

# Microfinance in South Asia

TOWARD FINANCIAL INCLUSION  
FOR THE POOR



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# Microfinance in South Asia

**Toward Financial Inclusion for the Poor**

DECEMBER 2006

This paper was written as part of a World Bank project in South Asia to celebrate the International Year of Microcredit 2005. It describes the emergence and development of the influential microfinance movement that has come to prominence in South Asia over the past 30 years and considers the issues and prospects that will face microfinance in the coming years.

The team that wrote this paper was led by Sanjay Sinha (EDA Rural Systems) and Stephen Rasmussen (World Bank, SASFP) and included Amit Brar (EDA Rural Systems), Frances Sinha (EDA Rural Systems), Gautam Ivatury (CGAP), Imran Matin (BRAC), Niraj Verma (World Bank, SASFP), Stuart Rutherford (SafeSave), and Syed Hashemi (CGAP).

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Simon Bell (World Bank, SASFP Manager) first proposed that this paper be written and he provided guidance throughout the process. Invaluable suggestions about the organization and focus of the paper were provided by three reviewers: Elizabeth Littlefield (CGAP), Vijay Mahajan (BASIX), and Priya Basu (World Bank, SASFP). Logistical support was provided by Rubina Quamber (World Bank, SASFP) and Sakm Abdul Hye (World Bank, SASFP).

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# LIST OF ABBREVIATIONS AND ACRONYMS

<b>a:</b>	ABN ABN Amro Bank	FSS Financial self-sufficiency
	ACLEDA ACLEDA Bank of Cambodia	FWWB Friends of Women's World Banking, India
	ADB Asian Development Bank	<b>g:</b> GDP gross domestic product
	ADBN Agricultural Development Bank of Nepal	GNI gross national income
	AKRSP Aga Khan Rural Support Programme	GPS Grameen Pension Savings
	AMA Afghanistan Microfinance Association	GTZ German Technical Cooperation
	AMAP Accelerated Microenterprise Advancement Project of USAID	<b>i:</b> IASC Indian Association for Savings and Credit
	APR Annual Percentage Rate (charged by MFIs)	IDB Inter-American Development Bank
	ARMP Afghanistan Rural Microfinance Programme	IGVGD Income Generation for Vulnerable Group Development
	ASA Association for Social Advancement	IMEC Impact Monitoring and Evaluation Cell
	ATM Automated teller machine	INAFI International Network for Alternative Financial Institutions
<b>b:</b>	BASIX Bhartiya Samruddhi Investments and Consulting Services Ltd.	IRDA Insurance Regulation and Development Agency, India
	BEES Bangladesh Extension Education Services	IRDP Integrated Rural Development Programme, India
	BRDB Bangladesh Rural Development Board	IS information system
	BURO BURO Tangail	<b>k:</b> KCC Kisan (farmer's) Credit Card, India
	BWDA Bullockcart Workers' Development Association	<b>m:</b> MACS Mutually Aided Cooperative Society, India
<b>c:</b>	CAR capital adequacy ratio	MBT Mutual Benefit Trust
	CBO community-based organization	MCDB microcredit development bank
	CDF Credit & Development Forum, Bangladesh	M-CRIL Micro-Credit Ratings International Limited
	CERISE Comite d'Echanges de Reflexion et d'Information sur les Systemes d'Epargne-credit	MDG Millennium Development Goals
	CGAP Consultative Group to Assist the Poor	MFAC Microfinance Advisory Council (proposed), India
	CMF Centre for Micro Finance, Nepal	MFI microfinance institution
	CMFR Centre for Micro Finance Research, India	MFO microfinance organization
	CRB Cooperative Rural Bank	MIS management information system
	CRISIL Credit Rating and Information Services India Limited	MISFA Microfinance Investment and Support Facility for Afghanistan
<b>d:</b>	DAB Da Afghanistan Bank	MSS Manabik Shahajya Sangstha
	DCCB District Central Cooperative Bank	<b>n:</b> NABARD National Bank for Agriculture and Rural Development, India
	DMFI Deposit-taking MFI, Afghanistan	NBFC Non-bank Finance Company, India
<b>e:</b>	EDA EDA RuOral Systems Private Limited, India	NBFI Non Bank Financial Institution
<b>f:</b>	FINGO Financial Intermediary Non-Government Organization, Nepal	NDTF National Development Trust Fund, Sri Lanka
	FISA Financial Intermediary Societies Act, Nepal	NGO nongovernmental organization

**NRB**  
Nepal Rastra Bank, Nepal's central bank

**NRSP**  
National Rural Support Programme, Pakistan

**O** **OER**  
operating expense ratio

**OSS**  
operational self-sufficiency

**P** **PACS**  
Primary Agricultural Cooperative Society

**PAR**  
portfolio at risk

**PKSF**  
Palli Karma Sahayak Foundation, Bangladesh

**PMN**  
Pakistan Microfinance Network

**PPAF**  
Pakistan Poverty Alleviation Fund

**PRA**  
participatory rural appraisal

**R** **RBI**  
Reserve Bank of India

**RDB**  
rural development bank

**RMDC**  
Rural Microfinance Development Centre, Nepal

**RMP**  
Rural Maintenance Program

**RMK**  
Rastriya Mahila Kosh, India

**ROA**  
return on asset

**ROSCA**  
Revolving savings and credit association

**RRB**  
Regional Rural Bank, India

**RRDB**  
Regional Rural Development Bank, Sri Lanka

**RSP**  
rural support program

**RSRF**  
Rural Self-Reliance Fund, Nepal

**S** **SAARC**  
South Asia Association for Regional Cooperation

**SBP**  
State Bank of Pakistan

**SBS**  
Samurdhi Banking Society, Sri Lanka

**SCCS**  
Savings and Credit Cooperative Society, Nepal

**SEEDS**  
Sarvodaya Economic and Enterprise Development Services, Sri Lanka

**SEWA Bank**  
Sri Mahila Sewa Sahakari Cooperative Bank, India

**SFMC**  
SIDBI Foundation for Micro Credit

**SHG**  
Self-Help Group, India

**SHPI**  
Self-Help Promotion Institution, India

**SIDBI**  
Small Industries Development Bank of India

**SKS**  
previously Swayam Krishi Sangam

**SML**  
SHARE Microfin Limited

**SPM**  
social performance management

**SPMS**  
social performance management system

**SSS**  
Society for Social Service, Bangladesh

**SWDMACTs**  
Swayamkrushi Women's Development Mutually Aided Cooperative and Thrift Society

**T** **TCCS**  
Thrift and Credit Cooperative Society, Sri Lanka

**The MIX**  
Microfinance Information Exchange, Washington, DC

**TMSS**  
Thengamara Mohila Sabuj Sangha

**TUP**  
targeting the ultrapoor

**U** **UCB/DCCB**  
Urban Cooperative Bank/District Central Cooperative Bank, India

**USAID-AIMS**  
United States Agency for International Development Assessing the Impacts of Microenterprise Interventions

**W** **WEP**  
Women's Empowerment Programme

**WFP**  
World Food Programme

## CURRENCIES

**Prs**  
Pakistan rupee

**Rs**  
Indian rupee

**SL Re**  
Sri Lankan rupee

**Tk**  
Bangladesh taka

**US\$**  
U.S. dollar

# EXECUTIVE SUMMARY

In South Asia, the modern microfinance movement was born in Bangladesh in the 1970s as a response to the prevailing poverty conditions among its vast rural population. Astonishing growth rates in Bangladesh, particularly during the 1990s, created a new dimension for microfinance worldwide as microfinance institutions grew to include millions of clients. For the first time, a substantial proportion of the low-income families of a major developing country were served by the activity. The start of the twenty-first century reinforced this trend as the Bangladesh numbers continued to grow impressively; in India, a substantial microfinance system based on self-help groups (SHGs) developed. Other countries of the region made slower and later starts but have since established active microfinance sectors.

Comparing the genesis of microfinance in South Asia with Latin America (another region in which the microfinance movement began in the 1970s and has since become well established), it becomes apparent that the industry in the two regions has developed distinct characteristics. In Latin America, microfinance was typically urban rather than rural, was more focused on financial services for microenterprises than on poverty, and saw itself as a business, potentially as a branch of commercial banking. In South Asia, given that modern microfinance effectively started during a time in which poverty was extensively examined, it was perhaps inevitable that the growth of microfinance would be rooted in the poverty discourse. Apart from cooperatives, the average low-income family in the region before the 1970s had virtually no recourse to

financial services, and were it not for the advent of the microfinance movement, they would not have much recourse today. Most South Asian countries have a reasonable banking system in urban areas; however, despite the fact that the majority of these populations live in rural areas, the access of rural populations to formal financial services remains limited.

By 2005, microfinance covered at least 35 million of some 270 million families in the region and met around 15 percent of the overall credit requirements of low-income families. Coverage was particularly impressive in Bangladesh and Sri Lanka, where microfinance services reached more than 60 percent of the poor. In addition, the focus on engaging women as essential contributors to economic and social well-being has had important spillover effects throughout the region. Even in a socially conservative country such as Afghanistan, microfinance activity has focused on women, thereby according them more explicit recognition as economic agents, while in India, the SHG movement has become the basis for programs promoting empowerment and overall improvement of the status of women in society. In Bangladesh, microfinance has become the basis for microenterprise promotion by some of the large microfinance institutions, although it also has been extended to the “ultra poor” through targeted programs. In both Pakistan and Nepal, the potential of microfinance demonstrated by these experiences has captured the attention of governments that have created specific legal frameworks to facilitate its growth.



## The Emergence Of Microfinance

While informal sector financing systems can be traced to the era of Kautilya in the fourth century B.C.E., the era of organized sector finance in much of South Asia (Bangladesh, India, and Pakistan) is generally acknowledged to have started with the Cooperative Credit Societies Act of 1904. The act's objectives make it clear that the cooperative movement in South Asia was initiated to reach out to those who were otherwise excluded by the formal financial system—farmers, artisans, and other persons of limited means. The failure of cooperatives to serve this purpose adequately is noteworthy because some seven decades later, in the 1970s, it was still thought necessary to nationalize commercial banks throughout the region, and the first attempts were made to launch microfinance as we know it today. Both initiatives responded to the quest for outreach, although the paths taken were quite different. The banks, now owned by governments, undertook the benevolent, statist path of creating a supply of products designed by bureaucrats ostensibly to maximize the welfare of the excluded groups. Conversely, the microfinance initiators experimented with ways of providing capital to those who needed it. The key concerns were to make capital available in small amounts, at convenient times and locations, and at the lowest possible cost. It is on such principles that Grameen Bank was born and that BRAC and the Sri Mahila Sewa Sahakari Cooperative (SEWA) Bank's early experiments were undertaken.

Although the microfinance movement in South Asia has permanently changed the face of the financial sector through innovation and challenges to conventional thinking, the limits of the microfinance model become evident when it comes to serving many more poor people who are still excluded and to capturing a larger share of the financial service business of the existing clientele. Recent research shows that although microfinance institution (MFI) outreach among various categories of the poor has been impressive, MFIs took a rather small proportion (15 percent) of the microfinance

business of households. In addition, aggregate calculations made for the number of poor families in the region indicate a substantial shortfall in the availability of microcredit in the region. It is suggested that formal financing channels meet only 15 percent of the needs of the poor in South Asia, with the proportion ranging from 2 percent in Afghanistan to 55 percent in Bangladesh.

Outreach is highly variable across the region. The six countries can be classified into high (Bangladesh and Sri Lanka), medium (Nepal and increasingly India), and low (Pakistan and Afghanistan) coverage levels. The very high coverage in Bangladesh is based on the programs of a few specialized institutions. At the end of 2004, some 73 percent of the microfinance clients in the country were borrowing from the four largest institutions, which count their clients in the millions, and only 12 nongovernmental organization (NGO) MFIs had more than 100,000 clients. High outreach in Sri Lanka is largely based on an extensive network of community-based organizations (CBOs) that receive considerable government subsidies. India saw a substantial increase in the outreach of microfinance services in recent years not only because of the phenomenal growth of the bank-SHG link program, but also because of the substantial growth of NGO-MFIs; this outreach, however, is concentrated in a few southern states. The concentration of microfinance in India is matched by Nepal, where the delivery of microfinance services by regional development banks, NGO-MFIs, and cooperatives is confined largely to the southern plain and the Kathmandu valley. In Pakistan, outreach is estimated to account for no more than 5 to 10 percent of the potential market, with services being provided by NGO-MFIs and specialized microfinance banks. Given the recent emergence of microfinance activity in Afghanistan, the low coverage of poor clients is consistent with the early stage of development of the microfinance sector.

However, the era of benevolent, statist intervention in support of financially excluded sections of the population has given some ground to a recognition of the need to create structures that cater to the financial needs of the poorer segments of society. This process is gradually leading to structures that may be able to integrate microfinance service providers into the broader financial landscape.

### Institutional structures and delivery systems

Given the early establishment and deep roots of the cooperative movement in South Asia, it is perhaps not surprising that CBOs, including cooperatives, are an important pillar of microfinance in the region. Together with the ubiquitous NGO-MFI, such organizations deliver virtually all of the recorded outreach of financial services available to low-income clients in the region. Only a small amount of additional microfinance outreach is provided by the retail operations of the banking system, the activities of post office banks, and, to a lesser but growing extent, insurance companies. Despite the importance of the CBO as a delivery mechanism, diverse institutional links channel microfinance services from funders to clients and some variation in delivery systems exist, which means that almost every conceivable type of microfinance activity in the world is available in South Asia.

A wide range of delivery systems is employed by these many different types of institutions, but the main methodologies can be classified into the following five types:

- **Grameen Model**—a delivery methodology pioneered by Grameen Bank of Bangladesh. Joint liability is the key factor in ensuring repayment, although there is no formal documentation of this, and accounts are maintained in the individual names of clients.
- **Self-Help Group**—operations of 15 to 25 member SHGs are based on the principle of revolving the members' own savings.
- **Cooperative Programs**—entailing the provision of financial services by MFIs to individual clients organized into credit and savings cooperatives. In cooperatives, all borrowers are members of the organization, either directly or indirectly, by being members of associations in which they hold shares.
- **Mixed Model**—some MFIs started with the Grameen model but later on mixed that with an SHG model or another model, adapting their approach to prevailing market conditions.
- **Rural Support Programs**—Pakistan makes a unique contribution to this discussion in that a number of the NGO-MFIs and, indeed, one of the microfinance development banks, have evolved out of multidimensional programs based on establishing and strengthening village organizations to manage their own development.

### Financing Structures

MFIs essentially perform the role of intermediating financial resources and services between (1) investors, banks, donors, and depositors, and (2) the poor. Like any other financial intermediary, MFIs need risk capital that can be leveraged to add to their funding base for operations and on-lending to low-income clients, either through debt finance or by raising additional deposits. Unlike commercial financial institutions, MFIs in South Asia have evolved largely from nonprofit entities. Given that the transaction costs of microfinance delivery are high and account

sizes are small, it typically has taken three to seven years for leading MFIs to become financially strong enough to attract commercial risk capital. As a result, donor funding has had to play the key role of “venture capital” in stimulating microfinance investment and promoting microfinance markets.

To the extent that MFIs address market failure and help to develop the financial sector by providing new avenues for low-income clients to access financial services, this role is justified and has a clear “public good” element

associated with it. Conversely, shares constitute the risk capital that forms the backbone of commercial investments in financial institutions. Even in terms of debt from lenders, MFIs in South Asia generally have relied on borrowing from specialized development finance institutions rather than from mainstream financial institutions and banks, although the extent of dependence and nature of financing from such institutions varies by country.

The level of current donor financing is high in Pakistan and in Afghanistan's fledgling microfinance sector. Bangladesh still has significant donor financing, but this is mainly historical: in recent years, the emphasis has been largely on subsidized debt financing by the apex institution, retained earnings, and accumulated compulsory deposits built up by leading MFIs. The broad trend in the region has been a gradual move from donor-funded microfinance toward subsidized debt and compulsory deposits, and then to near-commercial debt and social equity funding before financing by commercial sources (like banks and voluntary deposits) takes over. This trend is noticeable in all countries of the region, although the pace of graduation varies by country.

The challenges everywhere are surprisingly similar. MFIs must develop management capacity at every level, which will enable them to run efficient operations to attract commercial finance from equity investors, financial institutions, and voluntary depositors in the long term, thereby enabling microfinance services to reach increasing proportions of the large number of low-income families in the region.

### Diversity of products

From the beginning, microfinance service providers have focused on providing loans. Some approaches, however, included small amounts of required savings tied to loan products, so relatively rigid credit services continue to be the major microfinance activity.

More recently, attempts to provide much more flexible loan products have been noticeable, although not easy to implement, because of the tension between the client's need for flexibility and the MFI's need for uniformity and standardization.

Services to enable clients to deposit savings are an area of significant interest and innovation for MFIs. Deposit services are a potential minefield, however, because of the risk of loss in the intermediation process. In practice, most NGO-MFIs have been forced by regulatory restraints to limit deposit-taking to credit-linked products, while CBOs can offer such services because of their relatively informal nature and the fact that they operate within a mutually supporting group with a small number of members.

Microinsurance is drawing increased attention, although it is largely in an experimental stage and the implications for costs and for delivery systems are little understood by either MFIs or insurance companies. In Bangladesh, microinsurance was introduced as an extension of the microcredit revolution. In India, a key factor stimulating the growth of microinsurance is the regulator's stipulation that insurance companies must offer a certain proportion of their policies to rural clients. This requirement has driven insurance companies operating in India to work with MFIs in order to access their ready pool of potential clients, thereby limiting their transaction costs.

Money transfers are increasingly discussed but have drawn little attention in the region. Informal transfer systems are still dominant in most countries, although the use of post office money orders for remittances to low-income families from migrant relatives had become a tradition in the region more than half a century ago. Some MFIs have recently begun to experiment with providing transfer services, a trend that is likely to grow given the high dependence of poor families on this source of income.

Microleasing is an underutilized tool in rural and microfinance, largely because of a lack of experience with this financial tool. But this is beginning to change as MFIs add leasing services to their repertoire and mainstream leasing companies move into the microleasing market.

As discussed above, microfinance outreach to the genuinely poor is just 17 percent for South Asia as a whole. One reason for this low level of outreach is product rigidity. Poor clients need products that provide them with the flexibility to deposit money and to borrow very small sums of money almost daily. Except for SafeSave's famous experiment in Bangladesh, this type of product has not been provided by MFIs. The debate about standard products versus product variety continues, although the increasing concern for social performance in microfinance is likely to result in a greater focus on product relevance to meet the needs of the poorest.

### MFI performance

The leading microfinance service providers in the region are also “best practice” institutions. Countries in the region have relatively few institutions that provide microfinance services on a sustainable basis, but in general, the sustainable institutions are also the largest institutions in which substantial proportions of the microfinance clients in each country are concentrated.

All of the countries in South Asia have high levels of subsidy from foreign donors (Afghanistan, Bangladesh, and Pakistan), from governments (Sri Lanka and, to some extent, India), or from eroding net worth of cooperatives (India and Nepal). Problems with microfinance service delivery, mostly in terms of ineffective management and control systems, and poor recovery performance, are compounded by “social control” of interest rates. Politicians and bureaucrats in these countries periodically create misconceptions about microfinance by targeting the interest

rates as being high without reference to the clear economies of scale in microfinance service delivery. In reality, South Asian MFIs charge rates that are low by international standards but in line with their historical and philosophical poverty reduction agenda.

The overall financial performance of MFIs in the region is improving as the awareness of sustainability grows. However, the speed of improvement varies among countries at different points in time and is dictated by political pressures and the regulatory environment as much as by the awareness of good practices.

The link between depth of outreach and financial sustainability is apparent, and the view often held by government, some donors, and the public that reaching poorer people requires subsidies may not always be true. In fact, evidence shows that well-managed profitable organizations that remain committed to the double bottom line are doing more to increase the depth of outreach than MFIs with substantial subsidies.

### Impact and social performance

The power of the microfinance ideal lies in its potential to combine financial sustainability with social performance, or meeting the so-called double bottom line. Until recently, social performance has been understood primarily in terms of impact or change that can be at least plausibly associated with, if not attributed to, a microfinance program. And changes associated with microfinance relate significantly to several of the Millennium Development Goals, particularly to reducing poverty, promoting women's empowerment, and contributing to universal primary education and improved health.

More recent studies with relatively robust research methodologies provide evidence that the overall impact of microfinance is positive, although nuanced. Small loans have enabled client households to reduce their dependence

on irregular income sources, helped to smooth consumption, and reduced vulnerability, while they have also led to increases in income and assets for many households. These changes have been especially significant for poorer households, in some cases leading to movement out of poverty. But the overall evidence for direct poverty reduction varies; such change takes time and depends on the starting point, or relative poverty level, of each client household when a client joins a microfinance program. Conversely, indirect poverty reduction is possible through employment of the poor in the enterprises of better-off clients that are supported by microcredit and through wider market link effects.

Recently, microfinance has shifted away from traditional impact studies toward a new definition of social performance that retains impact as the overall goal but specifically unpacks the steps to get there. The focus of these studies shifts away from proving impact

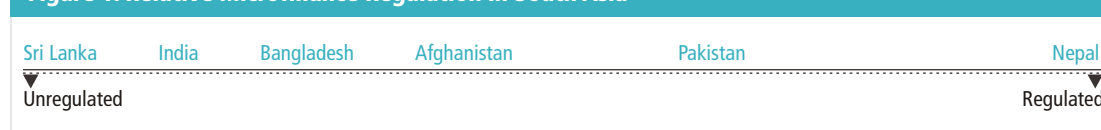
toward managing and reporting the steps that are likely to lead to positive social outcomes. These steps include mission clarity and systems alignment (targeting, staff incentives, reporting, and product design), client profiling, market segmentation, and market research (analyzing microfinance services in relation to client needs, client cash flows, and market competition). Change at the client household level may be assessed through simpler research techniques, including poverty scoring, which microfinance service providers can use to assess whether they are achieving their social objectives. This approach has led to the introduction of social performance management by MFIs and social rating by specialist rating agencies, both approaches complementing the now-established systems for financial performance management and credit rating. These initiatives are still somewhat experimental, but as they develop they are likely to provide an invaluable and relatively low-cost means of tracking and reporting on the achievement of social mission.

## Systems that support microfinance

Support structures and systems are variable across South Asia. Nepal and Pakistan have introduced microfinance-specific regulatory frameworks, while other countries are at various stages of discussion. All countries have well-established apex funding and networking organizations, and rating activities are relatively well established.

With respect to regulation, the countries of South Asia lie along a continuum, ranging from little more than the limited regulation of cooperatives in Sri Lanka to a substantial degree of regulation in Nepal, in the latter case at least by law if not in practice.

**Figure 1. Relative Microfinance Regulation in South Asia**



Source: Authors' creation.

