in the Western province. PNGSDP is charged with supporting development in that province, and in PNG more generally, financed by OTML dividends. The activities of PML are intended as one means of fulfilling this obligation. PML took over microfinance outlets established in the province by OTML and has subsequently increased the number of branches there to five. Outlets in the sparsely-populated Western province are a drag on PML's viability. It has also opened branches in the national capital and Oro province, where breakeven may be achieved more quickly. At end-March 2006, after 15 months in operation, PML had almost 49,000 depositors with balances totalling K10.8Mn (USD3.6Mn) at an average of around K220. Its portfolio of outstanding loans, involving individual and some group lending, stood at K2.6Mn to some 2600 borrowers, with a mean balance outstanding of K1000 (USD330). As with WMB, the deposit to loans ratio exceeds 4 to 1. PML's 2005 financial statements do not provide portfolio-at-risk data but loan provisions and notes to the accounts suggest portfolio quality is satisfactory.

Bank PNG is unlikely to repeat the WMB regulatory experiment. It is withdrawing from 'developmental' activities and is considering what simpler framework of regulation might be appropriate for microfinance, and how supervisory responsibility might be farmed out. The MCC is assisting with the formation of an MFI network that might grow into such a responsibility.

finding the appropriate savings product, is what is most interesting about the 'Hebridean' case study in box 3.

In section 3, above, it was argued that, at the aggregate level, the expansion of savings facilities among the financially excluded is likely to have macroeconomic benefits. This is because extension of deposit services to larger numbers of people supports the processes of financial deepening and intermediation, which are positively associated with economic growth. And at the personal level, access to deposit accounts is for many people a life-enhancing service. But in the Pacific, the strongest argument for the extension of savings services is that rural and low-income people so manifestly want it! Thus, among the case studies examined in this report are a number of institutions whose savings totals are two, three or four times as great as their lending. Leading MFIs, including VANWODS and Aglow MFI (the latter in Fiji), actually charge a fee for the collection and deposit of member savings. Although this amounts to a negative nominal rate of interest, the demand for deposit services still appears strong. The success of ANZ mobile savings services in Samoa and Fiji also suggests that rural people have a latent demand for deposit services. The success at savings mobilization of those institutions that have made serious efforts in the field suggests that this phenomenon may have much broader relevance across the Pacific region.

Efforts to increase financial literacy, in conjunction with well-designed savings campaigns, will increase the aggregate savings performance of Forum island peoples.

6. Conclusions and recommendations

i) Microcredit is not the solution to 'the missing middle', but *microfinance* is part of the answer

In Forum island countries, there is a gap between the introduced economic system and the traditional system of subsistence production. This gap is described here as 'the missing middle'. Microcredit is sometimes seen as a panacea (a 'magic bullet') capable of filling this gap by stimulating informal sector activities. This view is not correct, since the reasons for the absence of a thriving informal economy are complex and merely providing credit is a simplistic response to this complexity.

But it is true that achieving the transition from subsistence and stimulating private sector development from the bottom up will be assisted by giving rural and low-income people greater access to financial services. Microfinance is relevant to the needs of these people and is certainly part of the solution to achieving the necessary structural changes in Forum island economies.

ii) Rural and low-income people need a broader range of financial services

For Forum island countries, an appropriate definition of microfinance is provided by the Asian Development Bank:

Microfinance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and their micro-enterprises

This makes the important point that a broad range of services must be fostered. Among these, credit is only one and by no means the most important one.

iii) Instead of focusing on microcredit, or even microfinance, Forum island governments would do better to focus on 'financial inclusion' as an overriding policy goal. They should attempt to measure the proportions of their populations with access to financial services, as a yardstick of progress over time towards greater financial inclusion.

For rural and low-income people, financial inclusion can be described as 'the condition of having access to relevant and sustainable financial services'. The primary goal of policy should be the elimination of financial *exclusion*, and in the circumstances of Forum island economies, microfinance is the most appropriate tool for achieving this. To measure progress towards greater financial inclusion, governments and central banks should calculate and publish summary measures of the access of their populations to financial services. UNDP might assist in devising measures of access that are comparable across the region.

iv) The importance of savings is underestimated. Governments should support well-designed programs to assist households to save as well as action to increase their financial literacy. This is an area in which the UNDP Pacific Sub-Regional Centre in Suva has particular expertise, which could be made available to governments on request.

