Southeast Asia Working Paper Series

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No. 6 | November 2011

Asian Development Bank

ADB

ADB Southeast Asia Working Paper Series

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Asian Development Bank

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www.adb.org

November 2011
Publication Stock No. WPS114137

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I. INTRODUCTION

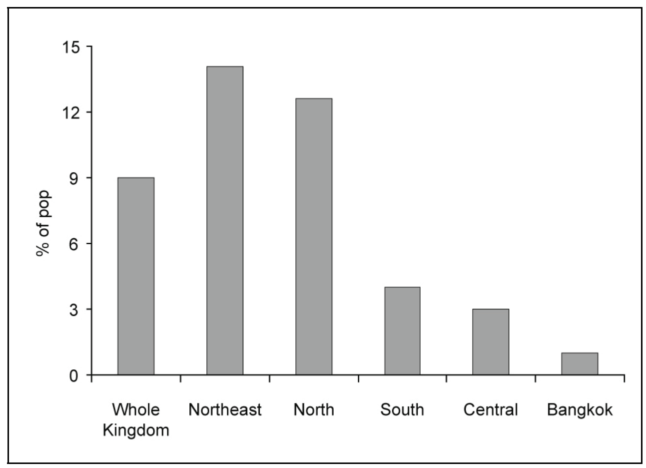
1. The purpose of this paper is twofold. First, to provide an assessment of recent developments in poverty and income inequality in Thailand, synthesize the literature on the key causes of persistent income inequality, and summarize the government's programs to address it. Second, to identify key priority areas for engagement of the Asian Development Bank (ADB) in supporting the government's poverty reduction efforts. Developing the microfinance sector is identified as the key priority.

II. POVERTY AND INCOME INEQUALITY IN THAILAND

Recent Developments

2. **Despite Thailand having been very successful in lowering the national incidence of poverty, significant pockets of subnational poverty remain.** The government's Household Socio-Economic Survey is used to estimate the poverty rate for Thailand. It shows that the incidence of poverty has continuously declined from around 33.8% in 1988 to 9.0% in 2008. The poverty rate of 9.0% is relatively low compared to other middle-income countries. However, the aggregate poverty figure masks considerable differences in the incidence of poverty across subnational regions and demographic groups. In particular, the poverty incidence in the Northeast region remains relatively high (Figure 1). About 40% of Thailand's poor reside in the Northeast region. Poverty rates are high among children and the elderly.

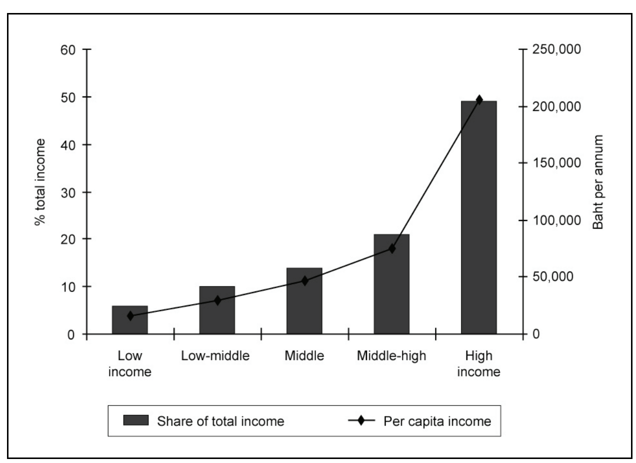
Figure 1: Poverty Incidence by Subnational Region
(% share of region's population)



Note: Poverty rates refer to persons above 15 years of age.
Source: National Economic and Social Development Board (NESDB). 2008. Household Socio-Economic Survey 2008.

3. **Income inequality in Thailand is among the highest in Southeast Asia.** Various measures of income inequality show that Thailand's income distribution is skewed toward a small percentage of the population. The richest 20% of households account for over half of total household incomes in Thailand (Figure 2). The Gini index of household income (a measure of income inequality) at around 0.51 is among the highest in Southeast Asia,[1] and similar to estimates found for several Latin American economies that until recently faced persistent inequality—Argentina, Brazil, Costa Rica, and Mexico. The concentration of wealth (financial assets) is

Figure 2: Income Distribution in Thailand



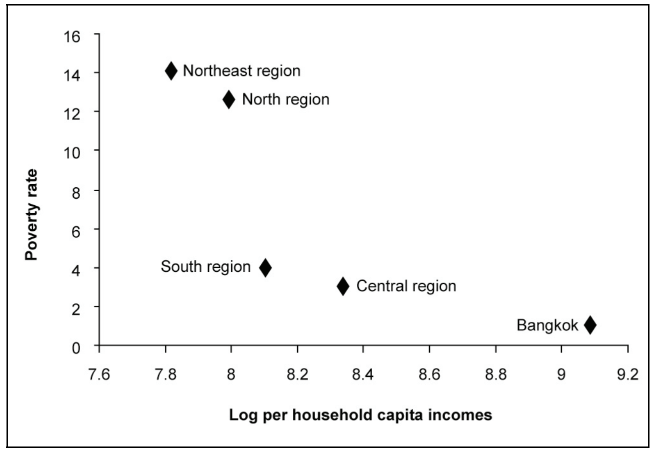
Source: NESDB. 2008. Household Socio-Economic Survey 2008.

[1] Indonesia, Malaysia, and Viet Nam have Gini indexes below 0.40.

more skewed with the richest 20% households accounting for 70% of total household financial assets.

4. **Differences in regional per capita incomes are the key determinant of poverty and inter-regional income inequality in Thailand.** A negative relationship exists between subnational per capita household incomes and the incidence of poverty, indicating that regional disparities in the level of economic development is a key determinant of poverty and regional inequality in Thailand (Figure 3). Very low rates of poverty are recorded in regions with high per capita incomes such as in Bangkok and in Central Thailand. High rates of poverty are recorded in low per capita income regions of the Northeast, and to a lesser extent the North and Southern regions. The poorer regions lag in terms of performance in other indicators of deprivation, such as lower school enrollment and student retention rates.