Overall, microfinance regulation in South Asia has been primarily concerned with the poverty agenda. In a long-term context, this approach presages an emerging concern for the “missing middle” in which microenterprise finance becomes as important as capital formation for low-income families. To this extent, the concept of tiered regulation may be counterproductive,

resulting only in a niche market for financial services for low-income clients rather than an inclusive financial landscape. In the long run, allowing and enabling freedom in pricing, for banks as well as MFIs, and competitive market development for financial services has greater potential.



Microfinance apex funding institutions have played a significant role in the development of the industry in South Asia, primarily by providing loan funds as well as operational grants, mostly to NGO-MFIs. They also provided capacity building support to MFIs and played a role in setting standards for the industry, in some cases acting as a quasi-regulator for the sector. With the exception of some of the Indian apexes, all of these funds were established by governments and most have received significant donor support. While these apexes play a significant role, have large amounts of funding, and even have become sustainable entities themselves, it is dangerous to their continue for too long in the mold in which they were created. If the original purpose was to overcome a market failure and jump-start the growth of microfinance, transition strategies need to be considered. Except partly in the Indian case, there is little evidence thus far that, having played their original valuable role, apex funding institutions have done much to help MFIs become market players that no longer require subsidized funds.

Five countries in South Asia already have national microfinance associations, while Sri Lanka is in the early stages of a second attempt to form a viable national association. All of these associations have taken on the role of industry advocates with various degrees of skill and success. While the associations have emerged out of the NGO-MFI sector, it is clear that they will have to evolve if they are to keep up with the changes, increase their value to the industry, and strengthen their ability to influence positive change. The evolution includes broadening their vision to create inclusive financial sectors—for example, including regulated commercial financial institutions—and playing a greater role in promoting transparency and setting standards of conduct.

South Asia is a worldwide pioneer in the field of MFI ratings; Micro-Credit Ratings International Limited (M-CRIL), based in India, is one of the first three international microfinance raters. Since then, two corporate

rating agencies have entered the microfinance rating business, one in Pakistan and one in India. This puts South Asia in a good position to further facilitate links between MFIs and investors.

Technology has considerable potential to reduce delivery costs and expand the scale of financial services for poor people. Using low-cost hardware and ubiquitous mobile phone networks, banks and MFIs may find it possible to deliver financial services less expensively than was possible earlier, even in rural areas. In a few countries outside South Asia, such initiatives appear to have had success at including more low-income people in the mainstream banking system, and these examples are attracting attention from commercially oriented microfinance providers in South Asia. The main issue with the introduction of technology is the extent of the efficiency gain achieved from the technology relative to the cost incurred. In the limited experiments undertaken to date costs have outweighed gains, but this is rapidly changing.

### Future perspectives

During the past 25 years, the microfinance movement has challenged conventional financial sector and government thinking, in the process fundamentally altering the financial landscape. Today, it provides most of the access to financial services available to low-income people in South Asia, but it is still largely a separate part of the financial system, with few examples of direct service provision to the poor by mainstream commercial institutions. Despite the growing discussion about and enthusiasm for developing a seamless and inclusive financial sector, there is little evidence that this has happened yet.

Over the next few years, most of the growth in microfinance will come from a few large, profitable, specialized institutions that might in some ways rival small banks. These institutions will provide a range of diversified and flexible

products and will do more to reach out to even poorer people. These dominant institutions will make more use of commercial funding, both debt and equity from commercial banks and the growing number of social investment funds. If competition is allowed to flourish and interest rates are not capped at levels that stunt growth and sustainability, effective interest rates could settle at 21 to 24 percent per year and outreach could expand to reach 50 to 60 percent of poor households across South Asia within a decade. Many initiatives in promoting regulation for the microfinance sector, as well as initiatives that encourage banks to do more to serve poorer people, promise to increasingly mainstream the microfinance movement. New technologies could lead to new ways to improve efficiency and expand outreach even faster.

Another step in the region's financial liberalization could occur if the wider political and social environment changes to recognize that economies of scale exist in financial service delivery—cost is inversely proportional to the size of the accounts. Central banks and finance professionals will need to take the lead to urge politicians and media to help change the conservative economic environment relative to the poor. Without such liberalization, the process of microfinance evolution is likely to slow down as it hits the barrier of sustainability, particularly if the formal sector reaches a point at which the marginal return to corporate social responsibility falls below the losses associated with microfinance service providers and low-income clients. That point has not been reached yet, although in India some banks are already testing its limits. As long as engagement with low-income clients in South Asia is largely a matter of social responsibility, financial inclusion will remain a dream.

# The Financial Landscape and the Emergence of Microfinance:

## Formal sector exclusion and the quest for new approaches

Something distinctive about the microfinance discourse in South Asia<sup>1</sup> is reflected in the way the sector has developed and how the products have evolved. A recent paper explores the differences in the discursive foundations of the idea behind microfinance in South Asia and Latin America, relating it to the situation in each region.<sup>2</sup> The paper argues that microfinance developed in South Asia under very different ideological, political, and economic conditions than in Latin America. The difference can be illustrated by a brief comparison of two of the most famous and influential microfinance institutions (MFIs): Grameen Bank of Bangladesh and Banco Sol of Bolivia. Modern microfinance was born in Bangladesh in the 1970s, in the aftermath of the country's war of independence, when Professor Muhammad Yunus began an experimental research project providing credit to the rural poor, an experiment that was driven by a strong sense of developmental idealism. In contrast, a collapsing populist regime in Bolivia led to widespread unemployment, and Banco Sol was created to address the problem of urban unemployment and provide credit to the cash-strapped informal sector. The notion of commercial profitability was embraced relatively early in this approach.

As a result of the different conditions under which the first MFIs were founded, the industry in the two regions developed distinctive characteristics. In the beginning, *by comparison with Bangladesh, the Bolivian intervention was typically urban rather than rural, less concerned with poverty and more focused on micro-enterprise. It targeted the “economically active poor”—people with established businesses that needed capital to grow...from the start, Bolivian microcredit was itself seen as a business, potentially as a branch of commercial banking.*<sup>3</sup>

Many of these differences still characterize the industry and the microfinance discourse in the two regions today. South Asian microfinance is primarily focused on poverty alleviation, while Latin American microfinance is more oriented toward the inclusion of microentrepreneurs in the financial system.

<sup>1</sup>This paper includes discussion about microfinance in six of the eight South Asia Association for Regional Cooperation (SAARC) countries: Afghanistan, Bangladesh, India, Nepal, Pakistan, and Sri Lanka. Maldives and Bhutan are excluded from the discussion because they do not have microfinance sectors as such. In both countries, a few attempts have been made to provide some microcredit services as part of integrated development projects, but these have never amounted to much. The Bank of Maldives, however, has become quite active recently with a “development banking” program that is expanding to provide savings and credit services to underserved populations.

<sup>2</sup> Montgomery and Weiss 2005.

<sup>3</sup> Rutherford, 2003.



## Poverty and Exclusion

Given that modern microfinance in South Asia effectively started in the 1970s, during a time in which regional poverty was being examined, it is perhaps inevitable that the growth of microfinance was rooted in the poverty discourse. Although cooperatives were formed in the region in the early part of the twentieth century, considerably more attention was paid to the formation of agricultural cooperatives than nonagricultural ones, a fact that was remarked upon repeatedly by review committees and in amendments to the original 1904 Cooperative Act of the Government of India. Nevertheless, the Indian scene continues to be dominated by the Primary Agricultural Cooperative Societies, while throughout South Asia, cooperatives are generally seen as a failure. In Bangladesh, cooperatives were typically used to promote green revolution technologies (seed, fertilizer, and irrigation tools) among farmers; however, a large chunk of the poor were omitted and the greater concern was to capture state agricultural subsidies than to develop pro-poor institutional mechanisms to ensure sustainable access to financial services. For the most part, cooperatives do not reach the poorer sections of the population because they were designed to serve the needs of cultivators rather than farm workers.

Apart from cooperatives, the average low-income family in the region before the 1970s had no recourse to financial services and, were it not for the advent of the microfinance movement, they would not have much recourse today. Most South Asian countries have a reasonable banking system in urban areas; however, despite the fact that the majority of these populations live in rural areas, their access to formal financial services is limited. Bangladesh, with a population in excess of 140 million, has just 6,000 bank branches; Pakistan, with 155 million people, has fewer than 8,000 bank branches, and this number is shrinking. Of the larger countries, only India

with more than 70,000 bank branches has a reasonable ratio of around 15,000 people per branch, which is similar to Sri Lanka. In Nepal, access to banking facilities is restricted because of topography constraints and the consequent lack of infrastructure; in Afghanistan, the banking system currently is in the early stages of revival after many years of civil war and is still largely confined to Kabul and a few other large cities.

Even where bank branches exist, access is not easy for low-income families. A recent study of alternative financial sources to microfinance in India found that, despite the reasonable distribution of bank branches, the typical microfinance client finds it difficult to use the banking system. According to EDA Rural Systems Private Limited,

*Focus Group Discussions reveal that most clients and non-clients find it difficult to deal with banks due to high transaction costs: delays, corruption and formalities. The survey results show that despite bank credit being cheaper, 83% of clients and non-clients have never approached a bank for a loan. Those who do are more likely to be better off, as we have seen, including women, in the South, who approach banks for 'gold' loans. Banks may be at some distance (2-5 km) but people say that this is less of a problem than the transaction costs of dealing with banks.<sup>4</sup>*

<sup>4</sup>EDA 2003, chapter 9.

Table 1.1 summarizes the reasons why, in spite of bank credit being cheaper, low-income families dislike dealing with banks.

**Table 1.1. Why Low-Income Families Like/Dislike Banks in India**

**LIKES**

- Very low interest rates
- In the south, large loans easily obtained against gold
- Very little or no follow up on the loans and little pressure to repay
- Likely waiver of the loans by the government because of political reasons
- The Kisan Credit Card (KCC)<sup>a</sup> enables easy access to credit for farmers for at least the first year

**DISLIKES**

- Bank loans involve multiple time-consuming formalities
- Mainly accessible to those with contacts or who can bribe officials
- For subsidized loans under priority sector schemes, the local *panchayats*<sup>b</sup> decide the list of beneficiaries, which is subject to favoritism
- The poor do not have anything to offer as collateral (land or gold) and, therefore, cannot obtain regular bank loans
- Poorer women (especially in the north) lack confidence, contacts, and understanding of bank procedures

Source: EDA 2003.

Note: a. Local governance councils (the poor are not usually effectively represented on them).

b. An agricultural line of credit available to virtually anyone with a land holding and a good credit record with the banks.

The net effect of these impediments is deterrence in the use of banking services, higher effective costs to borrowers, and consequent credit rationing.

Similar findings emerged from the World Bank-sponsored study on rural access to financial services in the two major states of Andhra Pradesh and Uttar Pradesh in India.<sup>5</sup> From the perspective of small rural borrowers the survey showed that the following:

- Banks do not provide flexible products and services to meet the income and expenditure patterns of small borrowers.
- The transactions costs of dealing with the banks are high resulting not only from the significant travel time to bank branches but also from cumbersome procedures and the need to pay hefty bribes (10 to 20 percent of the loan amount) in a significant number of cases.
- Banks demand collateral, predominantly land, which poor rural borrowers lack.<sup>6</sup>

In contrast to other South Asian countries, the cooperative movement in Sri Lanka along with Samurdhi banking societies has catered to a

significant proportion of low-income families, partly because of policy lending sponsored by the government. In addition, the cooperative rural banks and the SANASA Development Bank, which services the cooperatives, have developed out of the cooperative movement. As a result, the need for commercial banks to serve the needs of poor people is lower.

In much of the region, cooperatives failed because of their domination by rural land-owning elites whose short-term interests would be threatened by a more enlightened approach to financial outreach. In much of the formal financial system, the lack of innovation in developing alternative methodologies that consider the *constraints* (lack of traditional collateral, illiteracy, nature of enterprises of the poor, nature of the financial needs of the poor) and *strengths* (strong horizontal social capital, information) of *poor clientele* has been the main reason that the poor are being excluded.

<sup>5</sup> World Bank 2004. This is the first "access to finance" household survey conducted by the World Bank in South Asia, with similar surveys expected to follow in three more South Asian countries in 2006/07. The India study confirms the low level of access to financial services of poor people and describes the barriers to access in detail.

<sup>6</sup> Srivastava and Basu 2004.

## The Microfinance Response

The basic principle on which microfinance is based has been described as a process in which poor families borrow large amounts (or lump sums) of money at one time and repay the amount in a stream of small, manageable payments over a realistic time period using social collateral in the short run and institutional credit history in the long run.<sup>7</sup> Families can reborrow slightly bigger amounts upon repayment in a predictable and reliable way. This is a fundamental and robust innovation in the financial system, the simplicity of which has allowed it to be replicated widely, reaching a large number of low-income families globally as well as in South Asia.

Astonishing growth rates in Bangladesh, particularly during the 1990s, created a new dimension for microfinance worldwide because, for the first time, a relatively formal system for providing financial services covered millions of clients and a substantial proportion of low-income families of this major developing country were served by the activity. The start of the twenty-first century reinforced this trend as the Bangladesh numbers continued to grow impressively and a substantial parallel microfinance system based on a self-help group (SHG) developed in India. In the past few years, both countries have seen important moves toward product innovation, which, along with the innovative links with the formal financial system (particularly in India), have firmly established their microfinance markets as world leaders in the field. Other countries of

the region made slower and later starts but have since established active microfinance sectors that provide more widespread access to financial services.

Overall, microfinance has become a significant part of the economic landscape of South Asia. By 2005, microfinance in the region covered at least 35 million of some 270 million families in the region and met some 15 percent of the overall credit requirements of low-income families. In Bangladesh and Sri Lanka, coverage was particularly impressive, with more than 60 percent of the poor covered by microfinance services. The focus of the movement on engaging women as essential contributors to economic and social well-being has had important spillover effects throughout the region. Thus, even in a socially conservative country such as Afghanistan, microfinance activity has focused on women, thereby, according them more explicit recognition as economic agents; in India, the SHG movement has become the basis for programs to promote empowerment and overall improvement of the status of women in society. In Bangladesh, microfinance has become the basis for microenterprise promotion by some of the large MFIs and for more specifically targeted programs for the “ultra poor.” In both Pakistan and Nepal, the potential of microfinance demonstrated by these experiences has captured the attention of governments that have created specific legal frameworks to facilitate its growth.

## The Emergence of Microfinance

While informal sector financing systems can be traced to the era of Kautilya in the fourth century B.C.E.,<sup>8</sup> the era of organized sector finance in much of South Asia (Bangladesh, India, and Pakistan) is generally acknowledged

to have started with the Cooperative Credit Societies Act of 1904. The cooperative credit societies were based on the models of the German cooperative movement, in particular the Raiffeisen and the Schulze-Delitsch

<sup>7</sup> Rutherford 2000.

<sup>8</sup> Rangarajan 1987.

cooperatives. The objective of the Act was “to facilitate promotion of cooperative societies, for the promotion of thrift and self-help among agriculturists, artisans and persons of limited means.” To the extent that the wording of this objective could be applied to the objectives of many MFIs today, this Act is a true precursor to modern microfinance in the region. The cooperative movement in Sri Lanka was formalized through similar cooperative legislation in 1911; in Nepal, formal financial services only became available to small clients with the establishment of the credit cooperatives in the 1950s.

It is apparent from its objectives that the initiation of the cooperative movement in South Asia was a response to the perceived need for outreach to those who were otherwise excluded by the formal financial system—that is, farmers, artisans, and other “persons of limited means.” It is noteworthy that some seven decades later, in the 1970s, it was still thought necessary to nationalize commercial banks throughout the region, and the first fledgling attempts were made to launch microfinance as we know it today. Both initiatives were part of the quest for outreach, although the paths taken were quite different. The banks, now owned by governments, undertook the benevolent, statist path of creating a supply of products designed by bureaucrats ostensibly to maximize the welfare of the excluded groups. This approach had an inexorable logic that led to the packaging of credit products with a complex set of support programs and structures to promote the economic activities of the intended clients. These complex sets of programs came to be known as “integrated development programs,” while the intended clients were the “beneficiaries.”

The microfinance initiators experimented with a means of providing capital to those who needed it. The key concerns were to make capital available in small amounts, at convenient times and locations, and at as low a

cost as possible. It is on such principles that Grameen Bank was born and BRAC and Sri Mahila Sewa Sahakari Cooperative (SEWA) Bank's first experiments were undertaken in the early 1970s.

The following sections consider issues surrounding the emergence of microfinance in each of the countries of South Asia. The discussion begins with Bangladesh, which is widely considered to be the initiator of microfinance in the region, and continues with countries in the order of the extent of their microfinance outreach.

## Bangladesh

In the early 1960s, the late Akhter Hameed Khan started what became widely known as the Comilla Project, which fostered the creation of village cooperatives through which small loans were provided to poor farmers as part of an effort to improve food production and reduce poverty. This work originated what is now known as the Bangladesh Rural Development Board, the largest government-managed microfinance program in the country.

Postindependence in 1971 marked the beginning of the nongovernmental organization (NGO) movement that dominates the microfinance sector today. This movement, the famous story of what eventually became Grameen Bank in 1983, and the worldwide influence of the Grameen model of microfinance are well known and well documented.<sup>9</sup> The microfinance initiatives that emerged during this process remain the basis of what is now called “mainstream microfinance.”

In the 1980s, several NGOs began to build their management capacity and emerge as large organizations with the capacity to scale up their microfinance programs. BRAC's seminal experience with taking a program to national scale, although not a microfinance program,

<sup>9</sup> While many publications narrate the history of microfinance in Bangladesh, there is a useful summary in Zaman 2004.

began in the early 1980s. BRAC taught the effective use of oral rehydration therapy to prevent childhood deaths from diarrhea to every mother in all villages in the country.<sup>10</sup> The lessons learned and the confidence gained from this experience were influential in scaling up other programs, including microfinance.

At the same time, from the 1980s onward, donors channeled large amounts of funding to NGOs, helping them expand their microfinance activities. By the mid-1990s, NGOs had expanded the microfinance sector significantly by focusing on the simple and efficient model of mainstream microfinance pioneered by Grameen. This expansion was aided by Palli Karma Sahayak Foundation (PKSF), an apex financial institution that was established by the government in 1990 to provide wholesale funding to microfinance NGOs. PKSF was later expanded through funding from the World Bank and other donors.

In the mid-1990s, faster expansion of NGO-MFI programs was supplemented by experiments with new and more flexible approaches to providing services to clients. It was also at this time that NGOs began to focus more on the sustainability of their operations and on diversifying their sources of funding. More recently, NGOs have become more innovative, introducing flexible savings models and pioneering new ways to reach the poorest and most marginalized people as well as offering larger loans for microenterprises.

In the last two to three years, and accelerating in 2005, portfolio sizes and client outreach among the major NGO-MFIs, as well as Grameen Bank, have experienced rapid growth accompanied by changes in the way business is conducted. As of late 2004, the four largest microfinance service providers were estimated to have 73 percent of the total client outreach. Grameen Bank, for example, grew from about 2 million members to more than 5 million from December 2002 to December 2005, while both Association for Social Advancement (ASA) and

BRAC experienced significant growth. In addition, a number of mid-size MFIs such as BURO Tangail, Thengamara Mohila Sabuj Sangha (TMSS), and Society for Social Service (SSS) have shown strong growth.

In this development, Grameen Bank has been outstanding. Reacting to the difficulties it encountered in the late 1990s, Grameen Bank developed Grameen II; and, in 2002, it began to convert its branches to follow the new approach, a process that was completed by the end of 2003. In 2005, under this new program, Grameen Bank added 100,000 active clients per month. The changes brought about with Grameen II have not directly affected the environment in which its products are offered, because clients are still served in groups that meet weekly in their villages. But there have been two main changes. In the first, Grameen has become a true intermediary by offering competitively priced savings products to the nonmember public as well as to its members. This has led to a huge inflow of deposits by the end of 2004, the value of Grameen's savings portfolio exceeded that of its loan portfolio for the first time in its history. Since 2003, new branches begin by mobilizing deposits rather than by taking loan capital from headquarters, and they only establish borrower groups when they have first amassed their own capital. The second major change was in the products offered to members, which incorporate new savings instruments, including an extremely popular commitment plan. On the lending side, a substantial flexibility was introduced, which was shunned earlier because of administrative complications for the service provider caused by flexibility and the likelihood of such complications increasing operating expenses.

<sup>10</sup> This story and the lessons that were learned from it are described in Chowdhury, Mushtaque, and Cash 1996.

<sup>11</sup> Rasmussen, Alamgir, Ahmad, and Ahamed 2005.



## India

Although Bangladesh is widely recognized as the inspirational base of the microfinance initiators in the region, India was for many years the fountainhead of statist wisdom. Starting with the first wave of bank nationalization in 1969 and reinforced by the establishment of Regional Rural Banks (RRBs) in 1976, directed credit became the mantra of the Indian financial sector. In the meantime, the cooperative sector infrastructure had developed over the years through the creation of an apex banking structure at the district and state levels to ensure the smooth flow of capital in the cooperative system. The entire network of primary cooperatives in the country and the RRBs, established to meet the needs of the rural sector in general and the poor in particular, has not proven to be successful. The cooperatives suffered from mismanagement, leadership by the privileged, and corruption, and gradually were smothered by state patronage and protection, in many cases including management by ill-motivated government servants. Meanwhile, saddled with the burden of directed credit and a restrictive interest rate regime, the financial position of the RRBs deteriorated.<sup>12</sup>

For many years, bankers and senior government officers in India were fond of describing the Government of India's main poverty alleviation program, the Integrated Rural Development Programme (IRDP), as "the world's largest microfinance program." Commercial banks gave loans of less than Rs 15,000 (\$330)<sup>13</sup> to poor people, and over 20 years, provided financial assistance of around Rs 250 billion (\$5.6 billion) to roughly 55 million families.<sup>14</sup> The problem with IRDP was that its design incorporated a substantial element of subsidy, amounting to 25 to 50

percent of each family's proposed investment cost in an income-generating activity, prompting extensive misappropriation and misuse of funds. This situation led bankers to regard the IRDP loan as a politically motivated handout and they largely failed to follow up on repayments due from borrowers. The net result was that estimates of the repayment rates in the IRDP ranged from 25 to 33 percent. Not surprisingly, the two decades of IRDP experience in the 1980s and 1990s affected the credibility of microborrowers in the view of bankers and ultimately hindered the access of low-income clients to banking services.

Over the past 20 to 25 years, the resultant vacuum in the financial system has started to be filled, initially with the efforts of influential development organizations such as the SEWA Bank (Ahmedabad), Annapurna Mahila Mandal (Mumbai), and Working Women's Forum (Chennai). This movement gained momentum in the 1990s with the entrance of large numbers of NGOs into microfinance. And since 1995, attempts to reform the cooperative system have resulted in the creation of a new generation of cooperatives, the "mutually aided cooperatives societies" (MACS) that lie outside the purview of state control. Thus far, five states have enacted MACS Acts. The new system guarantees independent management and has resulted in the creation of hundreds of MACS in Andhra Pradesh, for example, many of which are engaged directly in microfinance. Current estimates of the number of NGOs and MACS engaged in mobilizing savings and providing microcredit services to the poor exceed 1,000 organizations.<sup>15</sup>

Initially, many NGO-MFIs were funded by donor support in the form of revolving funds and operating grants. In recent years,<sup>16</sup> apex development finance institutions such as the National Bank for Agriculture and Rural

<sup>12</sup> For a more detailed discussion, see Sinha 2000.

