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BWTP Network Industry Update

B.W T.P.
Banking With The Poor Network

The BWTP Network Country Updates are occasional updates on the Asian microfinance sector.

The BWTP Network Secretariat will consider any ideas or submissions by practitioners in the region.

Contributions for consideration can be submitted to the BWTP Network at: **info@bwtp.org.au**

Microfinance in Timor-Leste (East Timor)

One of the world's youngest countries is overcoming immense challenges to build a system of financial inclusion.

Introduction

Timor-Leste became a fully independent nation in 2002, following 400 years of Portuguese colonial rule, 24 years of Indonesian occupation, and approximately two and a half years under the transitional authority of the United Nations. One of Asia's poorest nations, Timor-Leste emerged from occupation and brutal conflict with 80 percent of the country's infrastructure damaged or destroyed and no functioning access to financial services. While several Indonesian banks operated in Timor during the Indonesian occupation, the system had to be completely rebuilt after 1999: nearly all professional staff (e.g., managers, loan officers, administrators), required retraining and support to adjust to more senior positions or to begin an entirely new profession. In rural areas, access to finance was not generally an option, supplanted by a culture of dependence.

In this context, beginning in 2000, a new financial services industry began to establish itself, with commercial banks in Dili, microfinance programs and cooperatives concentrated in the rural districts. The commercial banks have a presence in to eight of thirteen districts. In rural areas, donor-funded microfinance initiatives developed into more commercially minded operations, high-school leavers became loan officers, managers assumed more responsibility and territory.

Timor-Leste Demographic Data[1]

Population: 1.065 million (est. 2008)

Life expectancy at birth: 60.2

- Around 56% of the population is over 15 years of age.
- 3-600,000 economically active people.

Rural/Urban: 74% of population lives in rural areas 4 with majority formal jobs based in the capital Dili and second city Baucau.

Poverty: Increasing from 2001 to 2007 as proportion living below national poverty line ($0.88 per capita per day) increased

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Ten years on, three donor-founded initiatives have achieved operational sustainability, with two of them reporting solid profits. Branch by branch, centre by centre, client by client, a system of inclusive finance is being built in Timor-Leste.

Characteristics and Experience

The financial services sector in Timor-Leste is characterized by its context: on one hand weak infrastructure and market linkages as well as human capacity constraints, but on the other also by the resilience of current retail players, excess liquidity at the commercial banks, and stabilizing effect of the US dollar.

Overall access to finance has grown steadily since independence, from complete destruction of all access points in 1999 to an estimated 13% financial inclusion in 2009.[1] Coverage is moderate; 38% of the population has a bank or MFI branch in their sub district.[4] There are three foreign-owned banks, one Timorese (government- owned) bank, two microfinance institutions (MFI), approximately 25 credit unions of varying degrees of development, Western Union, and an array of pawn shops offering retail financial services, all strong enough to survive a major civil security crisis in 2006. There is a potentially large unmet demand for microfinance with market size estimates of between 275,000 and 400,000[4] clients. However, effective demand is probably lower given the slow growth of established providers and current poor state of infrastructure.

Most of the country's basic infrastructure was destroyed in 1999 and remains in disrepair. Road travel (walking, trucks, buses) remains the primary transport mode for people and trade. There is regular but not frequent ferry boat service to the outlying district of Oecussi and island of Atauro. A recent Asia Development Bank survey of core road conditions found 22% in poor and 70% in very poor condition.[2]

The number of people with internet access is negligible and less than 0.5% of the population has a landline.[3] Wireless phone coverage extends to 68% of the population; however cellular penetration is only 14%.[4] One Mobile Network Operator, Timor Telecom (TT), will operate under monopoly concession until 2017, and is not engaged in provision of financial services although has stated an intention to enter the field. There is no wholesale lending currently active, no capital market or bond market. Banks and MFIs have significant problems with cash-in-transit. Cash is difficult to move around the country, with financial service providers resorting to high price security or high risk self transport of cash outside of Dili. Poor road and security conditions only intensify the costs and risks of this problem to financial service providers, staff and clients.