Figure 3: Poverty Rate and Per Capita Incomes – Subnational Comparison



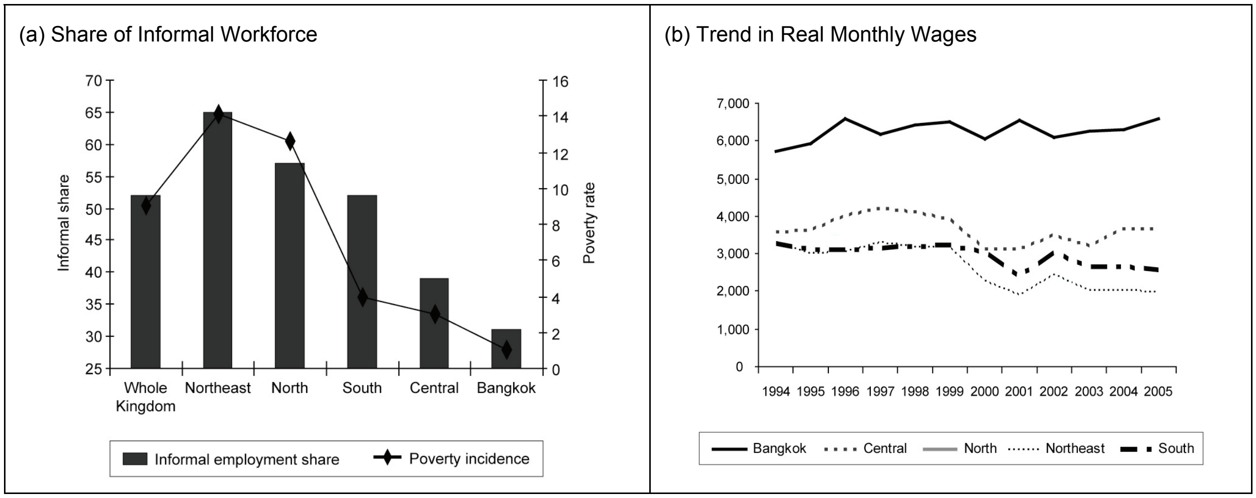
Source: NESDB. 2008. Household Socio-Economic Survey 2008.

5. **Most regions in Thailand exhibit a similar pattern of income distribution and inequality.** The subnational estimates from the Gini indexes are similar across regions, with Bangkok recording a similar Gini index as the other four regions. ***This suggests that interventions to address income inequality should be a combination of economy-wide, regional, and sector-specific programs.***

6. **The poor are overrepresented in the agriculture sector.** Low-income families and poor families are heavily concentrated in agriculture, with almost half of the poor engaged in the agriculture sector. About 90% of the poor reside in rural areas.

7. **Labor market informality also explains income inequality.** Families are more likely to be poor if they are engaged in the nonwage, informal sector compared to families in the formal sector. This labor market outcome also explains inter-regional income disparities. Figures 4(a) and 4(b) show that high rates of labor market informality and compressed earnings growth are associated with higher rates of poverty and regional income disparities. In recent years, there has also been a divergence in trends in real wage growth between the more advanced regions and less advanced ones, indicative of differences in labor demand and supply conditions. In particular, the Northeast region is characterized by a high rate of labor market informality (65% of workforce is informal), low real wage growth, and high rate of poverty. ***Thus, the expansion in non-agriculture and wage employment is important for poverty reduction in the less advanced regions and to address regional disparities in incomes.*** Education and size of families are other important labor supply variables that impact on poverty and income inequality in Thailand.

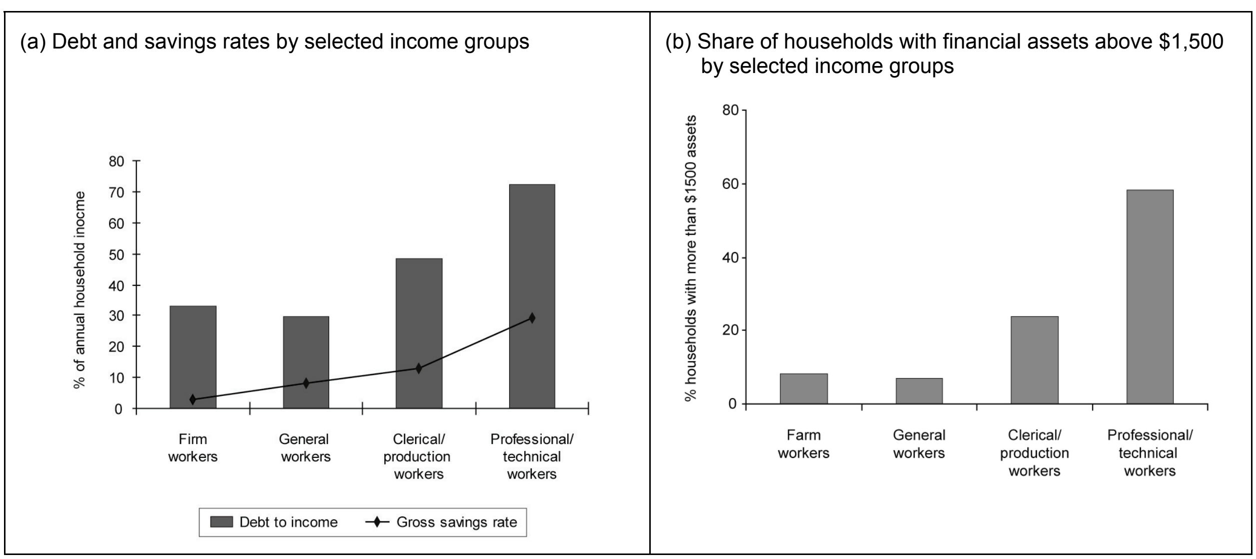
Figure 4: Labor Market Informality and Real Wages by Subnational Region



Source: National Statistics Office and Labor Studies and Planning Division, Department of Labor Protection and Welfare. 2010. Labor Force Survey 2010.

8. **Lack of inclusion of low-income families in the finance sector is a key determinant of persistent income inequality in Thailand.** Reflecting the pattern of income distribution in Thailand, savings and financial asset distribution is also relatively skewed in Thailand (Figure 5). Savings rates of high-income earners are in the order of 30.0% compared to less than 3.0% for farmers and laborers and less than 10.0% for general workers. Low-income households' holdings of financial assets (bank deposits, bonds, shares, etc.) are also very low with only 8% of low-income households reporting total financial assets of more than $1,500. While low incomes are a major reason for low rates of savings and financial asset holdings, the relatively shallow depth of the capital market, high transaction costs in the capital market and limited range of savings products, and a lack of private sector provisioning of microfinance products available to the poor are also factors that explain low rates of savings and financial asset holdings among the poor.