<sup>13</sup> All dollars are U.S. dollars (\$) unless otherwise noted.

<sup>14</sup> This suggests that virtually all the 60 million or so poor families were covered by the IRDP. This was not the case, however, as the numbers include many cases of repeat assistance (deliberate) and perhaps even more cases of unjustified selection of "beneficiaries."

<sup>15</sup> This number includes all registered societies, trusts, a few NBFCs, and "new generation" cooperatives acting as financial intermediaries. It specifically excludes unregistered SHGs, which are usually established and facilitated by the NGOs; it also excludes conventional cooperatives.

<sup>16</sup> Roughly since 1994.

Development (NABARD), Small Industries Development Bank of India (SIDBI), and microfinance promotion organizations such as the Rashtriya Mahila Kosh have provided wholesale loans to MFIs. This has resulted in MFIs becoming intermediaries between the largely public sector development finance institutions and retail borrowers composed of groups of poor people or individual borrowers who live in rural areas or urban slums. In another model, NABARD refinances commercial bank loans to SHGs to facilitate relationships between the banks and poor borrowers. This latter movement, initiated by the well-known NGO, MYRADA, and promoted by NABARD, has witnessed significant progress since 1998. The bank-SHG link program greatly increased banking system outreach to otherwise unreached people and initiated a change in the bank's outlook toward low-income families from beneficiaries to customers.

Although the NGO microfinance sector has begun to provide user-friendly formal financial services to the poor, its outreach is still tiny in comparison with need. Recent compilations of support provided by major financial institutions show that the outstanding microfinance loans of domestic financial institutions, including NGO-MFIs, did not exceed Rs 35 billion (\$804 million) by March 2005, with an outreach of about 15 million families, at best less than 25 percent of the 60 to 70 million poor families in the country. This includes the scheme for linking SHGs directly with banks, with available data showing around Rs 20 billion (\$460 million) in outstanding loans to some 11 million families at the end of March 2005.<sup>17</sup> This bank-SHG link program, promoted by India's main apex bank responsible for rural development, NABARD, started in 1992 and has grown phenomenally over the past few years. Cumulatively, the program had resulted in lending by the major commercial banks, regional rural banks, and cooperative banks to

some 1.6 million SHGs.

Other than the bank-SHG link program, the involvement of commercial banks in microfinance continues to be negligible in relation to the current volume of microfinance and to their broader engagement in rural areas. The total credit from the scheduled commercial banks to the "weaker sections"<sup>18</sup> was estimated at Rs 323 billion (\$7.2 billion) at the end of March 2004 compared with total rural deposits of Rs 1,760 billion (\$39 billion). Furthermore, the amount outstanding to SHGs was just Rs 14 billion at this time, less than 0.5 percent of the total outstanding loans of scheduled commercial banks. This loan amount for a potential clientele of around 40 percent of the population indicates the great distance yet to be covered in obtaining financial inclusion of underserved populations.

## Sri Lanka

As with the rest of the region, microfinance in Sri Lanka originated in the cooperative movement that was formalized in 1911 through the Cooperative Societies Ordinance. Financial services are provided through the Cooperative Rural Banks (CRBs), which are directly linked to multipurpose cooperative societies. The first CRB was established in 1964. Virtually in parallel, another set of cooperative finance institutions, the Thrift and Credit Cooperative Societies (TCCS), were established. The TCCS started to expand significantly in the 1980s when the SANASA Development Bank was formed as an apex institution to support them. In the 1960s, NGOs, such as Lanka Mahila Samithi and Sarvodaya, began to form village organizations on a large scale along with village societies of the integrated rural development programs. Since the 1980s, these groups have been the primary tool of microfinance service delivery in Sri Lanka.<sup>19</sup>

<sup>17</sup> Authors' estimate for the number of families. The information available on the bank-SHG link program does not cover amounts outstanding or the number of SHGs with outstanding loans. The numbers on the link have been estimated on the basis of data available on the NABARD Web site.

<sup>18</sup> "Weaker sections" is official parlance for the poor and underprivileged sections of society. This includes all families officially classified as poor but also some non-poor who belong to the lower castes or to specified groups of religious minorities.

<sup>19</sup> Charitonenko and de Silva 2002.

Both the Bank of Ceylon and the People's Bank were established to provide financial services to small borrowers; however, because they were reaching only a tiny proportion of such borrowers, the government began to establish Regional Rural Development Banks (RRDBs) starting in 1985. These banks are owned by the central bank along with a number of state-owned banks and can be considered to be microfinance providers because 80 percent of their portfolio is in loans of less than SL Re 100,000 (\$101).

In addition, there is a two-pronged microfinance activity under the government's poverty reduction program. The Samurdhi Development Credit Scheme is a conventional government lending program operated by state-owned banks and suffers from the usual weaknesses of subsidized interest rates and high default rates. Conversely, the Samurdhi Banking Society (SBS) Program has grown fast and has recorded better performance. Membership of SBS is limited to recipients of Samurdhi welfare benefits from government.

There are about 10 medium-size NGOs, led by Sarvodaya Economic and Enterprise Development Services (SEEDS), and more than 100 other NGOs and community-based organizations (CBOs) that have microfinance portfolios but suffer from operational problems and an excessive focus on social objectives, which prevents them from being able to function efficiently. Furthermore, a few of the private commercial banks, particularly Hatton National Bank and Seylan Bank, have ventured into microfinance with small portfolios. Their engagement has been hampered by the extensive subsidized government programs, and they have tended to move upmarket to rural entrepreneurs who are not necessarily poor.

How sustainable this system is remains to be seen. Overall, Sri Lanka has one of the highest microfinance penetration rates in the world, largely because of government programs that consume large subsidies. Despite the extent of

government subsidy in the system, the importance of community-based institutions in the overall financial landscape of Sri Lanka demonstrates that its microfinance sector has a much greater community orientation than other countries in the region.

## Pakistan

In Pakistan, too, it is the long history of the cooperative movement and the large extent and rich diversity of informal credit systems that set the stage for the emergence of the modern microfinance sector. Both systems were discredited over time through the exploitation of poor people, corruption, and in the case of cooperatives, institutional failures resulting in lost savings for many investors. These problems led the state and NGOs to seek better ways to provide financial services, particularly credit, to poorer people, many of whom live in rural areas.

The Aga Khan Rural Support Programme (AKRSP), an integrated rural development program, began in 1982 in what was then the most remote and poorest part of the country, the high mountain districts in northern Pakistan.<sup>20</sup> It could be said that AKRSP has been the most influential microfinance program in Pakistan since it spawned the rural support program (RSP) movement, which today accounts for nearly 70 percent of the NGO outreach in microfinance. AKRSP was also the first, and so far only, NGO to transform into a microfinance bank, the first privately owned microfinance bank in the country. AKRSP's microfinance program grew to be quite large through generous grant funding from bilateral donors. Eventually, it became operationally sustainable because of investment income earned by investing the surplus funds that were accumulated from donor contributions, although its lending activities were not operationally sustainable. While the AKRSP experience began the process, bilateral donor grant funding began to

<sup>20</sup> A history of AKRSP's microfinance program can be found in Hussein and Plateau 2006.



flow to NGOs in significant amounts during the early 1980s. It continued as the main source of support to NGO microfinance programs until the late 1990s, when the government and donor-backed apex institution, the Pakistan Poverty Alleviation Fund (PPAF), took over as the main source of funding.

Although two other RSPs based on the AKRSP model were formed in 1989 and 1992, the microfinance movement continued to be small and not very visible. One of these RSPs, the National Rural Support Programme (NRSP), which has the largest NGO microfinance portfolio today, began its microfinance program with a line of credit from Habib Bank. And although the NRSP is primarily dependent on subsidized funding from PPAF, it has always included some commercial borrowing. Other players also began to enter the market in the 1990s. Network Leasing Company was established as a listed leasing company in 1994 and, with some donor support, it began a microleasing program. The first commercial bank to begin a separate microfinance division, in 1995, was the Bank of Khyber, owned by a provincial government.<sup>21</sup> At about the same time, the government established the First Women's Bank. In addition to supporting the needs of women entrepreneurs, the bank tried to establish a microfinance program, although it has never been successful. More NGOs began to offer microcredit services during the 1990s, the most significant being the Kashf Foundation, which was the first NGO established exclusively to provide microfinance services and the first to be managed by women and have only women clients. Kashf later became the first MFI of any kind to be profitable after adjusting for subsidies.

A major shift in Pakistani microfinance occurred when President Musharraf came to power in late 1999 and the new government made microfinance promotion one of the pillars of its poverty reduction strategy. Overnight this thrust the microfinance sector into the national limelight and things began to change rapidly.

A previously planned apex institution, the PPAF, became operational in 2000 with government and World Bank funding. This was consciously modeled on PKSF in Bangladesh and soon became the main source of funding for NGOs engaged in microfinance. In 2000, the government established Khushhali Bank, a microfinance bank set up through a special ordinance. The government invited state-owned and private commercial banks, including multinational banks, to contribute capital and accepted a loan from the Asian Development Bank (ADB) to help Khushhali Bank begin operations and grow quickly. The government's rationale for setting up this bank was that the NGO microfinance programs were insignificant and that, to scale up quickly, a new kind of microfinance institution was needed. This effort was followed in late 2001 by the MFI Ordinance that allowed for the creation of microfinance banks under the supervision of the State Bank of Pakistan (SBP), on the heels of which AKRSP and the Aga Khan Fund for Economic Development set up the First MicroFinanceBank. Despite this attention accompanied by new opportunities and much larger amounts of funding than were previously available, the sector remains relatively small and weak. Progress under the microfinance ordinance has been slower than expected and only six microfinance banks have been established thus far, four with national licenses and two with district-level licenses.

Microfinance in Pakistan has a degree of prominence and well-meaning (if not always well-designed) state support that it does not enjoy elsewhere in South Asia. Prominence occurred as it captured the attention of the leadership as a special activity that could focus its development strategy, although microfinance was not seen as an integral part of the financial sector. To an extent, the design lacunae of the sector lies in the leaders' inability to move beyond a social development focus in considering the welfare of low-income families. In the short to medium term, this government orientation is perpetuating parallel

<sup>21</sup> See Arbab 2004 for a discussion about the Bank of Khyber's microfinance program.

development rather than promoting financial inclusion.

## Nepal

As in India, the origins of microfinance in Nepal lie in the credit cooperatives and later on some of the government's welfare-oriented rural development programs. In the 1950s, the first credit cooperatives in Nepal were initially intended to provide credit to the agricultural sector. The Agricultural Development Bank of Nepal (ADBN) emerged as a result of a shortfall in the supply of funds for agricultural lending by the credit cooperatives. In 1975, the Small Farmer Development Programme was established to provide further impetus to agricultural lending by providing credit to small groups of farmers on a group guarantee basis. In the 1990s, these farmers' groups evolved into the Small Farmer Cooperatives Limited.

The first major step in the development of microfinance in Nepal was taken with the launch of the first gender-focused program, Production Credit for Rural Women, in 1982. This program organized women into groups to enable group-based borrowing from the two main commercial banks, Nepal Bank Limited and Rastriya Banijya Bank, as well as from ADBN. Beginning in 1994, the partial involvement of NGOs in this process stimulated their engagement as intermediaries in financial service delivery.

In 1992, another important initiative was taken to augment the supply of microfinance when the government established the first two Regional Rural Development Banks. These banks were capitalized with government and central bank funds to replicate Grameen Bank of Bangladesh. By 1997, five such banks covered each of the development regions of the country. In parallel, the role of NGOs and cooperatives grew until 2001, when the delivery of microfinance services in Nepal was adversely affected by the ongoing insurgency. It was at this time that the ADB-funded apex institution, Rural Microfinance Development

Centre (RMDC), came into operation to provide wholesale funds to potential and viable microfinance institutions for on-lending to the ultimate borrowers for undertaking their productive activities. Rather like Pakistan, over time, Nepal accorded microfinance some degree of prominence through the establishment of an enabling framework and the provision of funding through apex institutions, because it was seen as a special activity with a social development focus.

## Afghanistan

In early 2002, Afghanistan began to emerge from almost 25 years of devastating conflict. There was no remaining formal financial system, at least in any operational form, but microfinance came into the picture early on in the reconstruction process, first as a means of social protection and employment promotion and later as part of the agenda for promoting “alternative livelihoods” to combat a growing opium economy.

Because there was almost no microfinance expertise in Afghanistan, experienced international NGOs were invited and supported to establish microfinance services. Notable among these were BRAC from Bangladesh and the Aga Khan Development Network, which relied on its experiences in Tajikistan and Pakistan. At the same time, the donors and government began to work on a proposal to promote the development of a microfinance sector in the country. In 2003, this led to the creation of the Microfinance Investment Support Facility for Afghanistan (MISFA), a multidonor-supported financing and capacity building apex institution, initially part of the Ministry of Rural Rehabilitation and Development, which later registered as a private company. From the beginning, MISFA focused on three objectives: scaling up outreach rapidly, supporting the development of sustainable MFIs, and ensuring that international NGO-managed microfinance operations become registered Afghan microfinance institutions. By late 2005, MISFA

was supporting 12 NGOs with microfinance programs, and at least two more NGOs had small active programs that were reasonably well designed, although not supported by MISFA.

In the absence of a widespread financial infrastructure, the independent MFIs currently constitute the only institutional means of access to financial services for the vast majority of the population outside a few major cities. Indeed, given the active establishment of MFIs at this early stage of development of a formal financial sector in the country, it is perhaps not surprising that the first commercial banking license granted in the country was for a microfinance bank, the Aga Khan–sponsored First MicroFinanceBank. The establishment of a commercial bank to provide microfinance services constitutes formal recognition of microfinance as an important and viable segment, if not yet an indistinguishable part, of the financial system.

Significant similarities exist in the origins of microfinance in the countries of South Asia, although in more recent years the paths taken by each country are notably divergent. These paths range from the NGO-dominant growth of microfinance in Bangladesh to the widespread bank-SHG link model in India and the predominantly community-based but government-sponsored institutions of Sri Lanka. In Pakistan and Nepal, direct government interest in microfinance as a poverty reduction model has led to the establishment of “enabling” frameworks, while the war-devastated economy of Afghanistan has sought to make use of the microfinance experience of international NGOs. In a variety of ways, microfinance has increasingly played a more important role in the evolution of poverty reduction programs in the region.

# Limitations and Challenges:

## The unfinished agenda

The microfinance movement in South Asia has permanently changed the face of the financial sector by challenging conventional thinking and introducing innovations. The limits of the microfinance model emerge, however, when it comes to serving many more poor people who are still excluded and capturing a larger share of the financial service business of the existing clientele.

### Financial Needs of Low-Income Families

Recent research shows that although MFI outreach among various categories of the poor in Bangladesh has been impressive, the MFIs took a rather small proportion (however measured) of the microfinance business of households.<sup>22</sup> There were five times as many interest-free loans as MFI loans reported during the year. Because almost all these MFIs were following the classic Grameen model, this phenomenon can be understood as an outcome of the fact that MFIs can give only one loan per year per client. Even so, this one MFI loan could be expected to be significantly bigger than the average informal loan, many of which might be assumed to be trivial matters of a few dollars passing between friends or relatives. But this assumption turned out to be false; the MFI share of the total transaction flow (their share of the \$839 borrowed per household per year) was only 15 percent – counting all outflows of loans and savings withdrawals, and inflows of repayments and saving deposits. It does not seem that the MFIs feature strongly on the household balance sheets, because the MFI share of household financial assets at the end of the research year was just 13 percent and accounted for only 21 percent of financial liabilities.

Other research in India has shown that, in a sample of more than 3,000 MFI clients, the median outstanding amount owed to MFIs was \$68. Conversely, for the 32 percent of clients who had borrowed from friends and relatives, the median amount owed was \$91, and for the 36 percent who had borrowed from moneylenders and other costly informal sources, the median amount owed was significantly higher at \$159.<sup>23</sup>

Another study of financial transactions undertaken by low-income households in India showed that the frequency of transactions, both borrowing and lending, is far higher than the typical MFI methodology caters to. According to Ruthven (2001), *...the financial needs of the low income respondents...entail frequent transactions—both inflows (borrowing and savings withdrawals) and outflows (repayments and savings accumulations or deposits)—within a fairly narrow range (in terms of amounts of money) which is closely related to the family's income level. An examination of the disaggregated financial diary information shows that some of the transactions take place because people, invariably, try to minimize their costs and*

<sup>22</sup> Rutherford 2003.

<sup>23</sup> EDA 2003, chapter 9.

*maximize their security (and returns) by shifting money from one sort of financial device to another. This nimble, if economically rational, financial behaviour of the diary respondents—and the reasons for it—have been well covered in other papers emerging from this research.*<sup>24</sup>

Essentially, when faced with an array of financial devices with different characteristics in terms of costs, returns, security, accessibility, and flexibility, people opt for a range that suits their needs at a given point of time. Their tendency to shift between these devices over time is dependent on their (often variable) income flows and expenditure needs as well as on the accessibility and suitability of a particular device.<sup>25</sup>

MFIs have added to the options available to low-income families and have contributed to the diversity of the options they can access to manage their financial assets. They have not yet replaced the moneylender, however, nor are all MFIs, or the microfinance sector as a whole, able to affect poverty to the extent that some microfinance proponents would like to believe. Ideally, low-income families need financial services in small amounts, transacted frequently—a need that continues to be catered to by the village- and slum-level service provider—because more formal MFI operations have yet to develop the technology, systems, and risk-spreading mechanisms to replace them.

## The Limits to Informal Financial Services

For the poor in South Asia, largely excluded from the cooperative system and unwelcome at the banks, the only recourses available (until the advent of microfinance) were traditional informal sources of credit. These included personal sources, such as friends and relatives; revolving savings and credit associations (ROSCAs) or chit funds; private non-bank finance companies (NBFCs); and costly informal sources, such as pawn shops, moneylenders, large landowners, and trade creditors. The study cited earlier<sup>26</sup> connects the terms under which each of these options is available to the typical microfinance client in India. This study shows that for loans less than Rs 25,000 (\$550) the MFI (with a cost range of 18 to 47 percent) is a cheaper alternative to informal sources (for which the interest range is 26 to 200 percent) unless a family has sufficient social capital to borrow from friends and relatives (the cheapest source). Much the same pattern applies in other countries across the region.

Banks are not meeting microfinance demand to any significant extent, and MFIs are not yet able to satisfy the demand from low-income families. In fact, aggregate calculations made for the number of poor families in the region indicate a substantial shortfall in the availability of microcredit in the region. The estimated credit requirement for meeting the needs of poor families in the region are presented in table 2.1. Compared with a total credit outstanding amount of some \$2.3 billion from microfinance sources, the conservatively estimated requirement to meet the immediate (rather than long-term) investment needs of poor families in the region amounts to more than \$15 billion. This suggests that just 15 percent of the total requirement to meet the needs of the poor is available in South Asia, with the proportion of needs being met ranging from 2 percent in Afghanistan to 55 percent in Bangladesh.<sup>27</sup>

<sup>24</sup> Ruthven 2001; Patole and Ruthven 2001; and Ruthven and Kumar 2002.

<sup>25</sup> EDA 2003, chapter 9.

<sup>26</sup> EDA 2003, chapter 9.

<sup>27</sup> In Sri Lanka's case, the proportion exceeds 100 percent because of the large number of borderline non-poor included in the figure for microcredit availability.

**Table 2.1. Estimate of Credit Requirement for Poor Families in South Asia**

Country	Poor Families <sup>a</sup> millions	Microfinance Clients millions	MFI Credit Outstanding		Credit Requirement		Outstanding Requirement %
			US\$ per family	Aggregate\$ millions	US\$ per family	Aggregate \$ millions	
Afghanistan	2.0	0.12	70	8	200	400	2
Bangladesh	13.0	16.00	60	960	133	1,733	55
India	60.0	15.00	70	1,050	182	10,909	10
Nepal	1.6	0.50	60	30	133	213	14
Pakistan	8.5	0.58	90	50	200	1,700	3
Sri Lanka	1.0	2.50	90	225	200	200	113
<b>South Asia</b>	<b>86.1</b>	<b>34.7</b>	<b>67</b>	<b>2,323</b>	<b>176</b>	<b>15,156</b>	<b>15</b>

Source: Authors' estimates based on M-CRIL and EDA studies and on secondary information.

Note: The estimates in the table for poor families are based on the population of the country, the size of families in that country, and the poverty ratio as indicated in sources such as the World Development Report. Average credit outstanding for each country is estimated from M-CRIL's rating database and the credit requirement is based on a conservative estimate of the immediate (rather than long-term) investment needs of poor families in each country.

a. poor families = families subsisting on less than government-defined poverty thresholds.

The magnitude of the gap between the conservatively estimated requirement and the present supply of microcredit is just one indication of the huge microfinance task that remains in South Asia, even without taking the borderline non-poor into account. Including the latter, which MFIs invariably do, not only is desirable for the process of inclusion in the financial system, but also is necessary to meet the needs and reduce the vulnerability of families at this level.

Although microfinance has taken great strides in South Asia over the past 30 years—in the process, beginning to address a gap that other efforts had failed to address and contributing much to the worldwide microfinance movement—the unsatisfied financial services needs of those at the “bottom of the pyramid” are enormous and much remains to be done.

## Outreach Revisited

The discussion above has explained the origins and growth of microfinance in South Asia and outlined the nature of the microfinance activity in the region, including a sense of the direction in which it is moving. This section provides an overview of the numbers entailed in considering microfinance activity in South Asia and discusses the quality of that outreach in terms of the depth of coverage of poor (as opposed to low-income) clients. The outreach information is summarized in table 2.2, which relates the data to the estimated poverty ratios of each country.

The [Bangladesh](#) situation is marked by very high coverage by credit, if not deposit services. To the extent that microfinance clients cannot

necessarily be classified as poor, table 2.2. estimates that around 50 of the microfinance clients in the country are poor. In many parts of Bangladesh, the operations of different MFIs overlap substantially, resulting in multiple memberships by clients. This occurs despite the fact that, until recently, Bangladeshi MFIs attempted to ensure exclusive participation in their programs. Given this extensive overlap in the membership of MFIs among microfinance clients, the 62 percent estimate of coverage of poor families appears realistic. In addition, this information suggests that significant numbers of clients with incomes above the poverty threshold, many of whom could be classified as near-poor, are also receiving services from



**Table 2.2. Breadth of Microfinance Outreach in South Asia (estimates)**

Country	Population <sup>a</sup> millions	Poverty Ratio %	Poor Families <sup>b</sup> millions	MF Clients millions	MF Poverty Outreach %	MF Coverage of Poor Families <sup>b</sup> %
Afghanistan	22	55	2	0.12	50	3
Bangladesh	143	50	13	16	50	62
India	1100	30	60	15	35	9
Nepal	26	35	1.6	0.5	45	14
Pakistan	155	33	8.5	0.58	35	2
Sri Lanka	20	25	1	2.5	25	63
<b>South Asia</b>	<b>1,466</b>	<b>33</b>	<b>86.2</b>	<b>34.7</b>	<b>41</b>	<b>17</b>

Source: Authors' estimates based on data available from ADB and others.