Government Policy

The Government recognizes inclusive finance as part of its poverty reduction program via the National Priority Working Group on Rural Development. The challenge is in coordinating four separate ministries currently planning or engaged in financial sector activities (MoED, MoF, OPM and MCTI). The United Nations Capital Development Fund provides support policy coordination on the government side while the IFC Better Business Initiative facilitates better information and specificity on priorities from the private sector side.

There is interest in reform and strong government participation in the Better Business Initiative working group on financial services. In 2008 and 2009, the World Bank

[1] Honohan, Household Financial Assets in the Process of Development. In: J.B. Davies, Editor, *Personal Wealth from a Global Perspective*, Oxford University Press, Oxford (2008).

[2] IMF: Democratic Republic of Timor-Leste: 2009 Article IV Consultation - Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Democratic Republic of Timor-Leste, July 2009

[3] DNE Nacional de Estatística,(2007): Final Statistical Abstract: Timor-Leste Survey of Living Standards, 2007, DNE, Ministry of Finance, July 2008.

[4] Bankable Frontier Associates: The potential for New Technologies and Branchless Banking Models to Expand Access to Financial Services in Timor-Leste. Draft Jan 2009, ADB

Group's 'Ease of Doing Business' ranked the country 170 out of 181. There was marked improvement in 2010 (164), based on the current government's reforms in the category of Paying Taxes.

Legal/Regulatory Framework

The Banking and Payments Authority (BPA), an embryonic central bank, is charged with maintaining price stability and solvency of the financial sector, Forex, payment system, general economic policies. It regulates 3 commercial banks and the Instituicao de Microfinancas de Timor Leste (IMfTL), which has special status according to a commercial banking law. There is an insurance law and two applications were made in 2009 for licenses but none approved, so there are currently no in-country providers.

There is a lack of clarity for MFIs on the issue of intermediating savings. MFIs currently operate under the official status of 'Non-Government Organization (NGO)'. This status has presented problems for both the BPA and MFIs and both have expressed a mutual interest in addressing this. The BPA has drafted regulations for Non-Bank Financial Institutions (NBFIs) and has agreed to accept support from UNCDF and the Better Business Initiative to review them and provide technical support and input to their implementation, which is planned for 2010. While there is no current regulatory framework for branchless banking, this work is expected to be done by the BPA, with support from the ADB in 2010.

A main constraint to the expansion of lending is the absence of a land law, asset registries or enforcement of contracts law. In March 2010, the Council of Ministers made a long awaited step forward, approving the land law proposed by the Ministry of Justice to define ownership of immovable properties and its expropriation and sent it to Parliament for approval[5].

In addition, some of the key challenges in the provision of an enabling financial services environment include:

- The Companies Act doesn't allow foreign banks to take mortgage over assets.
- There are no consumer protection laws pertaining to banking.
- No laws pertaining to branchless banking (though this work is planned in 2010).
- Low institutional capacity of the judiciary.

Institutional Level

Australian, Portuguese and Indonesian banks have established branches in Timor-Leste, resulting in a broad selection of products and practice for such a small market. Three foreign owned commercial banks have a total of 10 branches and 15 ATMs: Australia and New Zealand Bank (ANZ, 1 branch/8 ATMs); Caixa Geral Depositos (CGD, 8 branches and 6 ATMs); and Bank Mandiri (1 branch/1 ATM).[6] ANZ, the only merchant acquirer, has 37 point of sale service points – all in Dili. [6] Due to an inability to legally enforce agreements, banks have found lending to local businesses difficult thus maintain high excess liquidity. While commercial banks have some consistent policies, bank systems are not interoperable. All Banks report to the central banking authority, the Banking and Payments Authority (BPA), and have signed on to participate in the BPA's credit information system, launched in May 2009 and designed to include NBFIs.