Figure 5: Income Distribution and Financial Inclusion



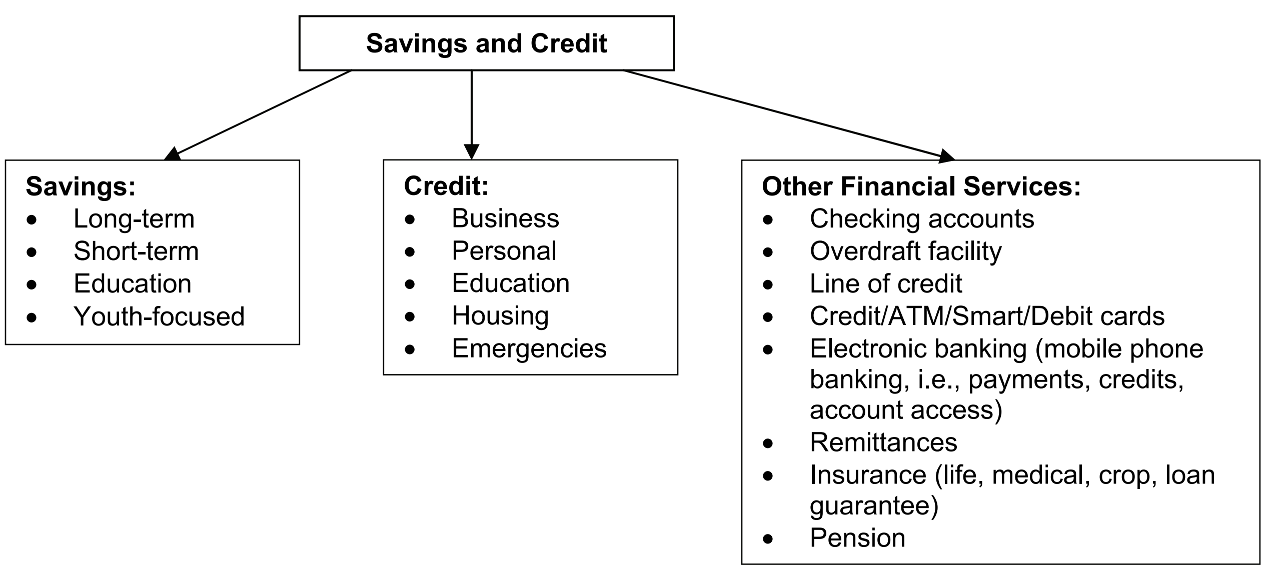
Source: NESDB. 2008. Household Socio-Economic Survey 2008.

III. INCLUSIVE FINANCE

9. **In recent years, countries have included measures in their finance sector development strategies or national poverty reduction strategies to enhance inclusive finance.** Inclusive finance refers to both the *opportunity* and *ability* to use financial services such as savings, borrowings, and transfer payments. Capability to use financial services is important to enhance household incomes and welfare through accumulating wealth, investing in productive or income generating activities, ensuring against unforeseeable events, managing risks, etc. To effectively access financial services also requires persons to have sufficient knowledge of financial services. Thus, inclusive finance refers to both financial access and financial literacy. An inclusive financial system offers permanent access to a broad range of high-quality financial services to the entire active population of a country at an affordable cost, including the most economically disadvantaged and also the “missing middle” who often find themselves excluded by maximum loan sizes extended by microfinance providers and the lowest amounts lent by small and medium-sized enterprises or commercial banks. An inclusive financial system can better reach and better meet the needs of the unbanked and underbanked through a much wider range of products and services, including agent banking, microsavings, electronic and branchless banking, mobile phone financial services, insurance products, long-term housing loans, and money transfer services. An inclusive finance approach differs from the traditional microcredit approach that focuses heavily on providing credit and using savings as collateral.

10. **Key goals of an inclusive finance sector include** (i) access at a reasonable cost of all households and enterprises to the range of financial services for which they are “bankable,” including savings, short- and long-term credit, leasing and factoring, mortgages, insurance, pensions, payments, local money transfers, and international remittances; (ii) sound institutions, guided by appropriate internal management systems, industry performance standards, and performance monitoring by the market, as well as by sound prudential regulation where required; and (iii) multiple providers of financial services, wherever feasible, so as to bring cost-effective and a wide variety of alternatives to customers (which could include any number of combinations of sound private, nonprofit, and public providers).

Figure 6: Evolution of Microfinance



11. **Published data indicates that a large share of the population has access to financial services.** A recent Bank of Thailand study showed that 91.0% of households had access to financial services of at least one type, 85.0% had access to savings products, and 64.0% had borrowed from a financial institution (formal, semi-formal, or informal). A recent report on microfinance industry in Thailand noted that about 72% of households needing credit have access to it, either formally or through informal channels.

12. **While access to financial services of the population appears to be substantial, there is considerable variation in the degree of access to financial services across income groups.** Low-income families (the poorest 40% households by income quintile) have access to a limited range of financial services and of lower quality services compared to the middle- to high-income families (the richest 60% of households by income quintile). For example, about 38% of low-income families have only used 1 or 2 types of financial services, while another 16.0% of low-income households do not use financial services at all. This compares with almost 80.0% of middle- to high-income families using 3 or more types of financial services. Similarly, almost half of low-income households do not borrow compared to 27.0% of the middle- to high-income households. About 28.0% of low-income households do not have access to savings products compared to 6.0% from the middle- to high-income groups.

13. **The government sector is the major provider of microfinance servicing low-income families.** The microfinance sector in Thailand comprises three main categories: (i) the formal and large microfinance institutions (MFIs), which are the banks and nonbanking institutions (NBIs) operating under prudential regulations and include commercial banks and special financial institutions (SFIs); (ii) the semiformal MFIs, which operate under nonprudential regulations but as member-based organizations can capture savings and investments within communities and include agricultural, savings, and credit union cooperatives, registered savings-for-production groups, and the Village and Urban Revolving Fund (VRF); and (iii) informal independent and self-help savings and credit groups, which are community and member-based organizations that are often supported by external entities including nongovernment organizations (NGOs) or local government agencies. The government-owned SFIs have the dominant market share in the microfinance industry servicing low-income households, with over 60% of SFI customers coming from low-income households. Government-subsidized microfinance programs are also prevalent. There are very few private MFIs operating in Thailand. This is in striking contrast with many other middle-income economies where the private sectors are major providers of microfinance to low-income households.