Note: Poverty information for India and Bangladesh match World Bank information; informed estimates for other countries. Poverty outreach from EDA studies for Bangladesh and India; for other countries, informed estimates based on secondary sources.

a. Population figures from World Bank Web site (updated from 2004 to 2005)

b. poor families = families subsisting on less than government-defined poverty thresholds. Poor families are estimated using family size 5 for Sri Lanka; 5.5 for India, Bangladesh, and Nepal; 6 for Pakistan and Afghanistan..

Table 2.2 illustrates the fact that microfinance outreach is highly variable across the region. The six countries covered by the table can be classified into high- (Bangladesh and Sri Lanka), medium- (Nepal and, perhaps, India), and low-coverage countries (Afghanistan and Pakistan).

MFIs, which are providing better coverage of the financial landscape in that country.

Despite the 700 plus MFIs listed in the statistical bulletin of the national network, Credit & Development Forum (CDF), the bulk of the outreach in Bangladesh is provided by a few large MFIs. At the end of 2004, some 73 percent of the microfinance clients in the country were borrowing from the four largest institutions (Grameen Bank, BRAC, ASA, and Proshika),<sup>28</sup> which count their clients in millions. Only 12 NGO-MFIs had more than 100,000<sup>29</sup> clients.

In **Sri Lanka**, exclusive membership conditions do not necessarily apply, particularly in the case of cooperatives. As a result, the 63 percent coverage of the poor encompasses not only extensive membership overlap but also significant outreach further up the income scale. Thus, substantial numbers of non-poor, otherwise not reached by the banking system, have access to financial services through the

extensive network of CBOs. This results in a broader canvas of coverage of the financial landscape than in any other country of the region.

In **India**, a substantial increase in the outreach of microfinance services in recent years occurred not only because of the phenomenal growth of the bank-SHG link program, but also because of the substantial growth of NGO-MFIs. Within India, there is far greater outreach of microfinance in the south, with an estimated two-thirds of microfinance clients nationally residing in just three southern states (Andhra Pradesh, Tamil Nadu, and Karnataka).<sup>30</sup> Key reasons for higher microfinance penetration in southern India include the following:

- The origination of the bank-SHG link program in Karnataka largely through the initiatives of the MYRADA, an NGO, and the consequent greater participation of Karnataka-based banks such as Syndicate and Canara Banks in the program

<sup>28</sup> Rasmussen, Alamgir, Ahmad, and Ahamed 2005.

<sup>29</sup> CDF 2004.

<sup>30</sup> Author's estimate based on figures available from a large apex organization (SIDBI) and the M-CRIL database.

- Better governance that has enabled the development of a larger number of quality NGOs that in turn have spawned MFIs
- More vibrant local economies in the southern states compared with the less developed states in the north and east
- Higher literacy and participation rates of women in the local economy, making them more suitable clients for MFIs

It seems clear that members of different MFIs and SHGs in India overlap and that all members are not poor. There is substantial competition between MFIs in areas such as the Guntur region of Andhra Pradesh and Thiruchirapalli in Tamil Nadu, also resulting in membership overlap. Furthermore, an extensive impact study undertaken across 20 NGO-MFIs operating in different parts of India has found that, typically, only 35 percent of MFI clients in the country can strictly be classified as poor.<sup>31</sup> This leads to the 9 percent outreach of microfinance services to the poor indicated in table 2.2. Much of this is concentrated in rural areas where MFIs and SHGs tend to operate, although there has been increasing interest in urban areas in recent years. Among the NGO-MFIs, clientele is significantly concentrated—more than 70 percent of approximately 3 million borrowers from MFIs are concentrated in the 10 largest organizations.<sup>32</sup>

The concentration of microfinance in India is matched by that in [Nepal](#). There, the delivery of microfinance services by regional development banks, NGO-MFIs, and cooperatives is concentrated mainly in the terai (southern plain) and, to some extent, the Kathmandu valley. To the extent that microfinance services are available in the hills, it occurs mainly through the diverse Savings and Credit Cooperative Societies (SCCs) that operate largely in the villages of the lower hills of the western, central, and eastern regions. Such institutions are relatively rare in the more remote midwestern and far-western regions of the country. Given open access to cooperative

membership, it is again unlikely that microfinance outreach in Nepal is entirely to the poor. It can safely be assumed that no more than 15 percent of poor families are included.

Given the recent emergence of microfinance activity in [Afghanistan](#), the low coverage of microfinance clients in that country is not surprising. However, one institution, the well-known Bangladeshi NGO, BRAC, which has established microfinance operations in Afghanistan, has so far dominated the coverage of microfinance clients in the country. BRAC Afghanistan accounts for about 80 percent of total outreach by the 14 MFIs operating there. Other MFIs are mainly local operations of international NGOs, many of which had little previous experience of microfinance in similar conditions. These MFIs are adapting their methodologies and systems to suit local conditions. Conversely, BRAC has registered growth rates on the order of 150 percent per year and has already reached more than 100,000 active clients. MFIs were active in 18 of the 34 provinces in the country by the end of 2005 and are expected to provide services in all 34 provinces by 2008.

[Pakistan's](#) 580,000 microfinance clients are expected to grow to between 1.5 and 2 million by 2009, with the total demand variously estimated between 10 and 16 million clients. Some 7 million of these clients would be from families classified as living below the poverty line. The key characteristics of microfinance outreach in Pakistan are as follows:

- Average loan size to gross national income (GNI) per capita ratio is between 11 and 25 percent, which could suggest a high poverty outreach but is partly due to limitations on loan size resulting from caps on loan size imposed by the main apex funding institution (PPAF) and other donor incentives to provide smaller loans.
- 84 percent of clients are concentrated with five MFIs (one registered as a microfinance bank and four NGOs).

<sup>31</sup> EDA 2004.

<sup>32</sup> M-CRIL database.



- More than half the clients are male, unlike other countries of the region where there is a predominance of female clients.
- Historically, microfinance began from rural areas, and coverage in urban areas is still low.
- Most of the outreach is attributed to multidimensional NGOs that focus on rural areas and provide credit as one of many inputs, although much of the recent growth has been from specialized MFIs.

The multidimensional RSPs that are predominant in Pakistan microfinance are relatively slow-growing programs. In percentage terms, the fastest growing NGOs over the past two years have been smaller organizations with more focused microfinance programs, although the bulk of the increase in numbers served by microfinance service

providers is attributable to two large organizations—Khushhali Bank and the NRSP. Again, the extent of poverty outreach in Pakistani microfinance is unlikely to exceed one-third of the total number of microfinance clients.

Overall, the information presented here is roughly compatible with the data from the Microcredit Summit campaign that shows penetration rates (clients as a percent of the population) in a number of South Asian countries (see table 2.3). Looking at cross-country data, the analysis suggests a threshold of 2 percent beyond which countries are able to scale up much more rapidly. In South Asia, only Bangladesh and Sri Lanka meet this criterion, although the recent rapid growth in India might challenge this proposition.

**Table 2.3. MFI Penetration Rates—Top Countries**

Country	Borrowing clients, % of population	Country	Borrowing clients, % of population
Bangladesh	13.1	Cambodia	3.0
Indonesia	6.7	Nepal	1.5
Thailand	6.5	Honduras	1.2
Sri Lanka	4.3	India	1.1
Vietnam	4.3	Bolivia	1.1

Source: Extracted from Honohan 2004.

Note: Using the same approach to calculate microcredit penetration, the Maldives had a penetration rate of 8.7 percent at the end of 2005, giving it one of the top outreach ratios in the world. In a population of 300,000, more than 26,000 active borrowers had microloans valued at less than half of the gross domestic product (GDP) per capita amount. These loans are for a maximum amount of \$1,200 and are provided without any collateral requirement, while GDP per capita is \$2,500, the highest in South Asia. In fact, if the number of microdeposit accounts (accounts with a value of less than \$1,000) is considered, the penetration rate is between 20 and 25 percent. Less than 15 percent of the population is considered to be poor, but it is estimated that the majority of these people are not yet covered by microcredit services.

Thus, even the theoretical coverage of some 35 million families in South Asia by microfinance services is no more than 17 percent of the total number of poor families. Apart from Pakistan, financial services are now largely provided by specialized institutions that focus on providing microfinance services. The overall concentration of microfinance in the region is on women clients based in rural areas, although in Bangladesh, and increasingly in India, the growing focus is on urban clients.

The era of benevolent, statist intervention in support of financially excluded sections of the

population has spurred recognition of the need to create structures that cater to the financial needs of the economically poorer segments of society. Except in Sri Lanka, where the cooperative system is already reasonably well served by the financial system, this process is resulting in the creation of structures—apex institutions and enabling legal frameworks—that eventually could integrate microfinance service providers with other parts of the broader financial system. Given the still relatively low overall coverage of poor clients, in particular, there is still a long way to go.

# Institutional Structures and Delivery Systems:

## A diverse collage

Given the early establishment and deep roots of the cooperative movement in South Asia, it is perhaps not surprising that CBOs—including cooperatives—are an important pillar of microfinance in the region. Together with the ubiquitous NGO-MFI, such organizations form the delivery interface for virtually all the recorded outreach of financial services available to low-income clients in the region. Only a small amount of additional microfinance outreach is provided by the retail

operations of development and commercial banks, the activities of post office banks, and, to an even lesser (but growing) extent, by insurance companies. Despite the importance of CBOs as a delivery mechanism in the microfinance landscape, diverse institutional links channel microfinance services from funders to clients and delivery systems vary, meaning that South Asia has almost every conceivable type of microfinance activity. A description of the diversity in the region follows.

### Institutional Structures

Annex 3.1 shows the main institutional links in South Asian microfinance. The major institutional types, the link of each type, and

the importance of each type to the microfinance delivery chain are identified in table 3.1.

**Table 3.1. Institutional Types and Links in the Microfinance Delivery Chain**

Type of Institution	Link as Lenders to...	Extent of Outreach Relative to Retail Market
Commercial banks	Microfinance clients (direct)	Insignificant
	SHGs and MFIs	Substantial: India
	Retail development banks/NBFCs	Significant: Nepal, India
Wholesale development banks/funds; apex organizations funded by multilateral or bilateral donors and/or governments	MFIs	Predominant: Afghanistan, Bangladesh Substantial: India, Nepal, Pakistan
	Retail development banks/companies	Significant: Nepal
	Cooperatives	Significant: Nepal, Sri Lanka
Retail development banks/companies	Microfinance clients (direct)	Substantial: Bangladesh Significant: India, Nepal, Sri Lanka Growing: Pakistan
	Lenders to cooperatives, SHGs	Significant: India, Nepal, Sri Lanka
MFIs; not-for-profit NGOs	Microfinance clients (direct)	Predominant: Afghanistan, Bangladesh Significant: India, Nepal, Pakistan
	SHGs	Significant: India
Cooperatives	Microfinance clients (direct)	Substantial: Sri Lanka Significant: India, Nepal
Community-based organizations	Microfinance clients	Substantial: SHGs India, SBS Sri Lanka

Source: Authors' compilation.

Note: MFI = microfinance institution; NBFC = non-bank finance company; NGO = nongovernmental organization; SBS = Samurdhi Banking Society; SHG = self-help group.

Microfinance outreach in each country of the region, the approximate number of each type of institution, and an indication of each institution's role are provided in table 3.2. The key institutional links in the delivery of microcredit in each country are illustrated in figure 3.1.

### NGO-MFIs

NGO-MFIs are dominant in Bangladesh, Pakistan, and Afghanistan and have a substantial market in India where the bank-SHG link is the dominant model (see table 3.2). In each country, NGO-MFIs deliver microcredit services but suffer limitations in their attempts to offer deposit services because of the lack of a regulatory framework for these services, which makes the legitimacy of their activities doubtful in the eyes of governments and clients (or potential depositors). In Afghanistan (BRAC) and in Bangladesh and India, most MFIs have overcome this problem by packaging compulsory deposits with their credit delivery mechanisms. In India, many NGO-MFIs have gone even further and become agents to large companies in the delivery of microinsurance services. There is even the notable case of an NGO-MFI, Adhikar in Orissa, providing money transfer services to its clients who migrate to Gujarat to work in the salt mines. In Nepal, even NGOs that are licensed to raise deposits are not particularly successful because of client concerns about their governance and financial stability. Savings are encouraged under the RSP model in Pakistan, but in this case savings are held and invested by community organizations that deposit the money in banks, not with the NGO, so no intermediation is possible. The few Sri Lankan NGOs are similar in characteristics to those in other South Asian countries, offering microfinance services through the medium of village-based community organizations.

### CBOs

Because Sri Lankan microfinance is dominated by CBO activities—TCCSs, CRBs, and other CBOs, such as Samurdhi Banking Societies—it is deposit rather than credit services that form the core of their activities.<sup>33</sup> Similarly, in Nepal, cooperatives not only form a significant part of the microfinance landscape, but also they are able to raise substantial deposits in relation to their overall funds. Community ownership and governance form the key to generating sufficient confidence to mobilize significant amounts in deposits. As part of their activities, some of the larger cooperative institutions also offer credit guarantee-type insurance products to their members. For the same reasons, India's new MACS system, based on similar principles, has grown strongly in recent years, but it is geographically concentrated in the state of Andhra Pradesh. It is now spreading slowly to the few other states—Bihar, Jharkhand, Madhya Pradesh, and Orissa—that have enacted similar laws.

India's SHG link program enables commercial banks to engage with microclients without having directly to undertake retail microlending. Under this program, SHGs of low-income families are formed by NGOs acting as self-help promotion institutions (SHPIs), government development agencies, or even bank branch staff. The SHGs are linked to the local branch of any bank (commercial bank, regional rural bank, or cooperative bank) operating in the area through a savings account opened for the purpose of managing the member deposits accumulated with the group. When ready, as assessed on the basis of a simple grading system, the SHPI assists the group in obtaining a loan from the linked bank. NABARD—India's apex bank for rural development activities—provides refinancing under this program to those retail banks that apply for it and sponsors training and exposure visits for bank, government, and NGO staff to enhance their ability to promote the program.

<sup>33</sup> See, in particular, CGAP 2006

The SHG-bank link program has grown strongly in recent years and all government-owned or -supported banks now participate in it. However, the program is substantially concentrated (54 percent) in the southern states of Karnataka (where it originated), Andhra Pradesh (where the SHG movement is particularly strong), and Tamil Nadu (where, along with Andhra Pradesh, the government has played an especially active part in its promotion). Because of the lack of appropriately disaggregated information, it is quite difficult to estimate the outreach of the program. In cumulative terms, NABARD reports that some 1.8 million SHGs had been assisted under the program by December 2005. In theory, with an average of 15 clients per SHG, this would amount to 27 million families assisted. In practice, the cumulative figure entails substantial double counting and discounting of disbanded SHGs. An estimate of 11 million clients (see figure 3.1) is reasonable based on the authors' understanding of the findings of various studies of SHG operations.<sup>34</sup>

### Development banks and NBFCs

Nepal has an eclectic mix of institutional links with the nine microfinance/regional development banks. These banks are emerging as the key institutional types in terms of outreach numbers. Although such banks can legitimately offer deposit services, client concerns about their institutional stability and sustainability still limit the relative use of such services. The six new licensed microfinance banks in Pakistan are struggling with their business models and have not yet been able to provide delivery channels that are easily accessible to clients. Khushhali Bank is the only one operating on a truly national level so far. In India, the six NBFCs engaged in microfinance are legally restricted from offering deposit services to their clients until they are able to obtain an investment grade rating from a commercial rating company. One of these, Bhartiya Samruddhi Investments and

Consulting Services Ltd. (BASIX), also has a local area bank that is specifically licensed to provide a range of banking services in the three districts in which it is permitted to operate.

India's 196 RRBs—each operating in two to three districts—were specifically constituted to provide financial services to the types of clients served by MFIs. In practice, they became a key instrument of the government's *garibi hatao* (poverty removal) program and fell victim to the largesse of subsidy and directed credit that this entailed. The consequential rationing of credit, accumulation of bad debt, and loss of bankers' faith in the creditworthiness of low-income clients is a classic case study in poor governance. The ensuing collapse of the fortunes of such banks meant that the revival efforts of most RRBs have resulted in a turning away from microlending and, indeed, the substantial negation of even rural lending for many.<sup>35</sup> Microcredit services continue to be offered by RRBs under directed lending programs, but the retail numbers are now small. Significant engagement of RRBs with low-income clients now takes place mainly through the SHG-bank link program.

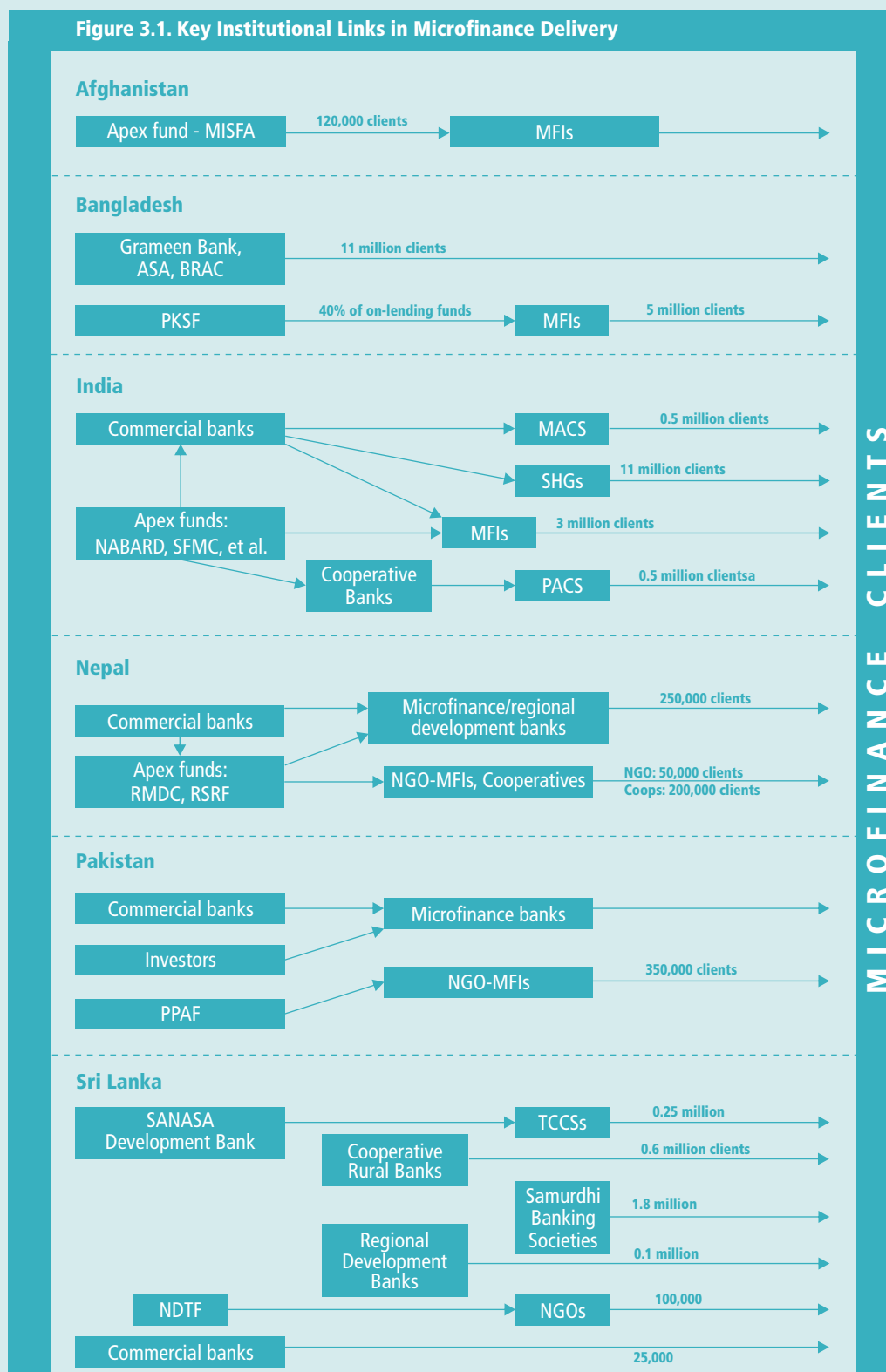
Another exciting innovation in the field of microfinance is the advent of microleasing. Bangladesh has seen some of its leading institutions (BRAC and Grameen) experiment with microleasing products, a leasing company with a micro- and small enterprise focus has recently been established in Afghanistan, and Pakistan has as many as four leasing companies with microproducts (Orix Leasing and Network Leasing are engaged significantly with the activity and have around 5,000 clients each).

Conventional banking products—of all sizes—are, of course, offered throughout South Asia through the branch networks of traditional agricultural or rural development banks. Thus, there are two agricultural banks in Bangladesh,

<sup>34</sup> Forthcoming paper by APMAS.

<sup>35</sup> For a more detailed discussion, see Sinha, Chetan, Ruthven, and Pathak 2003.

**Figure 3.1. Key Institutional Links in Microfinance Delivery**



Source: Authors' creation.

Note: ASA = Association for Social Advancement; MACS = Mutually Aided Cooperative Society; MFI = microfinance institution; MISFA = Microfinance Investment and Support Facility for Afghanistan; NABARD = National Bank for Agriculture and Rural Development; NDTF = National Development Trust Fund; NGO = non-governmental organization; PACS = Primary Agricultural Cooperative Society; PKSF = Palli Karma Sahayak Foundation; PPAF = Pakistan Poverty Alleviation Fund; RMDC = Rural Microfinance Development Centre; RSRF = Rural Self-Reliance Fund; SFMC = SIDBI Foundation for Micro Credit; SHG = self-help group; TCCS = Thrift and Credit Cooperative Society. a. Refers only to PACS microfinance clients, mainly to members of the 30,000 SHGs supported by Cooperative Banks.

a network of hundreds of cooperative banks and RRBs (the latter with over 14,000 branches) in India, one agricultural development bank in Nepal and one in Pakistan, and a series of regional development banks in Sri Lanka. All of these have some outreach to microfinance clients, but their traditional mold of branch-based operations, bureaucratic functioning, and ill-motivated staff, in practice, restricts access to a select few clients who typically would be found at MFIs.

Finally, the fact that Grameen Bank—the mother of Asian MFIs—is a specially constituted development bank is little known outside the region. Until recently, Grameen had begun to acquire some of the characteristics of a typical complacent and bureaucratic government bank, but in 2002 it completely rethought its products and operations. The launch of Grameen II appears to have revitalized this institution's leading to achieve phenomenal growth that has moved it past its main local NGO competitors (BRAC and ASA) to now reach some 5 million clients.