There is one state owned quasi-bank, Instituçao Microfinancas Timor-Leste (IMFTL), the largest MFI in terms of portfolio size. IMfTL began in 2000 as a donor initiative; founded with donor trust funds managed by the ADB and by 2004 established itself as an operationally sustainable institution with a

[5] Suara Timor Lorosa'e, March 15, 2010
[6] Respective Bank websites and conversations with bank personnel

solid branch network (eight including head quarters in Dili). IMfTL is profitable[7], primarily engaged in collection of deposits and provision of loans of public sector employees. 76% of the current portfolio are Payroll Loans or Loans to IMfTL Employees/Staff, the majority secured by direct deposit of the borrower's salary into the bank[8]. IMfTL's total portfolio is solid, with just 1% past due. In the unsecured lending products, past due loans continue to be a problem with 14% of the microfinance group direct and 6% of seasonal crop loan portfolios past due.[9]

IMfTL is in the process of a gradual transformation, obtaining a commercial banking license with the intention of privatization. In 2010, IMFTL's limited license was expanded from a $3 million deposit ceiling to a total of $5 million public deposits and $5 million private deposits. As of December 2009, IMfTL reported just under $3 million in deposits (41,580 accounts) and in January 2010 $5.6 million in deposits, with at least one significant new depositor, the Government of Timor-Leste. IMfTL has taken on a larger share of responsibility for Government transfers and it is likely that it will do more in the near future.

Two microfinance institutions, Tuba Rai Metin (TRM) and Moris Rasik, (MR) operate, with 19 branches and almost 14,000 clients (TRM: 2838, MR: 11089) between them.[10] The majority of clients are poor women using group loan methodology. Both institutions:

- began (MR in 2000, TRM in 2002) in a more crowded field of NGOs, grant and transfer programs;
- have demonstrated ability to sustain operations despite security diversions or uncertainty in the market;
- require members to open savings accounts which serve as loan guarantees;
- access grant funds to improve staff capacity;
- have identified client low financial literacy as a constraint to expansion.

Moris Rasik operates the largest rural finance network in the country, reporting $3.6 million in active loans for 10,478 loans, just under $2 million in deposits (including a new term product) and a total of 115 staff.[11] MR operates in every district except Dili (except for the island of Atauro) and Baucau (where TRM is dominant). MR's PAR has remained under 3% for more than four years and in December was 1.05%. Last year, MR reported profits of $192,615[12] with an operational efficiency rate of 22.4%.[13] Moris Rasik has secured international loans on commercial terms from Triodos and Blue Orchard, and currently seeks to source commercial loans in-country. MR is currently piloting micro-insurance (life with payout for death of client), financial literacy, and new staff incentive programs.

Tuba Rai Metin is the smaller, less developed of the two institutions operating primarily in Dili, Manatutu and Baucau districts with smaller branches in Maliana and Los Palos. TRM has a USD $437,162 active loan portfolio and 2,838 active borrowers. The institution has 15 staff members and an operating efficiency rate of 12.4%. Portfolio at Risk (PAR) has been a problem, particularly in Dili and areas in close proximity. PAR spiked when the country experienced a security crisis in 2006 and while TRM worked it down to 8.1 in December 2008, it was up to 18.1% in

[7] IMfTL, Consolidated Statement of Interest and Expense, December 2009.
[8] Ibid.
[9] Ibid.
[10] December 2009 Financial Reports, TRM and MR.

[11] Moris Rasik
[12] Profit/Loss is the actual surplus or shortfall in interest income after all operating costs have been paid.
[13] Annual Operating Expense over Average Loan Portfolio. It measures the cost of disbursing one dollar in cents

December 2009. After more than three years without a significant partnership to support operation, TRM began a partnership with BASIX (an Indian MFI), through Microlead (a UNCDF initiative), in 2009. BASIX will provide technical assistance and capacity building over 5 years.

There are Approximately 25 credit unions at varying degrees of development with 2,735 members in aggregate[14]; at least five may be categorized as self help groups. CUFA have a MoU with the MoED to build the capacity of the DNC and the credit unions. CUFA also have plans to assist in working towards the establishment of a regulatory body.