14. **The lack of private sector participation in the microfinance sector has limited efficiency in the sector, the quality of financial services, and innovations.** Thailand's microfinance industry lags behind its peers in the region in terms of providing targeted quality and innovative financial services to low-income families. For example, mobile phone banking has grown rapidly in other emerging markets (such as the Philippines) but is essentially absent in the Thai market. The lack of private sector participation in the sector may have impeded innovation in the microfinance sector.

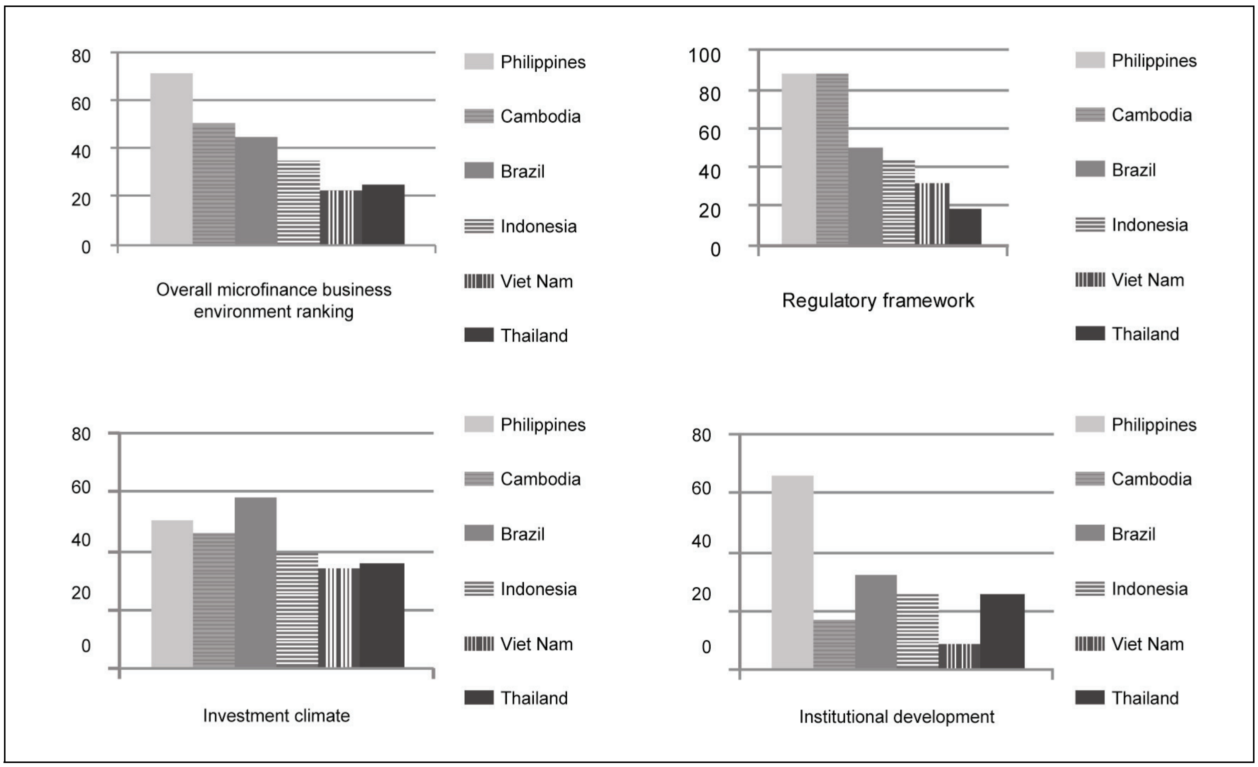
15. **Micro-insurance is critical to mitigate risks to the poor.** The micro-insurance sector is in its infancy but is growing fast with huge potential in Thailand. There are a small number of key players in the sector that have been providing insurance to farmers in the last four years. A regulatory framework promoting micro-insurance will be important for creating an enabling environment for the sector to grow.

IV. REGULATORY FRAMEWORK FOR MICROFINANCE SECTOR

16. **Thailand's enabling environment for microfinance was ranked 50 out of 54 countries in a recent global microfinance survey.** According to the *Global Microscope on the Microfinance Business Environment 2010* published by the Economist Intelligence Unit, Thailand ranked 50 out of 54 countries around the world in terms of its overall microfinance ranking and at the bottom of the scale in both regional and global comparisons based on an evaluation of the country's regulatory framework, investment climate, and institutional development (Figure 7).

Figure 7: Global Microscope on Microfinance Business Environment: Southeast Asia and Brazil

% (weighted sum of category scores)



Source: Economist Intelligence Unit. 2010. Global Microscope on the Microfinance Business Environment 2010.

17. The current microfinance sector has been successful in collecting deposits and providing funds to lower-income households including those in rural areas. However, compared to other countries in the world, as well as in the region, the microfinance sector in Thailand is very small and undeveloped. Very few NGOs and private sector MFIs are engaged in the sector. Recently, one NGO provider was forced to merge its operations with a government-funded village bank, because it needed access to capital and was not able to secure the necessary license to continue operating. Any exemption that might have been granted would have required that the NGO continue to only engage in group lending, further limiting its options to achieve sustainable growth.

18. **The regulatory regime for nonbanking financial institutions has restricted private sector participation in the microfinance industry.** The key regulatory impediments to private sector participation include the interest rate ceilings for nonbanking financial institutions (NBFIs), licensing restrictions on MFI entry, and government-subsidized programs. The key impediments to a sustainable MFI sector are discussed below.

19. **Licensing restrictions.** Currently, microfinance licenses are only issued to domestic banks. Exemptions for preexisting nonprofit NGOs are considered on a case-by-case basis and stipulate that the institution restrict its activities to group lending only, inhibiting financially sustainable growth and preventing the development of a range of products and services beyond credit that clients need.

20. **Subsidized credit.** Despite widespread access to subsidized credit, the main problem in Thailand is excessive credit available from multiple sources. A situation in which borrowers have multiple loans being used for non-income generating activities has led to over-indebtedness of poor families (Figure 5(a)). The poor who then turn to high-interest charging moneylenders to repay their outstanding debts fall further into poverty. In addition to pouring in large amounts of subsidized credit, the government has also offered debt restructuring, debt moratoriums, and debt forgiveness programs. These practices potentially undermine the basic fundamentals of a sound microfinance sector that teaches discipline and the understanding that benefits come with penalties for non-compliance.