### Commercial banks

Figure 3.1 illustrates some retail engagement of commercial banks in Sri Lanka with microclients. The numbers, however, are barely large enough (just over 1 percent of the total estimated number of microclients in Sri Lanka) to be noticeable. Despite India's long history of directed credit to poor people, as discussed above in the context of RRBs, the actual voluntary engagement of commercial banks—outside the purview of government development programs—would be minuscule in terms of clients served and negligible relative to the size of the overall market. A far more interesting engagement of commercial banks in Indian microfinance is the explosion of the past two to three years of lending to (and through) MFIs for on-lending to low-income clients. ICICI Bank, the largest private and the second

largest commercial bank in the country, has been in the forefront of this activity. A plethora of innovative products, including securitization and partnership arrangements, has emerged from ICICI Bank for this purpose. Not to be left behind, a number of other banks (private and government owned, Indian and foreign) are now engaging in this activity. With lending volumes in these programs now on the order of Rs 3 billion (\$67 million) and outreach exceeding 1 million clients, these initiatives now have a significant impact on the practice of microfinance in India. The emerging issues in this program and the design of products are discussed in chapters 4 and 5.

Elsewhere, Bangladesh has seen similar action with one government-owned bank (Sonali, the largest in the country) and one private bank (Pubali) taking an interest in wholesale lending to MFIs through simple, relatively short-term lending products. In both cases, this interest was stimulated and catalyzed by the efforts of a foreign donor organization (the Swiss Agency for Development and Cooperation) through a low-interest loan (3 percent) up to the extent of one-third of their total lending to MFIs and by commissioning credit ratings of MFIs identified by the banks as potential borrowers.

A certain amount of similar lending activity has also taken place in Nepal and Pakistan where there is some (but very small amounts of) retail lending by commercial banks to microclients. The wholesale lending volumes in both countries are very low, although the banks have invested in the equity of microfinance development banks. Such investment is basically seen as social responsibility—if not (as in Nepal) a response to outright central bank coercion—and is not significant or remarkable as engagement with microfinance.

For a region that accounts for 40 percent of the world's poor,<sup>36</sup> it is remarkable that no commercial bank can be classified as having taken a major initiative to retail microfinance services in the manner of Bank Rakyat

<sup>36</sup> Living on less than \$1 a day. See the Millennium Development Goals Web site of the World Bank Group, available at <http://ddp-ext.worldbank.org>.



Indonesia or Khan Bank of Mongolia. Nor, indeed, is there an example of scaling up an MFI into commercial banking à la ACLEDA Bank of Cambodia. This situation could be attributed to conservatism in formal banking in the region: the former to residual socialist notions of what interest rates are appropriate to charge the poor—making it impossible for banks to provide microfinance services viably—and the latter to regulatory conservatism on minimum capital requirements and branch/area expansion norms that create huge obstacles to the transformation of MFIs into banks and their subsequent expansion to serve large numbers

## Post offices

Despite their image as plodding government-owned bureaucracies, the regional post offices are purveyors of financial products to many of those who traditionally had no access to any other financial institution. Not a lot of information on post offices is available, but their networks of branches far exceed the numbers for banks. For instance, Bangladesh had some 9,400 post offices in 1999 (more than 8,700 of these in rural areas);<sup>37</sup> the Pakistan Post Office has 12,000 branches, many more than the 6,000 to 8,000 bank branches; and India had more than 155,000 post offices in 2001 (with 89 percent in rural areas), more than twice as many as the 70,000 commercial and rural bank branches in the country. The Pakistan Post Office offers a wide range of remittance, insurance, and savings services; had more than 3.5 million financial service clients in 2004; and now earns more revenue from its financial services than from postal services. The Indian Postal Savings Bank is the largest bank in the country in terms of the frequency of deposits and the numbers of accounts (124 million) with small balances.<sup>38</sup> The Indian Postal Life Insurance

Program had as many as 2.5 million policies in 2001 with an average sum of just Rs 42,000 (about \$900).<sup>39</sup>

Because of the lack of detailed information, it is impossible to assess the microfinance component of post office operations; however, access to post offices is far easier than to banks in terms of physical distance and because of psychological factors such as the relationship between clients and staff. In this situation, the small post office savings account is common among those who live in villages in the region, and the use of post office money orders for remittances to relatives who migrated to other parts of the country or region has been a tradition for more than half a century.

While the continued importance of post offices for the average low-income client in South Asia should not be discounted, recent institutional reforms have resulted in reducing the number of branches, particularly in more remote locations. In India, at the least, the net effect has resulted in some post offices closing and others consequently reducing services. The situation is such that a localized study of rural financial services in northern India in 2002 concluded the following:

*Other than money orders...the physical outreach of the post office is very limited. Besides the fact that the number of clients using the savings schemes of the (local) post office is very small and few of those would count amongst the poor, almost all of its current clients are from the village where the office is based.*<sup>40</sup>

Unfortunately, many of the post office accounts reported in the Consultative Group to Assist the Poor (CGAP) paper probably are already defunct. Nonetheless, there are efforts under way in India and being contemplated in Pakistan to restructure post offices and use their significant network to provide more

<sup>37</sup> Bangladesh Post Office 1999. This is the latest information in the public domain at the time of writing.

<sup>38</sup> CGAP 2004. More recent information suggests that there are 160 million accounts with deposit balances of Rs 2.6 trillion. However, this information is from a conference presentation with no indication of the date or primary source of the information (Department of Post, Government of India 2005).

<sup>39</sup> Indian Postal Services 2006.

<sup>40</sup> Sinha and Patole 2002.

financial services more profitably. Efforts in India include pilot projects to establish finance marts (shops and retail outlets) and provide

financial services to SHGs, the consideration of partnerships with banks and insurance companies, and the creation of a postal bank.<sup>41</sup>

## Delivery Systems

Diverse delivery systems are used by different types of institutions to deliver financial services to low-income families in the region. The main methodologies employed can be classified into the following five types:

- **Grameen Model**—a delivery methodology pioneered by Grameen Bank of Bangladesh. These models undertake individual lending, but all borrowers are members of five-member groups that, in turn, get together with 7 to 10 other such groups from the same village or neighborhood to form a center. Within each center, joint liability is, in theory, the key factor in ensuring repayment, although there is no formal documentation and accounts are maintained in the individual names of clients. Savings are a compulsory component of the loan repayment schedule, but they do not determine the magnitude or timing of the loan. In a sense, this is a credit delivery rather than an empowerment model because the development implications arise from meeting the credit needs of clients rather than from enabling them to develop group interaction, leadership, or financial management experience and skills.

This is the dominant methodology in Bangladesh where nearly all the NGOs use delivery systems similar to the Grameen Bank model. There are notable cases of the successful deployment of versions of this model in other countries of the region for example—20 of the leading MFIs in India, all of the retail development banks in Nepal, and major MFIs like the Kashf Foundation in Pakistan and BRAC in Afghanistan.

In the meantime, as discussed in chapter 2, Grameen Bank itself has changed and many others in the mammoth NGO-MFI movement of Bangladesh have changed along with it. The rapid growth of the major and mid-size NGO-MFIs has increased competition and noticeably changed the way in which these organizations relate to their members: again this is a long-term trend that has accelerated particularly in the last year or two. Most organizations now allow new members to join and to borrow much more quickly than before (one week is now the standard waiting time between joining and getting a loan) and the initial loan size has risen (in rural areas, the standard opening loan is now about \$100).

Organizations allow groups to vary in size, so that staff do not have to turn away a prospective member because no place is open in the group (there are even Grameen groups with more than 100 members). As a result, the old brand loyalty that helped organizations retain their members is slipping away fast. Many rural people now regard NGO membership as a temporary rather than a long-run matter: they are prepared to join whatever NGO happens to be available whenever they need a loan, and then leave again when the tedium of the weekly meeting becomes a nuisance. At any point, they may be members of between one and four NGOs, or of none at all. There is a noticeable change in the composition of the membership. This change is driven by the larger loans offered, which attract much better-off people than was traditionally the case in Bangladesh. This point is particularly noticeable in the case of Grameen II, where it is not just the bigger loans, but also the attractively priced Grameen Pension Savings (GPS), a

<sup>41</sup> Department of Posts, Government of India 2005.



commitment savings product, and the higher education and mobile phone loans that are attracting the middle classes. It is now common to find the professional classes and wealthier farmers or traders placing their wives in Grameen to access these products: very often the wives do not attend the meetings but send the money along through a poorer relative. Because product conditions have become friendlier, it is now more possible for very poor people to join and remain in NGOs than before. In this, the change to open-access passbook savings and the facility to “top-up” loans part way through the term have been especially helpful in making loans easier to manage for those with fragile, seasonal, or unreliable incomes.

- **Self-Help Group**—the dominant microfinance methodology in India. The operations of 15- to 25-member SHGs are based on the principle of revolving the members' own savings. External financial assistance (by MFIs or banks) augments the resources available to the group-operated revolving fund. Savings thus precede borrowing by the members. In many SHG programs, the volume of individual borrowing is determined by the volume of member savings or the savings of the group as a whole. Some NGOs operate microfinance programs by organizing federations of SHGs that act as the intermediary to obtain external loan funds in bulk, which are channeled to the members via the SHGs. SHGs aim to be an empowerment model that enables members to develop group interaction and financial management skills. At the same time, it is a far more time-consuming and expensive system to establish in a new area because fostering group cohesiveness takes substantial effort.

In India, NABARD has facilitated and extensively supported a program that entails commercial bank lending directly to SHGs rather than via bulk loans to MFIs. NABARD provides some support to SHPIs to establish the SHGs and largely refinances the loans of the commercial banks to SHGs. The vast majority of MFIs in India have SHG-based programs.<sup>42</sup> Some of these include MYRADA, SPMS of Tirupati, and groups organized by the DHAN Foundation, Madurai, and Chaitanya of Maharashtra. An important MFI in Bangladesh (Ashrai) is also well known for having followed this methodology and others like Afghanistan's CARE program and the Aga Khan Foundation, Afghanistan are experimenting with it.

- **Cooperative Programs**—entail the provision by MFIs of financial services to individual clients organized into credit and savings cooperatives. In cooperatives, all borrowers are members of the organization either directly or indirectly by being members of primary cooperatives or associations in which they hold shares and which are, in turn, member/shareholders of the apex society. Creditworthiness and loan security are a function of cooperative membership within which member savings and peer pressure are assumed to be a key factor. Although the magnitude and timing of savings and loans are largely unrelated, a special effort is made to mobilize savings from members.

As the above country illustration (figure 3.1) of links shows, cooperatives are the dominant methodology in Sri Lanka with large numbers of CRBs, TCCSs, and SBSs accounting for more than 95 percent of the microfinance service delivery in the country.

As discussed, a large number of “new generation” cooperative credit societies in India are devoted specifically to providing financial services. Most of these are located in the southern state of Andhra Pradesh, which was the first state to enact a law permitting mutually aided (as opposed to traditional government-assisted) cooperative societies. Elsewhere, a number of well-known programs such as the SEWA Bank in Ahmedabad, the Indian Cooperative Network for

<sup>42</sup> 50 of the 76 recently rated MFIs in M-CRIL's database.

Women in Tamil Nadu, and the Annapurna Mahila Cooperative Credit Society in Mumbai have survived under the traditional cooperative laws. However, the more than 90,000 Primary Agricultural Credit Societies (PACS) in India are not usually mentioned in the context of microfinance, because generally they are regarded as not being particularly geared toward working with typical microfinance clients—that is, low-income families in their operational area.

Nepal, too, has a large number (more than 2,300) of Savings and Credit Cooperative Societies (SCCS) with outreach to more than 100,000 members, but these societies are regarded largely in the manner of the Indian cooperatives and are not taken particularly seriously as channels of microfinance. Only 25 societies presently are or previously were licensed by the central bank to provide limited banking services in this context, but even these largely lend to borderline or non-poor farmers rather than to typical microfinance clients.

- **Mixed Model**—some MFIs started with the Grameen model but converted to the SHG model at a later stage. However, they did not completely do away with Grameen-type lending and smaller groups, but rather are an equal mix of the SHG and Grameen model. Others have chosen to adapt either the Grameen or the SHG model to cater to their markets, while some organizations like BASIX in India use a number of delivery channels and methodologies (including joint liability groups of individual borrowers and lending through SHGs) to provide financial services. Such organizations can not be classified as SHG or Grameen model MFIs. Such MFIs are still relatively small in number; however, with increasing innovation becoming the norm in microfinance, their numbers are growing.
- **Rural Support Programs**—Pakistan makes a unique contribution to this discussion in that a number of the NGO-MFIs (and, indeed, one of the microfinance development banks) have evolved out of multidimensional programs based on establishing and strengthening village organizations to manage their own development. RSPs are not microfinance specific and tend to maintain close relations with government because they are closely linked with government development programs. Their microfinance approach focuses on the provision of credit, although they also encourage voluntary savings that community organizations invest in banks. This program has evolved over time to a point at which it currently establishes groups of 15 to 20 people (all of whom take credit). Like the SHG system, this is a potentially empowering model, but the process of establishing it is equally resource intensive.

Financing microfinance activity in the region and the diversity of products and services available to microfinance clients are discussed in chapters 4 and 5.

Table 3.2. Institutional Structures for Microfinance in South Asia

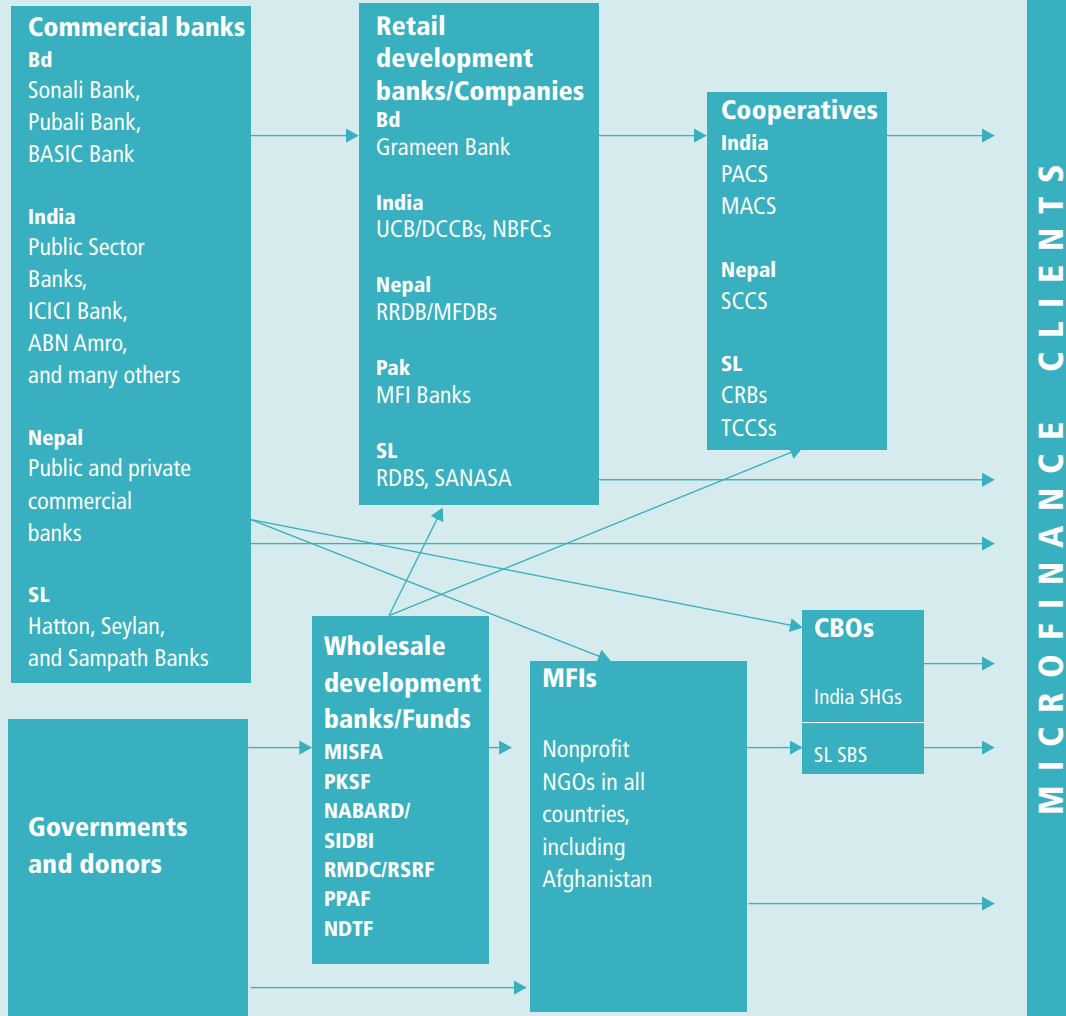
Indicators	Afghanistan	Bangladesh	India	Nepal	Pakistan	Sri Lanka
Outreach: active borrowers	~120,000	~16 million <sup>a</sup>	~15-16 million <sup>a</sup>	~500,000	~580,000	2-3 million
% of total number of families in population	3.0%	62%	8%	11%	3%	63%
Cooperatives		Some cooperatives, mostly defunct	100,000 primaries plus 600 MACS	2,300 SCCS plus 19 licensed	Some cooperatives, mostly defunct	1,539 CRBs 7,400 TCCSs
Other community-based organizations			700,000 SHGs			1,036 SBSs
Nongovernmental organizations	14 engaged in microfinance	721 listed in CDF statistics	~400	Unknown, 49 licensed	29 funded by PPAF	~200 NGOs
Non-bank finance companies		Delta Life Insurance Co.	5 engaged specifically in microfinance		4 leasing companies, especially Orix Leasing Network Leasing	
Retail development banks; retail delivery programs		Grameen Bank, BRDB plus 2 agricultural development banks	196 RRBs 400 DCCBs	5 RRDBs 4 MCDBs	Microfinance banks, 6 licensed	SANASA, 6 RRDBs
Wholesale development banks/funds	MISFA	PKSF	NABARD, SIDBI, RMK, FWWB women's and minorities development corporations	RMDC, RSRF, Small Farmers Development Bank	PPAF	NDTF, Susahana facility, Isuru Fund
Commercial banks	Retailer: First MicroFinance Bank	Wholesalers to NGOs: Sonali Bank, Pubali Bank, BASIC Bank	Wholesalers: ICICI Bank plus other private commercial banks, plus some government banks  Lenders to SHGs: All public sector banks plus RRBs and DCCBs	Wholesalers to and investors in development banks  Retailers (insignificant): four government banks  Investors in Khushhali Bank: All significant commercial banks	Wholesalers: Several commercial banks  Retailers (insignificant): four government banks  Investors in Khushhali Bank: All significant commercial banks	Some direct lending from 3 private and 2 government banks

Source: Authors' compilation.

Note: BASIX = Bhariya Samruddhi Investments and Consulting Services Ltd.; BRDB = Bangladesh Rural Development Board; CDF = Credit & Development Forum; CRB = Cooperative Rural Bank; DCCB = District Central Cooperative Bank; FWWB = Friends of Women's World Banking; MACS = Mutually Aided Cooperative Society; MCDB = microcredit development bank; MISFA = Microfinance Investment and Support Facility for Afghanistan; NABARD = National Bank for Agriculture and Rural Development; NDTF = National Development Trust Fund; NGO = nongovernmental organization; PKSF = Pali Karma Sahayak Foundation; PPAF = Pakistan Poverty Alleviation Fund; RMDC = Rural Microfinance Development Centre; RMK = Rastriya Mahila Kosh; RRB = Regional Rural Bank; RRDB = Regional Rural Development Bank; RSRF = Rural Self-Reliance Fund; SCCS = Savings and Credit Cooperative Society; SHG = self-help group; SIDBI = Small Industries Development Bank of India; TCCS = Thrift and Credit Cooperative Society.

a. Excludes primary cooperative societies.

### Annex 3.1. Institutional Links in South Asian Microfinance



Source: Authors' compilation.

Note: ABN = ABN Amro Bank; Bd = Bangladesh; CBO = community-based organization; CRB = Cooperative Rural Bank; DCCB = District Central Cooperative Bank; MACS = Mutually Aided Cooperative Society; MFDB = microfinance development bank; MFI = microfinance institution; MISFA = Microfinance Investment and Support Facility for Afghanistan; NABARD = National Bank for Agriculture and Rural Development; NBFC = Non-bank Finance Company; NDTF = National Development Trust Fund; NGO = nongovernmental organization; PACS = Primary Agricultural Cooperative Society; PKSF = Palli Karma Sahayak Foundation; PPAF = Pakistan Poverty Alleviation Fund; RDB = rural development bank; RMDC = Rural Microfinance Development Centre; RRDB = Regional Rural Development Bank; RSRF = Rural Self-Reliance Fund; SCCS = Savings and Credit Cooperative Society; SHG = self-help group; SIDBI = Small Industries Development Bank of India; SL = Sri Lanka; TCCS = Thrift and Credit Cooperative Society; UCB = Urban Cooperative Bank.

# Financing Structures:

## From subsidy to overenthusiastic commercialism

*M*FI essentially perform the role of intermediating financial resources and services between (1) investors, banks, donors, and depositors, and (2) the poor. This section looks at the financing structures of MFIs in South Asia and discusses the issues and challenges with regard to financing that arise in each country in the region. The underlying premise of this discussion is that improving the quality and quantity of financial services to the poor is the goal of microfinance and, for this goal to be attained, MFIs need to be financially sustainable institutions.

Like any other financial intermediary, MFIs need risk capital that can be leveraged to add to the fund base (either through debt finance or by raising additional deposits) for operations and on-lending to low-income clients. However, unlike commercial financial institutions, MFIs (except cooperatives) in South Asia have emerged from nonprofit entities. Additionally, the transaction costs of microfinance delivery are high and account sizes are small, typically resulting in MFIs taking three to seven years to become financially strong enough to attract commercial risk capital. As a result, it is mainly donor funding that has played the key role of “venture capital” in stimulating microfinance investment and promoting microfinance markets. Over the past couple of years, as social entrepreneurship (through the Bellwether Fund and others) has provided venture capital for the establishment of a few new, professionally managed MFIs, such funding has acquired some of the characteristics of commercial capital.

To the extent that MFIs address market failure and help to develop the financial sector in

terms of providing new avenues for access to financial services for low-income clients, this role is justified and has a clear “public good” element associated with it. Conversely, in for-profit companies, it is shares that constitute the risk capital that forms the backbone of commercial investments in financial institutions. To the extent that microfinance has evolved beyond the stage of proving itself to be a beneficial and viable activity to improving its performance in terms of efficiency, however, the era of soft financing may be coming to an end. The growing recent activity of social investors in microfinance is a highly positive trend that has already started to move the sector toward the market discipline of commercial finance. Some large MFIs in India—including BASIX, SKS, and others—as well as the start-ups mentioned earlier have already benefited greatly from this trend.