Pawn shops, informal money lenders and ROSCAs are active. There are no licensed domestic insurance companies, no equipment leasing companies, and no venture capital firms. Western union and commercial banks do international remittances, IMfTL, CDG and Western Union offer domestic remittance services but these are restricted to large towns – there is no current outreach to rural areas.

Wholesale and Investment

There is currently no wholesale lending, capital market or bond market. Both Moris Rasik and Tuba Rai Metin have at different phases been slowed down by inadequate access to capital and technical assistance.

With only Moris Rasik as potential borrower, the current market is too small for apex activity. A wholesale product is currently being considered for pilot at ANZ.

One wholesale loan was made (2005) by Mandiri Bank to Moris Rasik with collateral documentation for 150% of loan amount, MR did not renew and got better terms from international providers. ADB, IFC, Blue Orchard and Triodos have activities in country as can be considered potential investors while UNCDF lends through INFUSE program, currently at concessional rates.

[14] Credit Union Foundation of Australia: Timor- Leste Credit Union data for 2009

Challenges for the Future

Given recent (slower) growth in the microcredit category of lending, it is likely that demand for deposits will soon outpace demand for microcredit. This will present both challenges and opportunities as the MFIs consider how to handle deposit demand given unclear regulatory framework for savings and Moris Rasik's high return on deposits. Agency relationships to address MFI capital needs will likely be explored. On the regulatory side, uncertainty for MFIs to mediate savings may limit their scope to develop appropriate savings products demanded by their customers.

The market's capacity issues will continue to challenge financial sector development and broadening financial inclusion. The country's limited financial business support infrastructure, consisting of a government agency IADE (Institusau Apoio Desenvolvementu Empresarios) and a few NGO business and vocational training providers are not yet able to play a dynamic part in addressing low skills and weak rural market links.

The Government's intention to enter the financial services market to meet unmet SME demand[15] for investment finance will present a challenge to other financial service providers but also opportunity for joint ventures or other alternatives to traditional development banking. Planned public investment in rural infrastructure in 2010may present opportunities in rural areas and therefore increased growth/demand for rural financial services providers.

[15] Johansson, Johanna S. "SME Credit Demand in Timor-Leste: Credit Findings", Better Business Initiative, August 2009. The study confirms that there is unmet effective demand for SME credit. A majority of interviewed enterprises, from smaller to larger, revealed a need for longer termed financing across the range of $5,000 to $250,000 for start-up and expansion of business opportunities. Larger enterprises need and could service longer termed (12 to 48 months) loans in the range of $250,000 to $3 million. Firms revealed weak financial management capacity and limited access to business development or support services.

The introduction in March 2010 of the land law that which defines ownership of immovable properties will present several challenges that might need to be addressed at different levels. Education on financial matters will need to incorporate education on the implications of the land law. As financial products are many times awarded on the basis of physical collateral, the implications of signing contracts involving property must be a priority within financial education initiatives. In addition, the land law may imply that financial institutions will be more inclined to offer credit services and products. This may have a positive effect on microfinance expansion of coverage and services offered but may also reduce the liquidity amassed by institutions reluctant to award credits based on high default levels.

The BWTP Network would like to thank Milissa Day and the IFC Better Business Initiative for their work on the 'Microfinance in Timor-Leste' Country Update. The Better Business Initiative is a public-private dialogue providing a platform to refine and action private sector priorities in Timor-Leste.

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The Banking With the Poor Network

The Banking with the Poor Network (BWTP Network) is Asia's microfinance network that works towards building efficient, large-scale sustainable organisations, through co-operation, training and capacity building with the aim of achieving innovative, appropriate and demand-driven financial services for the poor. The Network is an association of a diverse range of microfinance stakeholders committed to improving the quality of life of the poor through promoting and facilitating their access to sustainable financial services. The BWTP Network is an initiative of the Foundation for Development Cooperation and its Secretariat is based in Singapore.

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