21. **Subsidized interest rates.** While there are no interest rate ceilings for formal financial institutions, including commercial banks, the Bank of Thailand, under the Civil Procedure Code, sets a 15% per annum ceiling with a cap of 28%, inclusive of all fees for lending from nonbanking financial institutions and private individuals. Most semiformal MFIs in Thailand charge an annual rate between 10% and 24%. Interest rates by informal lenders are, in practice, higher than the cap. Specialized financial institutions and credit unions and cooperatives can charge an interest rate of up to 19%, while the People's Bank Scheme under the Government Savings Bank can charge an interest rate up to 25%.

22. **Lack of credit information.** With borrowers taking loans from multiple sources and a lack of information on these transactions, microfinance providers are unable to mitigate their risks by evaluating the creditworthiness of a new borrower. Thus, both the MFI and the borrower lose out. Accompanied by appropriate consumer protection guarantees, a credit information sharing system linked to the formal finance sector would help address this problem.

23. **Lack of appropriate legal entity for MFIs.** Under current Thai laws, there is no appropriate legal entity for microfinance operations. Some informal providers have sought to become a nonbanking lending company. However, with a minimum capital requirement of 50 million baht (about $1.4 million), this is impossible for most existing microfinance providers. Any new regulations should consider the impact on the existing sector as well as the needs of the unbanked and underbanked population.

24. **Institutional capacity.** Many microfinance providers have been plagued by high turnover rates among management. Low institutional capacity limits the range and quality of products and services that can be offered to clients.

25. **Fund management and investment opportunities.** Informal microfinance providers including NGO MFIs have very limited opportunities to access additional capital. With a 15%-tax on interest received from savings placed on foundations and associations and the fact

that foundations are not allowed to do business, there is little room for them to operate. Under the Cooperatives Act cooperatives are not permitted to lend to non-members. This requirement creates an unbalanced situation in which some cooperatives have large amounts of unused capital, while others cannot meet the needs of their members adequately.

V. GOVERNMENT PROGRAMS

26. The government has a large set of programs aimed at reducing poverty, regional income disparities, and household inequality. These programs include state provisioning of credit to low-income households and micro-entrepreneurs, social assistance programs to poor households, transfers to villages, and social spending in the national budget. A brief discussion of these programs is presented below. Suggestions for ways to strengthen these programs and or additional analytical research needed are also provided.

27. **Microfinance.** The government's goal has been to expand microcredit to low-income households at a low cost. This has been done primarily through SFIs, numerous subsidized credit programs, and interest rate ceilings on loans from NBFIs. These programs have helped extend microcredit to the poor. However, there is little private sector participation and this may have impeded innovation and provisioning of a wider range of microfinance products. Global surveys highlight Thailand's poor microfinance-enabling environment. The Ministry of Finance is drafting a *Finance for People* strategy, and this may include a microfinance component. The Bank of Thailand is also looking at developing an appropriate regulatory framework for this sector. This provides an opportunity to address these weaknesses. It will be important for these strategies to include time-bound measures to

- (i) open the microfinance sector up to private sector participation and more competition by removing restrictive licensing on MFI entry, removing the 15% interest rate ceiling, and phasing out subsidized credit programs;
- (ii) restructure SFIs and unbundle any of their public service obligations, which will be necessary to ensure fair competition in the microfinance sector;
- (iii) develop a microfinance credit information bureau;
- (iv) develop an action plan for creating an enabling environment for mobile phone banking;
- (v) develop an action plan and an appropriate regulatory framework to promote the growth of micro-insurance; and
- (vi) develop a national financial literacy program aimed at low-income households.

28. **Social assistance programs.** Thailand has a large number of poverty reduction and social assistance programs. These include the village and urban community fund, sufficiency economy for community development, community welfare fund, one-product one-community enterprise program, noninstitutional debt program for the poor (noninstitutional debts converted into institutional loans), universal health care, and old-age allowance, among others. While the universal health care program has helped reduce out-of-pocket expenses of low-income households, it is not clear how well targeted some of the other programs are and what the magnitude of the long-term impact is on poverty reduction and income inequality. In particular, the impacts of the community-based programs are difficult to quantify. Many of these programs have inadequate incentives for recipient families to build human capital of the younger household members as a way to escape intergenerational poverty and income inequality.

29. **Recent international practice has been to consolidate poverty reduction programs within a strategic framework and introduce incentives-based social protection programs. One successful incentives-based approach is a cash voucher system targeting poor families such as the conditional cash transfer.** Programs on conditional cash transfer (CCT) have successfully reduced poverty and income inequality in Brazil, Mexico, and Turkey; and have become the core poverty reduction programs in these countries. The Philippines has introduced the CCT program, and it currently covers over 700,000 families in the poorest regions in the country. A CCT program links social assistance with certain conditions with which recipient families must comply. These are usually conditions related to education and health behavior, such as child school attendance and immunization. Conditions can also be linked to other economic and social variables, such as improving youth life skills, and can be region-specific. As such, the CCT is helpful in linking assistance to human capital development of children in recipient families as a way to escape intergenerational poverty and reduce inequality. However, its effectiveness also depends on access to good schools in the locality, good governance in program design and implementation, its insulation from political interference, and proper targeting of the poor. In addition, the use of technology in extending CCTs, such as through ATMs or the use of mobile phones, can reduce transaction costs and introduce the most marginalized populations to financial services. Upon graduation from social protection programs, beneficiaries can move forward within the financial system.

VI. REGIONAL EXPERIENCE IN MICROFINANCE SECTOR DEVELOPMENT

30. **The Philippines is recognized worldwide as one of the leaders in microfinance development.** It is considered the first in the Asia and Pacific region to adopt microfinance in the central banking system and was declared by the United Nations and the Consultative Group to Assist the Poorest (CGAP) as one of the best in the development of an effective microfinance policy and regulatory framework (2005 International Year of Microcredit, New York City).