In terms of debt from lenders, MFIs in South Asia generally have relied on borrowing from specialized development financial institutions as opposed to mainstream financial institutions and banks, although the extent of dependence and nature of financing from such institutions varies across countries in the region. Commercial financing from banks is gaining importance, however, and has reached quite significant levels in India. Elsewhere, debt financing by banks is in its early stages but starting to acquire some momentum in Bangladesh; BRAC has completed one large securitization deal as well. Regarding deposits from clients, MFIs' dependence on this source of financing is clouded by its ambiguous legality in most countries; as a result, a significant proportion of this financing has

been in the form of “compulsory collections,” which are closer in concept to cash collateral.

A worldwide consideration of the financing

structures of MFIs from a sustainability perspective suggests the four country-level classifications noted in table 4.1.

Table 4.1. Country-Level Classifications						
Sustainability Level	Donor Capital	Compulsory Deposits	Subsidized Debt	Directed Debt	Social Equity	Voluntary Deposits
Early period	Very high	Low/moderate	Nil	Nil	Nil	Nil
Weaning	High	Moderate/high	High	Low	Nil	Low
Maturing	Moderate	Moderate	Moderate	Moderate	Low	Low/moderate
Commercial	Low	Low	Low	High	Moderate	Moderate/high

Source: Authors' compilation.

Systematic data on the pattern of financing of MFIs in the region are of reasonable quality for all countries except Sri Lanka. Table 4.2 and figure 4.1 present a summary view of MFI financing structures in the other five countries. These summaries show the high extent of current donor financing in the fledgling microfinance sector in Afghanistan and the substantial levels of current donor financing in Pakistan. Bangladesh still has significant donor financing, but this is mainly historical. In recent years, the emphasis has been largely on

subsidized debt financing by the apex institution (PKSF) and on the accumulated compulsory deposits built up by the leading MFIs that have been in business for a decade and more. Some recent shift to voluntary deposits by Grameen Bank is also notable, while the efforts of other leading MFIs (such as ASA, BRAC, and BURO Tangail) to collect voluntary deposits reportedly have been stymied by the efforts of the central bank to rein in this perceived flaunting of authority.

Table 4.2. Financing Structure of MFIs in South Asia (percent of funds available)							
Country	Sample Size	MFIs with Accumulated Profits	Accumulated Profits and Losses	Paid-in Equity %	Donated Equity %	Deposits %	Debt %
Afghanistan	11	None	-31.4	19.9	42.9	6.2	62.4 <sup>a</sup>
Bangladesh	14	8	-9.8	0	36.2	36.7	36.9
India	110	23	-4.3	8	12.8	22.5	61
Nepal	60	37	0.7	8.1	0.4	37.4	53.4
Pakistan	14	5	0.7	13.1	37.6	9.5	39.1

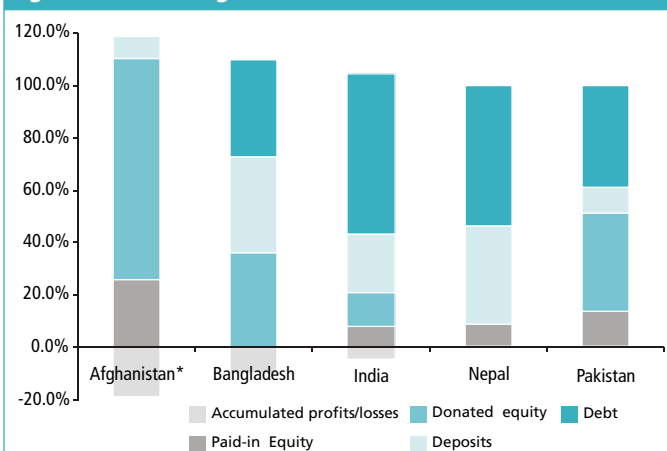
Sources: Data from M-CRIL, PMN, and NRB.

Note: a. Subordinated debt; MISFA support classified as long-term liabilities.

In India compulsory deposits are important, but, increasingly, it is loans from the wholesale development finance facility (SIDBI) that has driven the MFI financing activity. Riding on the back of SIDBI's success in financing MFIs, ICICI Bank and other commercial banks have joined the effort to increase their exposure to microfinance and simultaneously to fulfill the central bank's directed “priority sector”

lending norm. Such debt has become the dominant source of funding for Indian MFIs, while social investors have become active in contributing equity and supporting the transformation of NGO-MFIs into NBFCs. Once such NBFCs become established, and their operations are able to obtain an acceptable rating, they will be able to intermediate voluntary deposits.

**Figure 4.1. Financing Structure of MFIs in South Asia**



Source: Data from M-CRIL, PMN, MISFA, and NRB records.

The development banking system in Nepal, coupled with the licensing of financial intermediary NGOs and of savings and credit cooperatives by the central bank, has created a framework enabling a relatively greater flow of deposits to MFIs as well as substantial debt funds from the near-commercial apex institution (RMDC) and commercial banks keen to fulfill their directed credit requirements. Paid-in equity makes a contribution here as in India.

Although detailed financial information is not available for Sri Lanka, it is apparent from the discussion in the previous section that the two major channels of microfinance (the TCCS and the SBSs) have a substantial quantum of voluntary deposits and share capital contributed by their client members. The deposits with the TCCSs are intermediated by the SANASA Development Bank.

On this basis, the six South Asian countries with significant microfinance operations can be classified as follows.

**Table 4.3. Significant Microfinance Operations**

Sustainability level	Country
Early period	Afghanistan
Weaning	Pakistan
	Bangladesh
Maturing	Nepal
	India
	Sri Lanka

Source: Author's compilation

The following sections provide a more detailed picture of the financing structures of MFIs in each country discussed in this report.

## Afghanistan

Microfinance was initiated in Afghanistan through a World Bank-CGAP led multidonor-financed project only as recently as 2003–04. This project is being implemented through MISFA, which is the main financier of MFIs. Some 15 MFIs are now operational in the country, with 2 or 3 that are much larger than the rest showing considerable potential to scale up.<sup>43</sup>

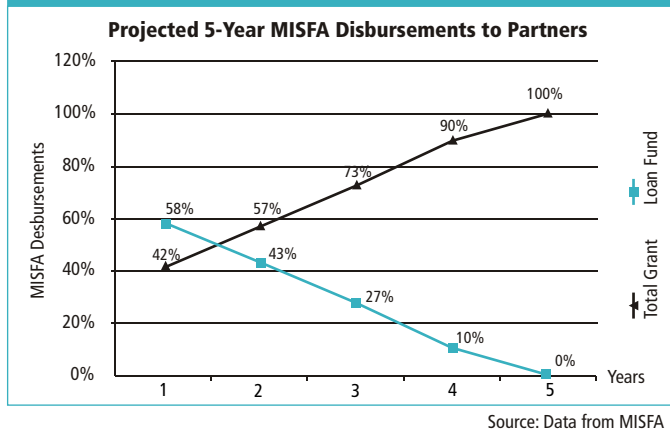
The most significant funder of microfinance in Afghanistan, thus far, has been MISFA, although a few MFIs have raised donor funds directly or have invested some of their own funds. MISFA has financed MFIs by providing grant funding as well as debt on soft terms, both of which contribute to building the equity and fund base of MFIs. And despite the short

history of the microfinance sector, MISFA's strategy from the start has been to significantly reduce the proportion of grant funds by the fourth or fifth year after the MFI becomes operational and to substitute this with debt funding. Compared with other countries in the region, this transition to debt financing for MFIs is on a much faster trajectory (see Figure 4.2) and, if successful, could become a broad blueprint for MFI financing in countries that are new to microfinance or have not transitioned adequately away from donor funds. By early 2006, \$46 million had been provided in soft loans and \$27 million in grants. Over time, the ratio of grant funds to total funds is expected to decline steadily as MFIs stabilize the financial positions and can raise commercial funds from other sources.

<sup>43</sup> Within this group, too, BRAC Afghanistan leads the way by a distance.



**Figure 4.2. MISFA Strategy**



With the intention of “seeding” the microfinance sector in Afghanistan, MISFA has been financing operating expenses and fixed asset purchases through grants and funds for on-lending through loans, although over time even the former category is funded increasingly by long-term debt. What helps MFIs manage their balance sheets is that the debt MFIs obtain from MISFA is really in the nature of quasi-soft equity, low-interest rates, and effectively long tenors, because the loans are rolled over if performance targets are met.

While the emphasis on sustainability has been built into the financing strategy by MISFA, the main challenge confronting the microfinance sector in Afghanistan relates to MFIs achieving the requisite improvement in their own financial performance. The challenge is that MFIs need to be able to build on the grant equity and soft debt financing to build their own equity capital after the first few years of operations and subsequently rely largely on debt financing. Without this happening, MFIs will not be able to transition as quickly to a debt-based strategy as may be necessary to avoid donor fatigue. It is encouraging, however, that initial trends in improvements in financial performance for the larger MFIs has been quite good with Afghanistan Rural Microfinance Programme (ARMP) recording an operational self-sufficiency (OSS) in excess of 100 percent for the first quarter of 2006 and BRAC making steady progress toward sustainability.

A related critical transition that the microfinance sector will need to ensure over the next three to five years is a movement toward obtaining commercial debt finance from the banking sector in Afghanistan. Crowding in such commercial funding is likely to occur if the performance of the MFIs stays on the broad path that has been envisaged by and agreed upon with MISFA. Indeed, initial discussions with a few banks about funding microfinance on commercial terms have already been initiated. Furthermore, apart from commercial debt financing, investors may gain interest in Afghan MFIs over a three- to five-year time span, given that at least two of the MFIs, Afghanistan Rural Microfinance Programme and BRAC, are projected to reach significant scale<sup>44</sup> over that period and have already shown good progress toward reaching operational sustainability.

The financing strategy of MFIs in Afghanistan, at least partly because of lessons learned from other countries, has been more clearly defined than in any other country in the region. The desired trajectory toward commercial financing is ambitious. The improvement in the financial and outreach performance of MFIs will be the critical determinant in defining how the financing actually moves ahead and the extent and rate at which increasingly commercial sources of funds contribute to the financing of MFIs in the country. If all goes well, the country could become the definition of an appropriate financing strategy and the transition to commercial financing; however, for now, the uncertainties and challenges are many before this stage is reached. One of the greatest challenges will be whether the government and donor consensus to support the development of a large microfinance sector led by experienced international MFIs will remain in place long enough to support the achievement of the desired outcomes—that is, scale with sustainability. Already, there are signs that this support might be pulled back midcourse, leaving the half-developed MFIs to fend for themselves.

<sup>44</sup> Even by current global microfinance standards, top MFIs in Afghanistan according to projected numbers may reach an individual asset base of more than \$50 to \$75 million in three to five years.

## Bangladesh

Being the first country to have achieved scale in terms of microfinance outreach, the case of Bangladesh is of particular interest. Microfinance in the country has been funded through significant contributions from the donor community provided over the years,<sup>45</sup> although more recently donors have become a relatively less significant source of funds. Another important source of funding has been PKSF, the government-funded, apex development finance institution, which has provided large volumes of debt to MFIs at subsidized rates of 4 percent (for all except the largest MFIs) compared with a commercial bank lending rate of 12 to 15 percent. Over the years, this lower-than-market interest rate has, in effect, contributed to the profitability of MFIs and boosted their net worth. Debt financing from commercial banks has generated some interest but has been relatively insignificant, while some of the largest MFIs now use donor capital to lend to smaller MFIs.

Another important source of funding has been collections from members (see table 4.1). A

large part of this includes compulsory deposits that are genuine savings instruments in that the MFIs pay an interest on the savings and clients are allowed to withdraw their savings when they leave the program. The neat design of this product, in fact, satisfies regulatory concerns because it is either a fixed amount for all clients or linked to the size of the loan and, therefore, can also be described as cash collateral. Data from the MIX Market show that only 3 of the 50 MFIs<sup>46</sup> that have reported to that database offer voluntary deposit products.

Regarding donor funding, examining the net worth composition of MFIs provides a clearer picture. While the data on net donor equity in table 4.1 show a little over one-fourth from donor funds, table 4.4 from the same sample of MFIs from M-CRIL's rating database shows that, for the 14 Bangladesh MFIs rated, total donated equity received is nearly 1.4 times the total net worth of the MFI (by comparison, this is almost twice the level of Indian MFIs in M-CRIL's database).

**Table 4.4. Composition of Net Worth of MFIs in South Asia**

	No. of MFIs in Sample	Paid-in Equity (%)	Donated Equity (%)	Accumulated Profit/Losses	
				% of net worth	No. of MFIs with Accumulated Profits
<b>Afghanistan</b>	11	43	107	-50	0
<b>Bangladesh</b>	14	0	137	-37	8
<b>India</b>	110	49	77	-26	23
<b>Nepal</b>	60	88	4	8	37
<b>Pakistan</b>	14	26	73	1	5

Source: Data from M-CRIL, MISFA, NRB, and PMN.

The availability of donor funds and soft PKSF funding in Bangladesh, particularly in the formative years for many MFIs, has likely met their desired objectives of enabling outreach by creating a very large, well-capitalized, and

growing microfinance sector. However, the benefits of this capital accumulation appear to have been limited in that there has not been much leveraging of this capital to raise commercial or near-commercial debt financing.<sup>47</sup>

<sup>45</sup> Donor funding has been made available to MFIs for on-lending purposes, acquisition of fixed assets, and covering operating expenses. The first two kinds of funding contribute to enhancing the net worth, while grant funds for operating expenses prevent an erosion of net worth.

<sup>46</sup> The MIX Market list includes several of the largest MFIs in the country.

<sup>47</sup> Including voluntary savings.

Indeed, having achieved substantial outreach, the next key challenge for the Bangladeshi financial sector, both MFIs and the commercial financial institutions, is to increase the share of commercial debt financing to fund operations and growth of MFIs.

The data presented in table 4.5 from ratings conducted by M-CRIL in Bangladesh<sup>48</sup> show that mid- to large-size MFIs (with portfolios in

excess of Tk 50 million or \$800,000) are typically *underleveraged* and, therefore, have not managed capital efficiently. The MFIs rated by M-CRIL had a weighted average capital adequacy ratio of 43 percent. Data from 30 MFIs reporting to the MIX Market also show a high capital-to-assets ratio of more than 20 percent (the capital adequacy ratio after risk weighting would be higher).

**Table 4.5. Capital Adequacy of MFIs in Bangladesh**

Portfolio size in million Taka	Number of MFIs	Capital Adequacy Ratio (CAR)			
		Average (%)	Median (%)	MFIs with CAR	
				<12%	<20%
0–5	1	316.0	316.0	0	0
5–10	3	4.6	6.0	2	2
10–50	2	16.0	16.0	1	1
50–100	4	21.3	21.3	0	2
>100	4	39.5	38.6	0	0
<b>Total</b>	<b>14</b>	<b>43.2</b>	<b>27.0</b>	<b>3</b>	<b>5</b>

Source: M-CRIL database.

Increasingly, MFIs in Bangladesh are moving toward more commercial sources of finance. BRAC and ASA have already moved away from the soft financing of PKSF, and a number of others would like to move away as well. Looking at the balance sheets of the two leading MFIs that have never relied on PKSF funds—BURO Tangail and the Shakti Foundation—it is interesting to note that their combined reliance on deposits is, in fact, not much more than that of the sample as a whole 39 percent (compared with 36 percent for the sample). The key difference is in the profits earned by these MFIs. This has reversed the 10 percent negative contribution of surpluses to usable funds (as indicated for Bangladeshi MFIs by the information in table 4.1); together BURO Tangail and the Shakti Foundation have a 13 percent contribution of accumulated profits to their usable funds, thereby reducing their reliance on debt and the necessity to raise

deposits for expansion. Thus, it is their profitability that has enabled them to remain independent of PKSF, because the commercial banks in Bangladesh continue to be, at best, reluctant lenders to MFIs. To strengthen the move toward commercial sources of financing, MFIs in Bangladesh need to focus on better transparency and sustained financial performance. The emerging regulatory structure for microfinance could help to strengthen this trend by according microfinance a more legitimate legal status in the financial landscape, thereby increasing the commercial banks' level of comfort in working with them.

If deposit mobilization is made legitimate under the impending regulatory changes, it is likely that the share of voluntary deposits will increase; however, for this to happen, the capacity of many MFIs for designing and offering deposit products and managing the

<sup>48</sup> Although the M-CRIL sample is a relatively small one, it includes various sizes of MFIs, including MFIs from among the top 10 in the country and relatively new entrants to microfinance.

funds efficiently needs to be enhanced. It is notable, in this context, that Grameen Bank—with its separate statute and changed approach to product development—now has a savings portfolio that is larger than its loan

portfolio and is growing 1.5 times as fast.<sup>49</sup> More efficient leveraging of the net worth and transitioning to commercial sources of finance constitute the financing challenge for the next phase of MFIs in Bangladesh.

## India

In recent years, the financing pattern of Indian MFIs has become distinct from that in other South Asian countries. The main distinction is that a substantial proportion of near-commercial debt funding has become the most important source of funds for on-lending by MFIs. As indicated above, Friends of Women's World Banking (FWWB) (a wholesale lender) and SIDBI (a development bank) have played an important lead role in this and have been emulated by some of the commercial banks. The role of FWWB and SIDBI as apex institutions is described and discussed in section 8.2. While donor funds have also played a part, relative to other countries, these have had a relatively small role in India—except through the activities of the apex institutions. As table 4.1 shows, while debt accounts for 61 percent of funds available to Indian MFIs, donor equity (before adjusting for accumulated losses) contributes just 13 percent. And, increasingly, the role of donor funds in financing MFIs is declining, probably at a faster rate and to a larger extent, than in other countries.

Debt financing for Indian MFIs was pioneered by FWWB in the 1990s and, since 1999, was expanded significantly by SIDBI. The advent of commercial banks<sup>50</sup> into this field in the past few years has led to a rapid growth of such financing for MFIs. While initially the capital base of MFIs was adequate to leverage debt, over time, this debt has grown much faster than the corresponding increase required in equity to sustain these high growth rates. As a

result, the capital adequacy of Indian MFIs has fallen even as outreach has expanded at a fast pace. This is apparent from the data on 15 leading Indian MFIs presented in table 4.6. Thus, the combined capital adequacy ratio (CAR) of these 15 MFIs fell from 12.4 percent in financial year 2002–03 to just 8.9 percent in 2004–05 even as their combined outreach grew by 300 percent from 82,000 to more than 360,000 clients.

While this has meant that the financing of Indian MFIs has been of a more commercial nature than in countries like Bangladesh and Pakistan, in the absence of adequate risk and long-term capital, it may probably have an adverse impact in terms of the growth of outreach and scale. Indian MFIs are more highly leveraged and have a higher cost of funds relative to the lending rate of commercial banks, than those in other countries in the region, reducing their ability to generate surpluses for future on-lending. Regulatory concerns have been considerable in India, reducing the role of member deposits in the financing of MFI operations to just over 20 percent.

The problem has been reinforced by another trend over the past couple of years: some private commercial banks, having “discovered” microfinance, have become overenthusiastic in their attempts to gain international recognition as supporters and innovators in the field.

<sup>49</sup> The resulting liquidity could pose its own fund management problems. At present, some of the additional liquidity goes to fund bigger “enterprise” loans (but some of these could prove risky because they are not accompanied by additional loan appraisal skills training for loan officers).

<sup>50</sup> These include ICICI Bank, State Bank of India, HDFC Bank, UTI Bank, IDBI Bank, Andhra Bank, Oriental Bank of Commerce, and ABN Amro Bank; recent entrants include HSBC, Citibank, and Standard Chartered Bank.

**Table 4.6. Trends in the Leverage of 15 Leading Indian MFIs**

Ratings Undertaken During	2002–03	2003–04	2004–05	Estimated 2005–06
Outreach (borrowers with outstanding loans)	82,591	187,663	365,633	585,000
growth		127%	95%	60%
Equity, million Rs	38	81	127	177
growth		109%	57%	40%
Risk-weighted assets, Rs million	311	744	1,417	2,268
growth		139%	90%	60%
Capital adequacy ratio	12.4%	10.8%	8.9%	7.8%

Source: M-CRIL 2005 from data sourced from MFI ratings.

While this has greatly accelerated the flow of finance to Indian MFIs, as debt and securitization deals, it has also led to creative moves, such as partnership financing, that keep the loans on the books of the banks but offer portfolio servicing by MFIs. The problem with this is the temptation for some banks to maximize their microfinance portfolio by pushing out larger sums of money than the MFIs have the capacity to handle. The net result is that this arrangement all but ignores the prudence of capital adequacy norms because the banks' internally generated targets take precedence over such prudence. Although the partnership model could be a solution to the equity constraint, it is only a short-term panacea if the capacity and management limitations of MFIs are ignored and financing to several multiples of the amounts required to fuel the reasonable and manageable growth of MFIs takes place. In the long term, a fall in terms of a couple of MFIs collapsing under the weight of their own ambitions may be imminent. Unfortunately, the effect of this collapse is likely to reach far beyond the affected MFIs and could damage the microfinance sector as a whole.

The implications of this trend and the current levels of debt financing clearly are that, unless the availability of risk capital increases, the rate of growth of additional debt financing could taper off and even decline. The alternatives to this are limited. Grant funds are

available only in limited volumes and shareholders' capital is not available because most MFIs are not structured as companies, and internal accruals of profits are constrained by the fact that there are only a small number of profit-making MFIs. Even for such MFIs, profits alone cannot drive growth because interest rate restraints affect their earning capacity.

In this context, there have been two positive developments over the past couple of years. First, a number of initiatives have been undertaken by SIDBI and some small private funds<sup>51</sup> to invest in the equity of MFIs. Second, the Government of India has launched a Microfinance Development and Equity Fund (housed at NABARD). These initiatives taken together may not be able to address the huge equity gaps in the country, however, keeping in mind the need to sustain high growth rates in the provision of financial services to low-income families. Conservative estimates of equity requirements for the next five years exceed \$100 million, which is several multiples of the amount indicated so far by equity funders. This situation provides an avenue for development and commercial investors, in the public and private sectors, to play a role in addressing the capital constraint in Indian microfinance.

<sup>51</sup> Bellwether Fund, Lok Capital, venture capitalist Vinod Khosla, and UNITUS.

## Nepal

The financing structure of Nepal's MFIs is almost paradoxical. With low outreach and a general concern about portfolio quality in the context of the ongoing conflict, losses in operations and overall subsidy orientation are expected. Yet, the pattern emerging from table 4.1 is that of a more mature microfinance sector with a significant proportion of equity and substantial debt (more than 50 percent of total finance).

Disaggregating this disposition of MFI funds by type of institution, table 4.7 shows the importance of debt as a source of funds for the development banks and the NGOs—in the latter case, the funds for NGOs come from the apex

institutions, RMDC and RSRF (the Rural Self-Reliance Fund), and in the former case, from RMDC and the commercial banks. To the extent that the funds are from RMDC, lending is near-commercial, but both RSRF and commercial bank loans are subsidized. In the commercial bank case, it is their directed credit requirement<sup>52</sup> that is placed with MFIs, which are then required to invest the funds, not in microfinance but rather as fixed deposits with specified financial institutions, including finance companies. RSRF mitigates its high (8 percent) interest rate by offering a 6 percent development rebate for on-time repayment, resulting effectively in a capital subsidy to its MFI borrowers.