Rural and low-income households will save if appropriate services are devised and provided for them. This report documents a number of institutions which collect savings two, three or four times as great as their lending as well as innovative approaches to savings mobilization through mobile banking. Efforts to increase financial literacy, in conjunction with well-designed savings campaigns, will increase the aggregate savings performance of Forum island peoples and disprove the conventional view that Pacific islanders lack a savings culture. Apart from the benefit to the households concerned, there are good macroeconomic reasons to encourage higher national savings. This is an area in which the UNDP Pacific Sub-Regional Centre in Suva has particular expertise, which could be made available to governments on request.

v) Diversity is desirable: a wide range of approaches and institutions will be needed to eliminate financial exclusion. Governments need to think in a more 'systemic' manner, to consider how the whole financial *system* might be made more inclusive.

A wide range of institutions can 'do' microfinance. A diversity of microfinance 'products', provided by a range of financial institutions, will be necessary. These will

include not only specialized ‘microfinance institutions’ (MFIs) in the voluntary sector, but also regulated financial institutions, including commercial banks, credit unions, savings and loan cooperatives, finance companies and specialized ‘microbanks’. Governments need to think in a more ‘systemic’ manner, to consider how the whole financial *system* might be made more inclusive.

vi) Pessimism about the sustainability of voluntary sector initiatives, including Grameen Bank replications, may prove overdone. However rigorous market surveys should precede the establishment of such schemes if they are to qualify for government or external assistance

Generally low population densities in the region lead to correspondingly high transaction costs of delivering microfinance services. However, a low national population density may hide the existence of concentrated pockets of population. If transport and communications infrastructure for such sub-populations is adequate, it may be possible to assure economical service delivery. While some MFIs, in Fiji for example, continue to find sustainability elusive, at least two others, in Samoa and Vanuatu, are recording increases in outreach and improved capacity to cover operating costs. This may be because they have tapped into suitable population ‘pockets’.

Thus pessimism concerning the suitability of ‘Asian’ models of microfinance for the Pacific may prove overdone in the longer run. However, the number of ‘pockets’ suitable for labour-intensive microfinance is likely to be quite small. And even though the small island states have some of the highest population densities, their low overall size makes it unlikely that many such pockets exist there. Detailed market surveys (such as that conducted by SPBD in Samoa) are necessary before government or external resources are invested in establishing labour-intensive MFIs, such as Grameen replications. UNDP may be able to assist in mounting such surveys.

vii) Private sector investments and public/private partnerships have great potential and government should facilitate such initiatives

There is growing awareness of the potential of the new emerging microfinance market among regulated private sector institutions, such as commercial banks and finance companies. Some are beginning to learn from the experience of MFIs and to develop their own innovative microfinance ‘products’. Other, small-scale, private sector initiatives are emerging in service areas such as remittances. Governments in the region are also turning their attention to the potential for public/private partnerships as a means of extending financial services to remote and regional areas. Governments are providing access to public infrastructure (postal agencies, Treasury cash offices) for private commercial banks. Deals for cost-sharing and risk-sharing are being struck to overcome the reluctance of commercial banks to serve rural communities.

viii) State banks charged with community service obligations may continue to play a useful role, especially in smaller states

The record of state-owned banks in the Pacific has not been good. But doctrinaire opposition to any role for state banks in achieving financial inclusion is not appropriate, especially in smaller states where it may be difficult to see alternatives. The key appears to be effective protection of the institution from political pressures and the benchmarking of performance. However the worst outcome, and one that governments need to avoid, would be for failed state institutions to attempt a comeback by jumping on the microfinance bandwagon.

ix) Some public initiatives do more harm than good. Governments should avoid 'packaging' ill-conceived microcredit schemes into other sectoral projects

Certain microcredit schemes are designed as 'add-ons' to activities in other sectors, such as agriculture or community welfare, rather than as ends in themselves. They are often created on the initiative of bilateral or multilateral agencies, but also by government agencies with no expertise in financial services. Typically, such 'add-on' schemes do not outlast the projects that created them. Worse, they often provide subsidized credit or are not serious about recovering monies loaned. This tends to leave behind a negative legacy, in the form of a poor 'credit culture' among the people who were served. Worse still, 'add-on' schemes tend to undercut the activities of genuine microfinance institutions that are attempting to operate on a sustainable basis. Governments should resist the inclusion of financial sector elements in sectoral programs unless these are shown to be well-conceived and implemented by microfinance professionals.

x) Innovations in information technology are cutting microfinance transaction costs in other regions. Telecoms reform in Forum island countries will increase the potential for sustainable microfinance in the region using new information technologies

Another reason for cautious optimism is that information technology (IT) is cutting the costs of delivering microfinance services in Africa and Latin America. Reform of the telecommunications sector in Forum island countries is important for many reasons. But for microfinance, its significance lies in the fact that by reducing call costs and facilitating the adoption of appropriate technologies, it could assist in lowering transaction costs of financial services to sustainable levels. These benefits would flow through to the full range of service providers, including commercial banks and other regulated institutions as well as MFIs. Governments need to appreciate the potential for lower telecoms costs and improved services, coupled with new IT applications for microfinance, to reduce financial exclusion in the Pacific.

xi) Governments may support microfinance directly, through support for financial system-building at the grass-roots, or indirectly by providing an enabling policy and regulatory environment

In terms of direct support, governments should encourage grassroots savings mobilization and the intermediation of resources to lending by sustainable institutions. Other positive measures include support for capacity-building of MFIs and other grassroots financial institutions pledged to sustainability. Governments could also provide support for MFI networks set up to exchange information and to define and monitor best practice standards of operating and reporting.