31. **The growth of the Philippine microfinance industry is largely attributed to the government's adoption of a market-based policy environment.** Implementation of market-based policy measures, such as adoption of market-based interest rates in microfinance, phaseout of subsidized directed credit programs in agriculture, and nonparticipation of nonfinancial government agencies in lending, encouraged the private sector to provide microfinance services to the poor (see attachment 1). From only a few large MFIs with an outreach of less than half a million clients in the late 1990s, there are now some 1,400 MFIs (over 2,000 including branches) providing microfinance services to about 7 million active clients (as of January 2010). These include all types of MFIs, i.e., rural banks, thrift banks, microfinance NGOs, and cooperatives. The recognition of microfinance and its peculiar characteristics in formulating banking rules and regulations facilitated the participation of banks in microfinance. Currently, there are 230 banks with microfinance operations (9 of which have more than 50% of their loan portfolio in microfinance). Recently, large commercial banks (e.g., Bank of the Philippine Islands, Allied Bank, United Coconut Planters Bank) have also entered the market by providing wholesale funds to MFIs.

32. **The government has assisted the development of the microfinance sector through legislation that promoted its growth, established a sound supervision framework, and incorporated the sector into the central banking system.** Most recently, two legislations were enacted to further develop the Philippine microfinance sector. These are the Credit Information System Act and the New Cooperative Code. The Act aims to address the emerging problem of credit pollution in microfinance and mandates the establishment of a centralized

credit registry to which all lending institutions are required to submit borrower credit information. The Code aims to strengthen the regulatory environment for cooperatives engaged in bank-like services to their members.

33. **Indonesia is also developing a vibrant microfinance sector.** While Indonesia lags behind the Philippines in developing its microfinance sector, it has made big strides in creating an efficient and vibrant microfinance sector. It has several thousand MFIs across the country. The government also phased out its subsidized programs and supervision has been strengthened at the central bank. With intense competition in the banking sector, a number of commercial banks have refocused on small and medium-sized enterprises lending.

34. **One successful micro-credit and savings program is Bank Rakyat Indonesia's village bank program (known as KUPEDES in Indonesia).** The Bank Rakyat Indonesia (BRI) microfinance unit has well over 3 million active accounts and a lending portfolio exceeding $4 billion. BRI has been successful in both mobilizing savings and lending to micro-enterprises in rural areas. The success of BRI shows that it is possible to create a micro-credit program that serves the poor and is profitable and self-sustaining. But to succeed the bank's units had to lend at market interest rates, use their income to finance operations, and devise an appropriate savings instrument for the poor that is at least as important as providing them with loans. BRI's success is also due to the simplicity of loan design, which enabled banks to keep costs down; effective management at the village bank level backed by close supervision and monitoring by the center; and appropriate staff training and performance incentives. The presence of an existing institutional network of village banks and a thriving economy that had spread to many rural areas were also critical (see attachment 2).

VII. STIMULATING INNOVATIONS IN THE MICROFINANCE SECTOR: MOBILE PHONE BANKING

35. While Thailand counted 66 million mobile phone numbers in use for the first quarter of 2010 (of which 88% were prepaid and 10.7% postpaid), the country does not appear to have gone very far in extending mobile banking services to lower-income populations. Most recently, Siam Commercial Bank and Bangkok Bank introduced a service called mPay. However, the service is quite basic (i.e., checking of bank account balance).

36. Mobile banking innovations in other parts of the world have greatly improved financial inclusion of the poor and have particularly benefited those in remote areas. Countries that have seen successful introduction of mobile phone banking have primarily been the result of private sector–led initiatives. Governments have provided an enabling environment through implementing a sound regulatory framework for mobile banking, and promoting competition in the microfinance sector and in telecommunications. Governments in these countries are also exploring ways to ensure that mobile phone banking is included within the anti-money laundering enforcement framework.

37. There are two common regulatory mobile banking models: (i) the additive model in which a mobile phone is used as an addition to other banking services and is appropriate for middle-income households; and (ii) a transformational model, in which the mobile phone is used as the basis for increasing access to financial services primarily among the poor or hard to reach

populations. The transformational model has been used successfully in such countries as Brazil, Jordan, Kenya, the Maldives, the Philippines, and South Africa.[2]

38. Fundamental issues for the government to consider or address as it creates an enabling environment for mobile phone banking include (i) the underlying soundness of financial institutions and an adequate level of risk management surrounding e-banking activities; (ii) introducing, if required, regulations that allow mobile banking or the transfer of e-money; (iii) developing the necessary legal structure that details the oversight by appropriate agencies and addresses issues of e-security and consumer protection; (iv) defining e-money, e-money services, card-based instruments, and related services; (v) developing guidelines for institutional requirements to allow for engagement in electronic banking; and (vi) developing adequate consumer protection regulations.

39. Institutions engaged in electronic banking must (i) demonstrate an adequate risk management process, (ii) provide a manual of security policy and procedures, (iii) conduct testing prior to implementation, and (iv) adopt continuity in the planning process.

40. The Philippines is a leading emerging market for adopting e-banking and mobile phone banking. Improvements in telecommunications sector, expansion of mobile phone usage particularly in the rural areas, and declining cost of mobile phone services provided the enabling factors for mobile phone banking (MPB) to develop in the Philippines. The introduction of MPB was essentially a private sector–led initiative. The government had laid down the regulatory environment for it to develop through the enactment of appropriate legislation (Electronic Commerce Act of 2000 and the General Banking Law of 2000) that allowed for e-banking and mandated the central bank to regulate electronic banking activities. Additional legislation was introduced in 2006 to provide consumer protection for e-banking.

VIII. KEY FINDINGS AND RECOMMENDATIONS

41. Despite Thailand having been very successful in lowering the national incidence of poverty, significant pockets of subnational poverty remain, particularly in the Northeast region. Income inequality in Thailand is among the highest in Southeast Asia and on par with estimates of inequality in several Latin American economies.

Key Findings

42. Differences in regional per capita incomes, dominance of agriculture in the poorer areas, and large informal labor markets, particularly in the North and Northeast regions, explain the higher rates of subnational poverty and national income inequality. While regional and sectoral income disparities help explain inequality, most regions in Thailand exhibit a similar pattern of income distribution and inequality. ***This suggests that government interventions to address inequality should be a combination of economy-wide, region-specific, and sector-specific initiatives.***

43. Financial exclusion of the lower income households also explains persistence of high rates of household income inequality in Thailand. While government programs have expanded

[2] In the Philippines, the Electronic Commerce Act of 2000 (Republic Act 8792) laid the basic legal and regulatory framework for electronic commerce which includes electronic banking. Subsequent laws and circulars provided general rules and regulations for electronic banking services in the banking sector.

microcredit, low-income families still have limited access to financial services, including savings products, transfer payments products, insurance, and pension programs, among others.