**Table 4.7. Financing Pattern of Different Types of MFIs in Nepal (percent of funds available)**

Type of MFI	Number of MFIs	Accumulated Profits	Paid-in Equity	Donated Equity	Deposits	Debt
MCDBs	4	8.2%	3.9%		19.3%	68.6%
RRDBs	5	-6.6%	11.3%		16.6%	78.7%
NGOs	31	1.6%		4.5%	15.3%	78.6%
Cooperatives	20	4.3%	9.3%		84.1%	2.2%
<b>Sample average</b>	<b>60</b>	<b>0.7%</b>	<b>8.1%</b>	<b>0.4%</b>	<b>37.4%</b>	<b>53.4%</b>

Source: Data from NRB records compiled by the authors.

Note: MCDB = microcredit development bank; MFI = microfinance institution; NGO = nongovernmental organization; RRDB = regional rural development bank.

The objective of financing from the apex funds is to facilitate outreach; however, to the extent that RSRF is lax in its follow up of delinquent loans, it is merely subsidizing inefficiency. However, commercial bank parking of deprived sector funds is a different matter altogether. In this situation, MFIs acquire risky assets with those loans, compromising their capital adequacy without there being any addition to microfinance outreach. Although the impact of this device may not be substantial at present, it certainly has the dimensions of a growing trend. It is a matter of concern in the context of the marginal capital adequacy of all except the smallest MFIs in the country (see table 4.8). By type of institution,

it is the loss-making RRDBs and the NGOs (many of which make operating losses) that have low capital adequacy and desperately need efficiency and portfolio quality improvements to strengthen their balance sheets and raise additional funds for growth.

Overall, the failure of the commercial banks to engage with the microfinance sector and the systemic inability of RSRF, which is housed at the central bank, to function in a professional manner means that, while microfinance in Nepal is not short of sources of funds, it is lacking efficient operations that would facilitate robust growth and greatly increased outreach.

<sup>52</sup> "Deprived sector" lending requirement amounting to 3 percent of the loan portfolio.



**Table 4.8. Capital Adequacy of MFIs in Nepal**

Portfolio Size (million Rs)	Number of MFIs	Capital Adequacy Ratio (CAR)			
		Average	Median	MFIs with CAR	
				<12%	<20%
0–5	20	22.7%	8.6%	12	13
5–10	6	10.0%	1.9%	4	4
10–50	13	11.2%	12.3%	5	10
50–100	7	12.9%	13.3%	2	6
>100	14	8.8%	13.2%	6	13
<b>Total</b>	<b>60</b>	<b>10.8%</b>	<b>12.0%</b>	<b>29</b>	<b>46</b>

Source: Data from NRB records compiled by the authors.

## Pakistan

Microfinance in Pakistan is still in a nascent stage and the outreach of microfinance is quite limited (see chapter 6). While the reasons for this limited outreach of MFIs in Pakistan are found in a variety of factors, including the country's relatively early stage of microfinance development, an analysis of the financial data from the Pakistan Microfinance Network's (PMN's) Performance Indicators Report shows

that, at least in terms of financial leverage, there are no constraining factors. In fact, there is considerable scope for growth. MFIs in the country have high capital adequacy levels, higher than perhaps in any other country in the region, and there is a significant degree of underleveraging of capital. As the PMN data in table 4.9 indicate, capital adequacy levels have reached a high of 45 percent.

**Table 4.9. Capital Adequacy of MFIs in Pakistan**

Portfolio Size (million Rs)	Number of MFIs	Capital Adequacy Ratio (CAR)			
		Average	Median	MFIs with CAR	
				<12%	<20%
0–5	1	97.3%	97.3%	0	0
5–10	0	0.0%	0.0%	0	0
10–50	5	28.1%	31.2%	2	2
50–100	2	54.1%	NA	0	0
>100	7	45.5%	58.2%	0	1
<b>Total</b>	<b>15</b>	<b>45.4%</b>	<b>41.5%</b>	<b>2</b>	<b>3</b>

Source: PMN 2005.

Donor funds have been the primary source for building the capital base of MFIs in Pakistan has, although the specialized microfinance institutions have also relied on shareholder capital. Debt from apex development financial institutions—such as the PPAF—forms a major source of funding. Because the extent of leverage is suboptimal at present, if the MFIs

demonstrate an adequate capacity to absorb funds, future growth can readily be funded by commercial debt financing. At present, commercial liabilities account for a little more than half of the total debt raised by MFIs, so there is significant scope for increasing the extent of commercial financing. A positive aspect of the financing structure of Pakistani



MFIs is the extent of financing received from voluntary deposits enabled by licensing under the Pakistan Microfinance Ordinance of 2002. The concern in this situation is that one of the three specialized MFIs has a negative net worth but is still able to raise deposits, an aspect that poses a problem for regulators.

Nonetheless, in overall terms, the key issue for MFIs in Pakistan is to optimize their capital base effectively and to obtain increased debt financing. Because subsidized debt funding is likely to be available for some time, in the short to medium term, it is likely that at least a part of the incremental debt financing from lenders will be available on subsidized terms. Although this is clearly desirable for MFIs and their ability to generate profits, in the long term, more commercially financed debt is likely to provide the volumes required to fuel growth and increase outreach.

For this growth and outreach to happen, MFIs will need to ensure that they develop the confidence of commercial lenders, improve transparency (as indeed they have through PMN) and, most important, become more solvent and profitable institutions. This process is likely to require significant capacity building efforts and appropriate policy guidance that encourages and increases the interface of commercial financiers with MFIs. At the same

time, deposits from members could become an increasingly important source of funds for licensed MFIs. While this is clearly a move in the right direction for the financing of MFIs, supervisory oversight will be critical to protect the deposits of low-income families from fraud or failure that could impede the growth of the microfinance sector in Pakistan.

Another important feature of microfinance in Pakistan is the advent of microfinance banks. With the possible exception of one of the six licensed banks, none has investors who expect to receive a return on their investments at least for the first five or more years. From a purely financial perspective, this absence of a requirement to pay returns to investors constitutes a relatively large subsidy that parallels the soft funding received by NGO-MFIs from PPAE. Only one of these, the First MicrofinanceBank Ltd, has started deposit mobilization, with the bulk of its deposits coming from people who are not poor and, therefore, would not be eligible for bank loans.<sup>53</sup> Just one of these banks has become a listed company so far (49 percent of share capital), but even those who purchase the bank's shares on the market are told that they will not receive any return for some time. These banks have found more than enough funding from subsidized sources to mobilize deposits or commercial debt and equity.

## Sri Lanka

As indicated earlier in this section and discussed previously, microfinance in Sri Lanka follows a completely different pattern than other countries in South Asia. It is, however, the one country that, at the client interface, most closely approximates commercialization. The overwhelming proportion—perhaps 95 percent—of microfinance is channeled through cooperative institutions and SBSs, which are financed predominantly by member deposits and significantly by equity. While exact numbers are not available, information from a

few years ago indicates the distribution of funding shown in table 4.10. Deposits are virtually all voluntary and lending by the SANASA Development Bank to the TCCSs is available at commercial rates of interest around 12 to 13 percent.

The concern with the financing of Sri Lanka's mainly community-based MFIs is the uneven performance within institutional types. Thus, while large numbers of these institutions are reported to be doing well, a number of SBSs in

<sup>53</sup> Although some 80 percent of its depositors are in fact low-income clients, the volume of their individual deposits is small relative to the average deposit size.

the northern part of the country are said to have low recovery rates and several hundred of the CRBs and TCCSs are “poorly performing.”<sup>54</sup> A continuation of this over an extended period of time could result in the collapse of institutions and loss of public confidence in these community-based institutions.

Looking at Sri Lankan microfinance at a more holistic level, the link of the SBSs, RRDBs, and other banks to government programs does entail a large amount of government subsidy into these programs. Nevertheless, it could be argued that the high interest rates charged by the SBSs (3 percent per month) are sufficient to ensure long-term sustainability given that repayment rates are also high. In this situation, even if the government's development subsidy were to be withdrawn, the program as a whole could be sustainable. The key to the future

must be to determine the extent to which the government can afford to continue its subsidy programs. Because these program generally are seen in Sri Lanka as the key to the state's social welfare program, it is likely that they will continue.

**Table 4.10. Estimated Distribution of Sources of Funds for Sri Lankan Microfinance**

Type of MFI	Equity	Deposits	Other
CRB	10%	90%	
TCCS	5%	80%	NDTF, 5% Donors, 10% through SANASA Development Bank
SBS	25%	75%	
NGO			Donors and SANASA

Source: Authors' compilation.

Note: CRB = cooperative rural bank; MFI = microfinance institution; NDTF = National Development Trust Fund; NGO = nongovernmental organization; SBS = Samurahi Banking Society; TCCS = thrift and credit cooperative society.

## Challenges for the Future

Microfinance around the world traces its roots largely to donor-driven and funded growth. This applies to much of South Asia that receives substantial financing from donors either directly or through microfinance-focused wholesale financial institutions. The broad trend in the region has been a graduation over time from donor-funded microfinance to a greater integration with mainstream financing, as considerable innovation (through securitization and partnership financing models) has taken place. This trend is noticeable in all countries of the region, although the pace of the graduation varies and the level that each country has reached is different. Thus, for example, while India has graduated to near-commercial levels over the past few years, progress in Bangladesh has been slow because of the subsidized loans available from PKSF and the reluctance of

commercial banks to engage with MFIs. At the same time, Nepal has suffered from significant policy distortions and public subsidies, while Sri Lanka's system displays considerable commercial characteristics despite the availability of substantial subsidies in the system. Pakistan, meanwhile, still has a high element of donor funding, although the advent of an enabling regulatory mechanism could help change the situation in the future. Afghanistan, understandably, is in an early period of development in the field, but encouraging signs of sustainable microfinance service provision are already emerging.

As the above discussion shows, each country of the region faces challenges in the financing of microfinance. These challenges are summarized in table 4.11.

<sup>54</sup> Charitonenko and de Silva 2002

**Table 4.11. Challenges in the Financing of Microfinance**

Country	Financing Structure of MFIs	Challenges for the Future
<b>Afghanistan</b>	Financed by grants to initiate the microfinance sector in the country	Meeting performance targets and transitioning to debt financing
<b>Bangladesh</b>	Financed by donor grants and subsidized debt from apex institutions plus growing volume of "compulsory deposits" from clients	Optimizing the capital base through better financial leverage and attracting commercial sources of financing
<b>India</b>	Largely debt financed by near-commercial sources; initial equity financed by donors now increasing but insufficient social equity	Addressing the equity constraint and the problem of overleverage compounded by overenthusiastic financing
<b>Nepal</b>	Reliance mainly on subsidized debt finance, including directed lending programs; limited deposit collections by development banks and cooperatives	Shift to genuine (not illusory) financing by increasingly commercial sources
<b>Pakistan</b>	Donor-financed for the NGOs and donor- and shareholder-financed equity for specialized institutions; debt from a mix of commercial and subsidized sources	Improving leverage of net worth through increased levels of commercial debt financing; improving financial performance to attract commercial capital
<b>Sri Lanka</b>	Financed mainly by voluntary deposits with community-based MFIs	Ensuring that some MFIs do not damage the system because of management limitations

Source: Authors' compilation.

Thus, the financing structure of microfinance in South Asia runs the gamut of types from Afghanistan's early period finance to Pakistan and Bangladesh's weaning off of subsidized finance to Nepal's maturing microfinance. Meanwhile, the overenthusiastic commercialization currently seen in India is vastly different from the solid deposit-based institutionalization of formal microfinance in Sri Lanka. The challenges everywhere are surprisingly similar. The challenge is to develop the management capacity of MFIs at every level to enhance their ability to run efficient operations, which will attract commercial finance—from equity investors, financial institutions, and voluntary depositors—enabling microfinance services in the long term to reach increasing proportions of the large number of low-income families in the region.

# Product Diversity:

## A growing responsiveness to client needs

Microfinance is often used interchangeably with “microcredit.” However, it is now well understood that the poor (or low-income families) normally classified as the target clients of microfinance need, and use, more financial services than just microloans. Therefore, it is advisable to use “microfinance” to more accurately describe financial services of any sort provided in very small (micro-) amounts. Thus, for the purpose of this paper, in addition to microcredit, microfinance covers the following:

- Deposit services (or savings facilities for clients)
- Insurance for microclients
- Money transfer (or remittance) services
- Microleasing

The discussion in chapter 1 about the fundamental difference between the origins and basis of the microfinance movement in South Asia compared with that in Latin America relates directly to the nature and suitability of the design of products offered. While products in Latin America were designed to address the need to scale up microenterprises in urban settings, from the start, the practice of microfinance in South Asia was firmly rooted in rural, agrarian economies. Paradoxically, because Professor Yunus' early experiment was undertaken with landless, poor women, the design of the early products was based not on the seasonality of agriculture but rather on microtrading and service activities undertaken through door-to-door selling or *haat*-based (marketplace-based) entrepreneurship at the village level. Thus, product design in the Grameen model was

based on a presumption of weekly cash flows from such activities. Elsewhere, particularly in many SHG and cooperative-based programs, more flexible approaches emerged as the agrarian basis of cash flows was taken into account for designing products.

Even in the Grameen-type system, starting with some rather rigid credit products designed to simplify delivery for the MFI rather than to reduce transactions costs for clients, a more diverse product range is now offered, particularly in countries like India and Bangladesh that have a number of years of microfinance experience and a solid base from which to add new products. In other countries (for example, Afghanistan and Pakistan), most MFIs still lack depth of experience and, therefore, focus on already-proven products before a transition to more flexible and diverse products and services takes place. The financial services offered by MFIs in the region are described and discussed in this chapter.

## Loan Products

Loan products act as the vanguard of financial service providers' initiatives (although SHGs and other CBOs often start by offering mutual savings products before revolving the funds as loans). Thus, relatively rigid credit services originally were, and continue to be, the major activity in microfinance initiatives, although increasingly diverse and flexible arrangements are developing. The major types of loan products offered are discussed below.

### General loan

General loans are the most common product. These loans usually are presented as enterprise support loans, but they are widely acknowledged as being general-purpose loans, which often (but not always) are used for productive investments.<sup>55</sup> It is usually the first loan product offered to clients after they join an MFI. The amount of the loan is limited by a ceiling that increases from one loan cycle to the next and generally varies from \$30 to \$300. Typically, repayment cycles are annual, with 50 regular weekly or 10 to 12 monthly installments. Many MFIs charge loan processing fees and, in addition, most MFIs using the Grameen delivery system levy interest as a flat charge on the disbursed amount. Other MFIs, most CBOs and SHG-based MFIs, charge on declining balances. Grameen-type organizations run loan utilization checks by credit officers, most others do not.

CBO programs, especially those based on SHGs rather than cooperatives, have additional flexibility built into them. Loans have fixed terms but not necessarily regular installment obligations. Many SHG programs in India, in particular, do not expect any repayment during the loan term as long as the principal plus interest is finally repaid at the end of the term.

In practice, however, many borrowers do repay occasionally during the loan term with the remaining amount paid in a lump sum at the end of the term. This loan product is a microfinance analyst's nightmare: there are no fixed installments, no repayment schedule, and only a loose understanding of the loan term. Quite often repayments that are made many months after the end of a loan term do not attract an interest penalty. It takes a heroic level of assumption to estimate a portfolio quality measure and determine the expected yield (or annual percentage rate, APR).

For the typical rural client, depending on the agrarian economy, this product (along with a voluntary savings account with the SHG) has the ultimate features of flexibility that meet borrowers' financial needs. Essentially, they are able to save and withdraw from their voluntary savings when they please and to deposit loan repayments when they have funds that exceed immediate needs. Only a loose understanding of loan term sets some boundaries on financial behavior.<sup>56</sup> This loan product works for the MFI (or bank) because it is based on the SHG partly intermediating its own members' deposits within the group and using MFI (or bank) funds largely as a supplement to the member deposits. Then, even high portfolio-at-risk (PAR) levels of 30 percent or more do not upset the system as long as the SHG can meet its repayment obligations to the MFI (or bank) on time.

### Supplementary loan

Offered mainly by Grameen-type organizations, supplementary loans are shorter-term loans (usually six-month terms in South Asia) intended to supplement the general loan for whatever purpose it was provided. Apart from the loan term, other conditions are similar to those applied to the general loan.

<sup>55</sup> Most frequently used in South Asia for animal husbandry but also extensively for trading, food processing, other microenterprise activities, and working capital for crop production.

<sup>56</sup> Sinha and Patole (2002) analyze the daily financial needs of low-income families based on the financial diaries of such families in India and argue that it is really microlines of credit rather than fixed-term finance with regular repayment instalments that microclients need.

## Microenterprise loan

Microenterprise loans are larger loans in the \$300 to \$5,000 range offered to individual clients on the basis of collateral (land title or, at best, the hypothecation of productive assets acquired with the loan) or guarantors. Examples from Bangladesh include BRAC's microenterprise loan, Grameen's microenterprise loan, and Proshika's SEED. In India, Spandana, SHARE Microfin, and ASMITHA offer such loans, as does BASIX. The loan terms range from one to two years and interest rates and conditions are similar to those applied to the general loan. A few MFIs—such as BURO Tangail in Bangladesh—have lines of credit and other similar products for microenterprises.

## Flexible loan

Designed for poor clients who have trouble meeting a rigid repayment schedule, ASA (Flexible Loan Program), SafeSave (flexible savings and borrowings), Grameen II (flexi-loan), and BRAC (Income Generation for Vulnerable Group Development [IGVGD]) are some of the prominent examples from Bangladesh. The common feature among these programs is that clients are not required to repay loans in fixed weekly installments. Instead, a variable amount can be paid, although some have set a minimum amount equivalent to all of the outstanding interest and a portion of the outstanding principal. Loan sizes start small (Tk 500, less than \$10) but typically range from \$30 to \$60. Unlike the “mainstream” Grameen-type MFIs, most of the flexible programs do not have a compulsion that clients must borrow. It is not clear how successful these programs have been in attracting and retaining very poor clients, maintaining flexibility (recent evidence from Bangladesh shows that the scope of flexibility has had to be reduced),<sup>57</sup> and achieving financial sustainability (of the flexi-microfinance programs, only SafeSave with

11,000 clients, of whom 70 percent are borrowers, has reached breakeven so far).

## Home loan

Very few MFIs offer home loans, mainly Grameen Bank in Bangladesh and the Indian Association for Savings and Credit (IASC) in India. Grameen Bank gives a housing loan for up to Tk 15,000 (\$250) to be repaid over a five-year period in weekly installments. The interest rate of 8 percent is cross-subsidized with other loan products. IASC has loans ranging from Rs 20,000 (\$450) to Rs 54,000 (\$1,200) over loan terms of 7 to 15 years at an interest rate of 15.5 percent. Unlike Grameen, which has weekly installments, IASC has monthly payments, because its clientele is drawn mainly from SHGs promoted by SHPIs that are active under the bank-link program.

## Special loan

In Afghanistan, special loan products have been designed to meet particular needs—for example, refinancing the opium debt of small farmers, or providing loans for nomadic people, people with disabilities, and demobilized fighters. Shariah-compliant lending remains a challenge, especially in Afghanistan and Pakistan. The problem is usually resolved by levying service charges and fixed fees instead of charging interest.

## Grameen II

Given the seminal nature of Grameen Bank's early initiatives and the contribution it has made to microfinance in the region, the changes it has made recently in its products deserve closer examination. Grameen has attempted to do away with the large array of multiple loan types it had earlier and to replace it with just one loan type: the basic loan. In theory, members may now borrow for almost any term (minimum three months) and they

<sup>57</sup> EDA 2005.



may negotiate individual repayment schedules. In practice, however, most basic loans are still given for one year and repayments remain equal and weekly. A creeping proliferation of loan types has surfaced again, as Grameen struggles to meet the demand for bigger loans (and looks for profitable investment opportunities for the huge inflow of deposits). For example, business expansion loans are now available, ranging from about \$300 up to \$3,000: these loans are more likely to have terms longer than one year.

Another innovation in Grameen II is the rapid rescheduling of loans that get into trouble. These contract or flexi loans are supposed to replace a basic loan as soon as it is in arrears

of repayment for more than a certain number of weeks. Here again, however, practice in the field differs. Most workers prefer not to issue flexi loans, and find other ways of managing troubled loans. For example, a provision in Grameen II “tops up” loans to their disbursed value (or even more) halfway through the term, and at the time of topping up, the loan term can also be lengthened: so workers may choose to nudge a troubled borrower along to the point at which the loan can be topped up. On the whole, joint liability has disappeared, although bank workers prefer to collect all weekly payments at the meeting and are prepared to keep members waiting until that is achieved.

## Deposit Products

Services that enable clients to deposit savings are of significant interest and innovation for MFIs. However, they are also a potential minefield because of the risk of loss in the intermediation process—that is, use of the clients' deposits as part of the lending process. In practice, most NGO-MFIs have been forced by regulatory restraints to limit deposit-taking to credit-linked products. CBOs are able to offer such services because of their relatively informal nature and the limitation of their activities within a mutually supportive group of a small number of members. Similarly, cooperatives are legally permitted to do so on the understanding that it is mainly member funds that they revolve as loans. In Bangladesh, such considerations have been less of a problem because NGO-MFIs have dominated the rural financial system for some years. Recent moves to establish a regulatory framework for microfinance are effectively designed to regulate and supervise the practice of taking compulsory as well as voluntary deposits that have been undertaken without a license from the central bank until now. Similar moves are being offered in India. The introduction of regulatory frameworks, now in place in Pakistan as well as in Nepal, however

lax, has started to create a greater awareness of prudential issues among MFIs. The main deposit products available in microfinance may be classified as follows.

### Compulsory savings

Compulsory savings are common among Grameen replicators in Bangladesh, India, Nepal, and Pakistan, where some amount has to be saved regularly as a condition for receiving loans. Each member saves \$0.02 to \$0.30 per week (Indian Rs 5 to Rs 20), which can only be withdrawn when the member leaves the program. The transactions cost of such deposits is limited by combining collection with repayment installments and by imposing limitations on withdrawals. Alternatively, compulsory deposits in Grameen programs are fixed at a proportion of the loan size, in the range 5 to 12 percent of the principal repayment. Compulsory deposits earn annual interest close to (but usually more than) the prevailing bank rate on savings accounts (4 to 5 percent per year).



## Voluntary savings

Voluntary (or passbook) savings accounts with flexible deposit and withdrawal terms form the backbone of the operations of most credit cooperatives. But, regulatory restraints on NGO-MFIs apply particularly to such products and prevent voluntary deposits from commonly being offered. Typical products include regular deposits like recurring deposits (that could be fixed on a monthly, weekly, or sometimes even daily basis) or time deposits (fixed deposits). Interest paid is usually more (by 100 to 200 basis points) than the rates paid by banks on passbook deposits<sup>58</sup> and withdrawals are allowed flexibly (subject to minimum balances). Such products impose additional transactions costs on the MFI and expose them to the risk of provoking a response from the central bank, unless they are offered by cooperatives or at the CBO level.