An enabling environment is characterized by the absence of interest rate caps or subsidies, and of government grants that undercut sustainable microfinance. There would be no inappropriate legislation inhibiting institutions such as credit unions from operating in accordance with modern microfinance principles. Government would be cautious about adopting anti-money laundering measures that might inhibit the development of economical local solutions to the demand for remittance services. Government would support efforts to increase the financial literacy of populations. And it would avoid 'the rush to regulate' microfinance unnecessarily. UNDP is an agency with an overview of policy and regulatory developments in the region and is well-placed to advise governments on these issues.

xii) Government's role is not to lend, nor to fund lending

Direct lending by government agencies is a mistake. Allocating resources for lending by other entities is also problematic, especially if done without making complementary investments in capacity and without giving attention to systemic issues.

xiii) Governments should avoid the 'rush to regulate' voluntary MFIs

Premature or excessive regulation is likely to stifle innovation in a new industry. The main argument for regulation of MFIs is prudential, to protect the savings of poor people. For MFIs whose principal business is lending, and which accept savings from members as an element in the loan contract, the case for regulation is not convincing. In some Forum countries, savings mobilization is tolerated so long as the MFI deposits the funds immediately with a regulated institution, on behalf of its members. This is appropriate.

Well-established MFIs might be permitted to operate on a 'net balance' basis (that is, permitted to accept deposits equal to some set proportion of the outstanding loan balance). The case for this is strong where MFIs have proved themselves capable of self-regulation on the basis of agreed standards. In the largest Forum countries, national networks or associations of MFIs could play a role in the process of defining and agreeing appropriate standards. Governments could usefully assist such networks to develop and should accord them status. For isolated institutions in smaller states, international networks could assist in keeping them informed about standards and trends in the microfinance industry.

xiv) Some regional initiatives are desirable, to generate and share information relevant to the effort to establish sustainable microfinance processes in Forum island countries and to reduce the financial exclusion of their peoples

The most obvious characteristic of microfinance practitioners in the region is their isolation, not just in a geographic sense but in the sense of their lacking peers with whom they can share experience and from whom they can learn about successful innovations in the field. The need for contact and communication is not confined to MFIs in the voluntary sector. Regulated institutions benefit from a better understanding of successful MFI practice. All can benefit from learning about opportunities for commercial linkages (or partnerships) between regulated and unregulated, or larger and smaller entities.

Forum Secretariat could usefully examine the potential of the proposed new *Microfinance Pasifika* network to bring together the disparate set of players in microfinance in the region for information exchange and for capacity-building. As a practitioner network, *Pasifika* might play a role complementary to that of the UNDP Pacific Sub-Regional Centre, which has been mentioned at several points in this study as the premier source of technical assistance for microfinance across the Forum island region. The *Pasifika* network is an Australian initiative but it will be incorporated in Vanuatu. It is worth noting that the three most significant international microfinance networks are all headquartered in the United States. They are *Accion* (for Latin America), Women's World Banking and the Microfinance Network (both inter-regional). This is understandable in the sense that microfinance leaders in developing countries are fully occupied running their own institutions and generally do not have time or resources to give to international organizations, even though they recognize their value.

Microfinance Pasifika could be encouraged to take the lead in examining the potential for IT innovations in microfinance to be applied in the Pacific context. This is a rapidly expanding field and an effort to pull together the lessons of international experience for demonstration and dissemination in Forum island countries would provide a valuable service. The network might also provide opportunities for discussion of the policy and regulatory environments for microfinance in Forum island countries.

xv) By demonstrating strong interest in microfinance, Forum Economic Ministers have shown that they regard it as a financial sector issue rather than a social welfare project. If they further resolve to review progress in the field again in some years' time, they will assist in keeping the attention of officials and external agencies focussed on the need to make progressive reductions in financial exclusion.

It is extremely helpful to the cause of financial inclusion for the FEMM to demonstrate its strong interest in sustainable microfinance. It helps to assure that the reduction of financial exclusion is seen as a financial sector issue rather than a social welfare problem. If the FEMM would further resolve to review progress in the reduction of financial exclusion across the region at some future time, this would assist in maintaining the priority of issues of sustainable microfinance and the extension of financial services for governments in Forum island countries.