44. **Thailand's microfinance sector is small and underdeveloped compared to its regional peers.** Thailand's enabling environment for microfinance was rated 50 out of 54 countries in a recent global microfinance survey, based on an evaluation of the country's regulatory framework, investment climate, and institutional development for microfinance. In contrast to many other countries, the sector is dominated by state provisioning of microcredit and savings. There is little private sector participation in microfinance, and this may have impeded innovations in the sector.

Key Recommendations

45. **The government is drafting a strategy for financial inclusion (referred to as *Finance for People*) which may include microfinance, and this provides an opportunity to address the key weaknesses in the sector.** It will be important for the strategy to include time-bound measures to (i) open the microfinance sector to greater private sector participation by removing restrictive licensing on MFIs and the 15% interest cap on loans from NBIs, and reforming the government-subsidized credit programs; (ii) strengthen the supervisory capacity of the Bank of Thailand's microfinance division; (iii) restructure the role of SFIs in microfinance; (iv) develop a microfinance credit information bureau; (v) create an enabling environment for mobile phone banking and mobile branches; (vi) develop an appropriate regulatory framework to promote the growth of micro-insurance products; and (vii) develop a national financial literacy program aimed at low-income households.

46. **Other recommendations.** Besides microfinance, this paper recommends a government review of its poverty reduction programs. There are numerous poverty reduction programs, of which the impacts of some are difficult to quantify. It is recommended the government establishment of a national social protection commission or council which will oversee the review of poverty reduction programs, and provide recommendations on a social protection framework and to the government on program consolidation. This paper also recommends examining the feasibility of introducing a CCT program in the poorer regions. A CCT links household cash transfers to certain family conditions, such as education, health, and youth life skills. A CCT can also be used to link families to the government's financial inclusion initiatives by making the cash transfers through MFIs. Finally, this paper recommends that the government carry out further analytical research on labor market informality in the poorer regions, to better understand youth labor market experience and poverty. Thailand has a flexible labor market. Labor market policies, such as minimum wage severance, and employment regulations have been properly balanced between the need to protect workers and to create employment. This balance has supported economic growth and kept Thailand's unemployment rate—including youth unemployment—at relatively low levels compared to neighboring economies. Despite this, the share of labor market informality in Thailand (and especially in the Northeast region) is relatively high compared to other middle-income economies. There is also a link between greater labor market informality and slow wage growth.

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ATTACHMENT 1

An Overview of the Development of the Philippine Microfinance Sector with ADB Assistance

1. The Philippines is recognized worldwide as one of the leaders in microfinance development. It is considered the first in Asia and the Pacific to adopt microfinance in the central banking system and was declared by the United Nations and the Consultative Group to Assist the Poorest (CGAP) as one of the best in the development of an effective microfinance policy and regulatory framework (2005 International Year of Microcredit, New York City).

2. The growth of the Philippine microfinance industry is largely attributed to the government's adoption of a market-based policy environment. Implementation of market-based policy measures such as adoption of market-based interest rates in microfinance, phaseout of subsidized directed credit programs in agriculture, and non-participation of non-financial government agencies in lending encouraged the private sector to provide microfinance services to the poor. The Rural Microenterprise Finance Project of the Asian Development Bank (ADB) implemented from May 1996 to December 2002 has laid the foundation for successful microfinance wholesale lending operations by providing institutional and operational support to the People's Credit and Finance Corporation (PCFC).[1] From only a few large microfinance institutions (MFIs) with an outreach of less than half a million clients in the late 1990s, there are now some 1,400 MFIs (over 2,000, including branches) providing microfinance services to about 7 million active clients (as of January 2010). This includes all types of MFIs, i.e., rural banks, thrift banks, microfinance nongovernment organizations (NGOs), and cooperatives. The recognition of microfinance and its peculiar characteristics in formulating banking rules and regulations facilitated the participation of banks in microfinance.[2] Currently, 230 banks have microfinance operations (9 of which have more than 50% of their loan portfolio in microfinance). Lately, large commercial banks (e.g., Bank of the Philippine Islands, Allied Bank, United Coconut Planters Bank) have also entered the market by providing wholesale funds to MFIs competing with the PCFC and other government commercial banks (e.g., the Land Bank of the Philippines and the Development Bank of the Philippines).

3. In 2008, two legislations were enacted to further develop the Philippine microfinance sector. These are the Credit Information Systems Act and the New Cooperative Code. The former aims to address the emerging problem of credit pollution in microfinance and mandates the establishment of a centralized credit registry to which all lending institutions are required to submit borrower credit information. The latter aims to strengthen the regulatory environment for cooperatives engaged in bank-like services to their members. The government initiatives legitimated by these two laws are among the policy actions called for under ADB's **Microfinance Development Program**. The program which was implemented from November 2005 to December 2007 called for further development of the microfinance sector through the strengthening of the microfinance policy environment, improvement of regulatory capacity, MFI capacity, and financial literacy. The program is complemented by ADB's Japan Fund for Poverty Reduction (JFPR) Project for Developing Financial Cooperatives, which was implemented

[1] PCFC is a government finance company affiliated with the Land Bank of the Philippines.
[2] The General Banking Law of 2000 recognizes microfinance as a legitimate banking activity and its unique features.

from May 2006 to September 2010. It has assisted the government in further improving the regulatory environment for credit and savings cooperatives engaged in microfinance services.[3]

4. Aside from savings and loan products, both MFIs and their clients have recently recognized the need for another type of financial service—insurance to address the risk protection needs of the poor. Several MFIs have adopted various schemes (partnering with commercial insurance companies, self-insurance, creation of mutual benefit associations, etc.) to meet their clients' demand for insurance. In February 2008, ADB provided a new JFPR Project for Developing Microinsurance to help the government develop an appropriate regulatory environment for microinsurance. In this regard, the Department of Finance (through the National Credit Council) and the Insurance Commission (IC) with participation of the private sector reviewed existing regulations on insurance to determine how best to facilitate the provision of microinsurance services for the poor with minimal regulatory risks. The Microinsurance Regulatory Framework developed by the project, along with the National Strategy for Microinsurance, was officially launched on 29 January 2010. Concurrently, two circulars on microinsurance were signed, as follows: (i) Insurance Memorandum Circular 01-2010 – Regulations for the Provision of Microinsurance Products and Services and (ii) Joint IC-Cooperative Development Authority (CDA)-Securities and Exchange Commission (SEC) Memorandum Circular 01-2010 – Defining Government's Policy on Informal Insurance Activities. The former recognizes microinsurance as a formal insurance activity and promotes social protection through appropriate regulations on the microinsurance industry. The latter announced the collaboration among the three agencies on the transformation process of informal insurance activities conducted by cooperatives and NGOs to formal operations licensed by the IC.[4] The launching ceremony also announced the following information and communication tools on microinsurance:

(i) Microinsurance Blogspot (http://microinsurancephil.blogspot.com/)
(ii) Microinsurance video (http://www.youtube.com/watch?v=t2tlSesCzx0)
(iii) Press releases (available at http://microinsurancephil.blogspot.com/)

The project will also strengthen regulatory capacity of IC and other regulators, improve the operational capacity of microinsurance providers, and promote financial literacy on microinsurance.

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[3] The project scope includes the finalization of the Manual of Rules and Regulations (MoRR) and the Supervision Manual for savings and credit cooperatives, and the strengthening of the regulatory capacity of the CDA. The implementation period was extended by 1 year until September 2010 in order to align the project activities with RA No. 9520 or the Cooperative Code of 2008 (new Code) provisions taking effect in March 2009. The project has formulated the implementing rules and regulations (IRRs) replacing MoRR for finalization.

[4] The microinsurance regulations require all insurance operators to comply with the universally recognized prudential requirements. Among challenges ahead are to put a regulatory net on widely operating informal insurance systems. Half of some 6,000 cooperative life insurance programs are assumed to be operating informally with no registration or reporting to IC. There are also many cases of NGOs offering unregulated insurance services. The Joint Circular requires transformation of an informal insurer to an IC-authorized formal insurer within a 2-year transition period or transfer of informal insurance operations to a formal insurer within a 1-year grace period.

ATTACHMENT 2

Overview of Microfinance in Indonesia—The Case of Bank Rakyat Indonesia

1. Indonesia's approach to credit for micro-, small and medium-sized enterprises (SMEs) has evolved over the last 20 to 30 years mainly in response to lessons learned from preceding programs. In the 1970s and 1980s, the government adopted special credit programs for SMEs. As these programs proved costly, the government then moved toward regulating commercial banks to provide credit to SMEs. As this approach also failed to accomplish its goal of expanding SME credit, as well as created additional costs to the banking sector, the government refocused its efforts on establishing a policy framework that encouraged diversification of the banking and finance sector as a way to improve SME access to credit.

2. Indonesia's most successful microcredit program is the KUPEDES program of Bank Rakyat Indonesia (BRI or Indonesian Peoples' Bank). In the 1970s, BRI established a vast network of village banks to deliver subsidized credit to microenterprises in the rural areas, mainly farmers (the credit program was known as BIMAS). However, by 1983, years of heavy loan losses (nonperforming loans [NPLs] in BIMAS were high) and fiscal cuts had made the network of village banks unsustainable, and the government was seriously thinking about shutting them down. However, shutting down the village banks risked serious job losses and the loss of an important credit delivery mechanism. The government responded by taking a novel approach. In 1984, it established a new, market-based rural small credit program KUPEDES, aimed at transforming village branches into self-sustaining full-service financial units. The program's principal goals were to provide credit to small borrowers at market interest rates and to mobilize rural savings. The village banks operated a savings scheme called SIMPEDES, offering market-determined interest rates on small deposits. The new credit program did not target particular groups, but was open to all micro-enterprises that are creditworthy.

3. KUPEDES became a model credit program in Indonesia. Between 1984 and 1994, it grew sixfold. By year 2001, it had 4,000 village banks around the country, 30 million savings accounts (reaching well over 15% of all rural households), and about 3 million borrowers (just over 5% of all households in Indonesia). The total loan portfolio was over $2 billion and savings over $3 billion in 2004. Microloans range between $5 and $6,000 with interest rates generally above 20% per annum (during the 1998 economic crisis KUPEDES interest rates reached 35% per annum, but NPLs remained around 2%–3%). The minimum savings deposit is $2. Microloans now account for about 31% of BRI's total loan portfolio. Most of the borrowers are small traders and households borrowing for working capital and/or consumption purposes and for short periods—2 to 3 months.

4. Several assessments of KUPEDES identified the following factors as contributing to its success:

(i) Adoption of market-based lending operations – application of sound banking principles; market interest rates; and village banks treated as profit units and revenues used to finance their operations.
(ii) Appropriate staff training and performance incentives, effective management at the village bank, and close monitoring by the center.
(iii) A focus on objectives and simplicity of loan design.
(iv) Focus on mobilizing savings of households just as important as providing them with loans.

(v) As the village bank mobilized savings and lent them on to micro-enterprises in the same village, it ensured that local savings were reinvested in the village contributing to development.

(vi) Finally, the KUPEDES program also benefited from long-term technical assistance from international microcredit experts.

5. In Indonesia, there are over 2,000 rural microcredit banks called BPRs. These are microlending banks located at the village level. Most of them only have one branch. Many also receive deposits from households. Financial viability and quality of BPRs varies. Some BPRs are operated professionally and are financially viable. The BPRs serve over 2 million borrowers. However, prudential supervision and regulation of BPRs is a major challenge for the central bank due to their large numbers, small size, and the high administrative costs required for prudential supervision.

Poverty, Income Inequality, and Microfinance in Thailand

This paper provides a summary assessment of recent developments in poverty and income inequality in Thailand and discusses the role microfinance can play in addressing inequalities. Income inequality in Thailand is among the highest in Southeast Asia and particularly high in northeast Thailand. A contributing factor is the limited access to financial services and limited financial literacy of poor households. Thailand's microfinance sector is undeveloped compared to its regional peers; this has impeded poor families' access to financial services. This paper suggests ways to strengthen the microfinance sector aimed at improving income disparities.

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Asian Development Bank
6 ADB Avenue, Mandaluyong City
1550 Metro Manila, Philippines
www.adb.org/poverty
Publication Stock No. WPS114137

Printed on recycled paper

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