Many MFIs in India have moved savings collection to separate institutions, wherever local laws allow the formation of MACS (Mutually Aided Cooperative Societies) or MBTs (Mutual Benefit Trusts). These MFIs are member-owned institutions that collect savings of Rs 5 to Rs 50 per month, usually without offering interest, although members can borrow from the savings pool. In recent months, however, the collection of savings by MFI staff on behalf of MBTs has been discontinued under the instructions of the Reserve Bank of India (RBI), because the practice constituted a violation of the spirit (if not, strictly, the letter) of the regulatory restrictions on unlicensed deposit collection.

## Group savings

Like Grameen, most SHG programs as well as the SBS in Sri Lanka have fixed deposit installments. The group decides the rate of savings (\$0.50 to \$2.50 per month), collects the deposits, and rotates/lends the funds internally. Many cooperatives also follow this

practice. Members do not receive interest on deposits but instead receive a share of the profits earned from lending the savings to members or even nonmembers.

## Grameen II

Grameen Bank has made extensive changes in its own approach to deposits. Grameen II has done away with the old system of pooling member savings and offers instead individual passbook savings into which members are encouraged to save regularly each week, but from which they can withdraw at will. A second savings account, known as “special savings,” is opened for all members who borrow: 2.5 percent of the disbursed value of all loans goes into this account, but when the account is three years old, it can be drawn down to Tk 2,000 (about \$30). A commitment (or recurrent, or contractual) savings product, the GPS, is offered to all members and has proven to be very popular. A low-value GPS is mandatory for all borrowers who take loans of \$120 or more. Deposits are made monthly and the term is usually 10 years, although there are some 5-year terms. For the 10-year term GPS, the interest rate offered is 12 percent per year, so that the matured sum is almost double the deposits. As a result of these changes, two-thirds of the total savings portfolio at Grameen Bank belong to members—a characteristic that has brought this product much closer to that of many SHGs and, as argued earlier, has made it more suitable to the financial needs of low-income clients.

<sup>58</sup> Interest on passbook savings accounts held with commercial banks range from 3.5 percent in India up to around 8 percent in Bangladesh.

## Microinsurance

Microinsurance is a service now drawing increased attention; it is still in the experimental stages in India and, perhaps, is a little more established in Bangladesh. However, its implications for cost and delivery systems are little understood by MFIs and insurance companies. A key factor stimulating the growth of microinsurance in India is the regulator's (Insurance Regulation and Development Agency, IRDA) stipulation that insurance companies must offer a certain proportion of their policies to rural clients. Thus, life insurance companies with more than six years' operations are required to place at least 18 percent of their policies with rural clients. For general insurance, the maximum stipulation is 5 percent of policies for three or more years' operations. This cost has driven insurance companies operating in India to work with MFIs to limit their transactions costs effectively by using the ready pool of potential clients available with the latter.

Insurance is available in Bangladesh and India for a variety of risks and covers the following:

- Life—of the client and (occasionally) her spouse—for natural and/or accidental death
  - Health—of the client and her family
  - Assets—dwellings as well as productive assets with livestock often attracting separate cover
- Some interesting experiments in Bangladesh and India include the following three types of insurance models:
- **Community-based models** (Swayamkrushi Women's Development Mutually Aided Cooperative and Thrift Society [SWDMACTS] in Andhra Pradesh, India): Essentially, the group pools the premium of its members and uses the funds to pay benefits when the need arises. This is possible only within cooperative structures in which members know each other. It limits the coverage of risk (to the overall financial strength of the group) and the scope for expansion.

- **Full-service schemes** (Grameen Kalyan, Delta Life in Bangladesh, Spandana in India): The institution offering the service carries the risk by itself and is able to achieve high outreach by offering simple products. Claims processing is internal but the (contingent) risks are high, and none of the providers have purchased reinsurance.
- **Partner-agent model** (BASIX, SEWA, ASA Grama Vidiyal in India, BRAC in Bangladesh): Allows for rapid increase in outreach. MFIs can use the expertise of established insurance companies to design products and determine premium, whereas the latter can piggyback on MFIs to enroll clients, collect premiums, and, most important, facilitate the verification and processing of claims. As an extension of this, FWFB (the Indian apex NGO) has organized seven of its partners under its Microinsurance Project. Under this program, the partner organizations cover various risks—life, livestock, health, dwellings—and link up with life and general insurance companies to provide a single composite product for their clients. Sometimes the partners include benefits like funeral expenses and loans to meet medical expenses from their own resources to meet client needs.<sup>59</sup>

### Life insurance – most successful

Delta Life in Bangladesh is the best known of the microinsurance programs in the region. It covers nearly 800,000 policy holders—that is, roughly one-third of all microinsurance policies in Bangladesh (by late 2004).<sup>60</sup> Delta Life offers two highly successful endowment products: 10- and 15-year endowment policies with sum assured from \$85 to \$1,650. The bonus of 7 percent per year paid at the end of the term positions this as a long-term contractual savings account by low-income client households. The innovation here is doorstep premium collection on a weekly, monthly, or biannual basis.

<sup>59</sup> FWFB 2005.

<sup>60</sup> McCord 2005.

In India, VimoSEWA and Spandana's life insurance are two of the largest microinsurance schemes. VimoSEWA, started in 1992, provides voluntary insurance covering life (of the client, spouse, and children), accident, health, and asset protection. The scheme had an outreach of 106,000 clients by late 2004 but was not yet profitable.<sup>61</sup> Its viability was affected by low renewal rates and full coverage extended to higher-risk households. It was expected to take another seven years to breakeven.

Spandana runs a profitable microinsurance business in the Guntur region of Andhra Pradesh through a compulsory life insurance scheme for borrowers. It offers a single product with no riders and a low claims processing time with 75 percent of claims settled within one week. The program is perhaps the largest of its type and had reached more than 300,000 clients by March 2005.<sup>62</sup> However, it has been criticized for charging high premiums and having low value to clients.

As indicated above, although a number of the leading insurance companies in India have become engaged in microinsurance through the partner-agent model, one insurance provider (TATA AIG) is experimenting with a different model in which the company has decided to offer insurance services on its own.<sup>63</sup> The insurer forms groups of village-level insurance sellers, only one of whom is a registered insurance agent. The group of sellers is jointly required to ensure that there is no fraud or false claims. The premium collected by the group members is passed on to the insurance company, which pays them a commission. As of March 2005, 34,100 policies had been sold under this scheme.

## Health insurance

Relatively few examples of health insurance schemes are available to low-income clients. A couple in Bangladesh (Grameen Kalyan with 60,000 families and SSS with 45,000 families)<sup>64</sup> have relatively large outreach; however, these are not really insurance schemes but more like subsidized health service provision. In this example, the NGO plays the dual role of insurer and service provider. These programs have received grants for start-up and continue to require ongoing support.

In Pakistan, the rural support programs recently linked up with Adamjee Insurance to provide hospitalization insurance to members of the community organizations with whom they work. Thus far, about 130,000 members have signed up for a program, which charges an annual premium of about \$4 for hospitalization coverage with a cap of about \$400.

In India, health insurance has been offered on a small scale by a few NGO-MFIs (FWWB partners Shepherd and PSA) to about 6,000 people.<sup>65</sup> It is commonly acknowledged that the main hurdle to acquiring health insurance is not the availability of the insurance service but the availability of good health facilities for the facilitating MFIs to link up with in rural areas. Shepherd's Uni-Micro Health Insurance, offered in conjunction with the United India Insurance Company Limited, provides for the risk of destruction of assets caused by fire and allied perils, death or disability because of accident, and reimbursement of hospitalization expenses. Shepherd's Sugam (Health) Fund provides loans to meet medical expenses until the reimbursement is available from the insurance company.

<sup>61</sup> Garand 2005. Coverage information from Devadasan 2005.

<sup>62</sup> FWWB 2005.

<sup>63</sup> Roth and Athrye 2005.

<sup>64</sup> EDA 2005.

<sup>65</sup> Roth, Churchill, Ramm, and Namerta 2005.

## Weather insurance—a novel idea

A leading Indian provider of financial services to low-income clients, BASIX, is piloting a weather insurance scheme as an alternative to the traditional government-sponsored crop insurance schemes that have failed across the region. Under this new scheme, launched in collaboration with a formal insurer (ICICI Lombard), farmers are entitled to a payout if their crop production suffers because of poor rainfall or if it does not rain at the right time (affecting seed plantation and germination, for instance). This insurance currently is being offered to castor and soy farmers in two districts of Andhra Pradesh, India. By late March 2005, 657 customers were insured for an average sum of Rs 6,000 (\$133);<sup>66</sup> 305 claims were settled, and the claim amount presently exceeds the total premiums collected.

## Livestock insurance—few takers

Many FWWB partners in India offer livestock insurance. By August 2004, six FWWB partners were offering this product to 6,700 customers. However, large-scale fraud was reported in one northern MFI that offered this

product. In rural, southern India little fraud was reported by MFIs.<sup>67</sup>

## Key lessons on microinsurance

Following are the key lessons on microinsurance:<sup>68</sup>

- Successful microinsurance schemes are most likely to be run by insurance companies that also have a mainstream insurance product and that are not looking for immediate profits from the microinsurance sector.
- Insurance companies and MFIs often face a mismatch while trying to form partnerships because insurance companies cannot find progressive and trustworthy partners in rural areas. Conversely, the common problem faced by the MFI partners is the lengthy and highly technical documentation required by insurance companies. This results in delays in the processing of claims.
- Most microinsurance schemes cover clients (who are usually women), whereas the real need reported by low-income families is to cover the breadwinner (usually a husband or son).
- To reach large numbers of clients, a microinsurance product must be simple, with easy-to-understand terms and conditions (riders can be confusing and complicate claims processing).

## Money Transfers

Money transfers are increasingly talked about but have still drawn little attention in the region. As discussed in section 3.1.5, the use of the post office money order for remittances to low-income families from migrant relatives has been a tradition for more than half a century. In the modern world, however, analysis shows that the money order imposes very high transaction costs on the remitter and the family. In India, the post office charge for the money order amounts to 5 percent of the remitted amount. Given that most postal

carriers in north India are prone to collect an informal “delivery fee” on the order of 2 to 5 percent from the low-income recipient as well, the cost of the service becomes prohibitive and results in the use of the money order only where and when there is no alternative.

A couple of “alternative” experiments such as Adhikar and ICICI Bank in India are in progress and a BRAC-Western Union collaboration has been launched in Bangladesh. Yet, the total value of domestic remittances (in-country

<sup>66</sup> See <http://www.basixindia.com/insurance.asp>.

<sup>67</sup> Roth, Churchill, Ramm, and Namerta 2005.

<sup>68</sup> Culled from CGAP paper on microinsurance and Pathak 2005.

transfers) in India alone is estimated to be \$4 trillion in 2000.<sup>69</sup>

In Pakistan, First MicroFinanceBank is one of the key providers of the remittance service to all kinds of clients. According to the SBP regulations, however, microfinance banks are allowed only domestic remittances. Hence, transfers are generally made from major cities in Pakistan to upcountry areas (small towns or villages) by main earners for their families' household requirements (like living expenses, education fees, or hospitalization and other health needs). Remittance services of the bank are also used by upcountry traders to pay wholesale suppliers sending goods from city-based depots.

Notable initiatives in the microremittance market in India include the following:

- Adhikar, an NGO in the eastern Indian state of Orissa, started a money transfer service (*Shramik Sahajog*, help for the worker) in 2002 targeting migrant Oriya laborers working in the western state of Gujarat. NGO staff collect remittances from the workers in Gujarat and deposit it in a
- single account in a local commercial bank with branches in Orissa and Gujarat. Twice a week, this money is transferred internally between the bank's branches to the NGO account in Orissa. Adhikar staff then deliver the money to the remitter's family in Orissa. Thus, Adhikar provides doorstep collection and delivery for a service fee of 3 percent.<sup>70</sup>
- As of September 2005, Adhikar offers this service in two districts of Gujarat (Surat and Gandhidham) to a total of 960 clients and an average amount of Rs 3,400 (\$75) remitted per member. Costs in the Adhikar scheme are low because most of the migrants are from the same district in Orissa where the NGO also runs its microfinance operations.
- ICICI Bank has linked its international money transfer service (Money2India) with village-level kiosks. This is expected to eliminate the need for villagers to travel to towns or ICICI Bank branches. The kiosk operator will inform the recipient when the money is transferred, and the latter can collect at the kiosk (through a low-cost automated teller machine [ATM]) or at the local bank branch. The bank estimates that a kiosk can profitably service a village (or group of villages) of 2,000 households.

## Microleasing

Microleasing is an “underutilized tool”<sup>71</sup> in microfinance, especially in rural areas. As the World Bank discussion paper notes, “Leasing has the potential of partially addressing the market failure in rural credit...Apart from the benefit of access to a means of financing equipment, leasing is also likely to be more affordable to rural enterprises than are loans.”<sup>72</sup> Leasing overcomes most of the collateral constraints with low down payments and much lower equity (or borrower contribution to the asset) than often required by lenders. However, the growth of microleasing is constrained by an overall lack of experience with leasing as a tool in South Asia. According to the World Bank discussion

paper, leasing facilitated just 7 percent of overall productive investment in Pakistan and an even lower 3 percent in India. South Asia has few experiences with microleasing.

Grameen Bank has been offering microleases in Bangladesh for more than 10 years, but no other major player in the market has followed their example. Grameen Bank has offered this product since 1992 with an average lease amount of \$364 and total outstanding lease portfolio of \$22 million in 2002/03. The lease enables the purchase of equipment for rural microenterprises. Lessees are selected among existing microfinance clients, which tend to be those who are better off and have additional sources of income. No down payment is

<sup>69</sup> Isern et al. 2005.

<sup>70</sup> By comparison, post office money orders in India cost 5 percent, there is no doorstep collection (although there is delivery) and there are problems with postal carriers expecting a “commission” on the remitted amount from the recipient. In practice, this effectively doubles the cost of the money order to the sender.

<sup>71</sup> Nair, Kloeppinger-Todd, and Mulder 2004.

<sup>72</sup> Ibid.

required from the lessee and a 20 percent flat interest rate is charged. Flexible repayments include allowing lessees to repay the entire amount if they wish.

Two private companies in Pakistan, Orix Leasing and Network Leasing, offer specific microleasing products, and have around 5,000

and 2,000 microclients, respectively. Network Leasing has a greater focus on microenterprises than Orix.

Greater focus on leasing is required to build in these experiences and enhance the suitability of the product for microclients.

## Conclusions on Microfinance Products

Despite the diversity of products offered in South Asia, in practice, the average microfinance client's relationship with an MFI can be defined by a fairly standard set of obligations:

- Attendance at regular weekly (fortnightly or monthly) meetings of the group
- Training in "loan utilization" or participation in discussions of development issues, such as social discrimination, gender awareness, health, sanitation, and education (optional)
- Contribution of fixed amounts, termed "savings," to a fund managed by the group or by the MFI with direct access of the member limited or even barred
- Repayment of fixed amounts as installments (weekly, fortnightly, or monthly) on any loan she or he obtains from the MFI or from the group
- Visits from MFI staff or the institution's guests to verify loan utilization or to assess impact formally or informally (occasional)

What the client actually receives in return for fulfilling these obligations are as follows:

- Fixed amounts of loan apparently "for productive activities" with the size of the loan usually determined by the longevity of his or her relationship with the MFI or, in the case of some cooperatives and CBOs, by the volume of savings rather than by financial needs
- Emergency loans for "consumption"—in the case of some MFIs/CBOs—but relatively small amounts and subject to the approval of her

group

- A small pool of savings resulting from her or his compulsory deposit available to her or him if she or he decides to withdraw from the program
- In some cases (especially Grameen Bank in Bangladesh, CBOs in Sri Lanka, and microfinance development banks in Nepal and Pakistan), access to flexible and voluntary deposit services
- Insurance—provided by a risk fund or insurance fund created by a few MFIs or by an insurance company in collaboration with the MFI
- In the case of SHGs and some cooperatives, a degree of empowerment based on a sense of belonging to a group with similar social concerns and reinforced by knowledge and understanding of issues in the financial management of group funds

By and large, fulfilling these obligations results in enhancing the ability of the microfinance client to meet his or her need for funds for productive activities, health and education services, and life cycle events. Enhancing ability is not the same as enabling complete fulfillment of those needs, however, and research studies have shown that most microfinance clients have loans from other sources as well. One study of the programs of 20 MFIs in India showed that 75 percent of MFI clients must also borrow from other sources<sup>73</sup> and that 58 percent of their total borrowings are obtained from these other sources. Another study in Bangladesh shows that 31 percent of

<sup>73</sup> EDA 2003.



households borrow from sources other than a single NGO-MFI, but these data are likely to be highly understated because there is considerable apprehension (in Bangladesh) about reporting borrowing from multiple MFIs.<sup>74</sup>

However, as discussed in chapter 2, microfinance outreach to the genuinely poor is achieved among less than 15 percent of the population in all countries of South Asia except Bangladesh and Sri Lanka. The average for the region as a whole is just 17 percent. One reason for this poor outreach is the rigidity of products: poorer clients need products that provide them with the flexibility to deposit money and to borrow very small sums of money (equivalent to a few dollars at a time) almost on a daily basis. Except for SafeSave's famous experiment in Bangladesh, this model has not been tried by MFIs. Regarding the depth of outreach, even the results of SafeSave's experiments are mixed thus far; its client profile is doing little more than reflecting the overall income distribution of the slums in which it operates. While SafeSave has now reached sustainability, the 45 percent effective interest rate charged by it on borrowings (relative to 6 percent paid on deposits) is somewhat higher than the rates that are politically acceptable in the region.<sup>75</sup> So, although a greater emphasis on deposit and insurance products may be the key to increasing depth of outreach in microfinance, balancing this emphasis with an equally important concern for sustainability has not yet been achieved. Thus, the debate about "plain vanilla" (the Ford motor model of ASA in Bangladesh<sup>76</sup> and of much of Pakistani microfinance) versus product variety rages on; however, inevitably, the increasing concern for social performance in microfinance is likely to result in a greater focus on product relevance to meet the needs of the poorest.

Although the practice of microfinance has made some contribution to the lives of low-income families in South Asia, questions still exist about the extent to which it fulfils its purpose. Ultimately, whether or not microfinance has a substantive impact on a microfinance client's social and economic status is a matter of debate. This debate is summarized in chapter 7 after a discussion of MFI performance in chapter 6.

<sup>75</sup> EM-CRIL 2006.

<sup>76</sup> Fernando and Meyer 2002.



# Transparency and Performance:

Seeking sustainability and depth in a complex environment

The effectiveness of institutions in providing financial services to low-income clients can be seen from a number of angles. These include the following:

- Breadth of outreach—the extent to which low-income families are able to obtain financial services
- Depth of coverage—the extent to which coverage actually reaches the poor and poorest sections of the population
- The scope and quality of services offered by providers—the extent to which they are able to provide appropriate types of services and whether the needs of clients are met
- Sustainability—the longevity of financial services provision to low-income clients as determined by the sustainability of institutions providing such services.
- The relationship between depth of outreach and sustainability in serving the financial needs of low-income clients.

Breadth of outreach and some broad indication of depth of coverage were discussed in chapter 2. The fourth and fifth angles (sustainability and relationship between depth of outreach and sustainability) are discussed in this chapter. More detailed coverage of depth of outreach and the methodology for collection of data on this indicator are discussed in the following chapter on the impact of microfinance. Chapter 7 also covers means of obtaining feedback on client satisfaction and determining the scope and quality of services offered by microfinance providers.

But first to transparency: judgments of the effectiveness of institutions engaged in providing microfinance services can be made only if information on the performance of institutions is readily available in a usable form. This chapter begins with a discussion of the state of transparency in South Asia before discussing sustainability and depth of outreach.

## Transparency<sup>77</sup>

All stakeholders in microfinance may need (or use) product and performance information:

- Directors and managers to improve operations and planning institutional growth
- Investors and donors to make sound investment decisions and tracking subsequent performance
- Regulators to assess and ensure prudential performance

- Clients to determine the most reliable and convenient provider of financial services
- Industry analysts to map sector performance, make interinstitutional comparisons, and establish performance benchmarks.

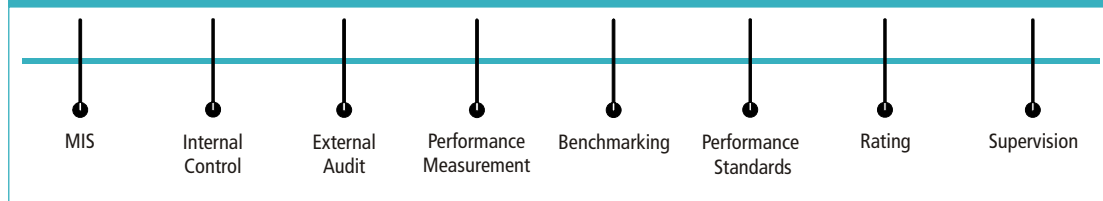
The MIX Market has identified a continuum of information systems and processes that provides for the production, testing, dissemination, and use of information about

<sup>77</sup> The discussion in this section is based on The MIX 2006. This document emerged from a major initiative to document the state of transparency in the region sponsored by the World Bank as part of the Year of Microcredit Initiative in South Asia.

the performance of MFIs. The components of the transparency spectrum are the essential building blocks of standard reporting and disclosure. Figure 6.1 illustrates this spectrum from (1) primary information generation through the management information system, (2) quality assurance through internal controls,

which are validated by (3) external audits, leading to (4) performance measurement. This facilitates (5) benchmarking against (6) performance standards and risk assessment through (7) rating along with (8) supervision for risk management within reasonable limits.

**Figure 6.1. The MIX's Building Blocks of Transparency**



Source: The MIX 2006.

Note: MIS = management information system.

## Industry reporting

Microfinance service providers in South Asia monitor their expansion in terms of numbers of clients, disbursements, loan volumes, and funding sources. M-CRIL's experience, however, shows that even here borrower numbers and client numbers (in terms of numbers of people who conduct deposit or credit transactions with MFIs) are often confused by inconsistencies in recording and monitoring dropouts. This confusion is combined with a lack of consistent data on institutional performance (only the leading MFIs tracking it consistently). As in the bank-SHG link program, an undue emphasis is placed on cumulative measures, following a project-based approach that fails to track the process of financial inclusion in an effective manner.

## External audits

External audits generally are regular to comply with the requirements of donors or commercial funders. However, these audits are useful only for assessing the extent to which appropriate accounting policies are followed and not for understanding the MFI's financial position.

Audited statements fail to provide disclosures in keeping with international reporting norms, although this is not the case for the leading MFIs, such as those registered as microfinance banks in Pakistan and NBFCs in India.

## Performance monitoring initiatives

Performance monitoring initiatives in South Asia are undertaken by national networks and apex finance institutions. The latter publish only aggregate data on outreach and portfolios with institutional data kept out of the public domain. This is the case for PKSf in Bangladesh (with its 200 plus partners) and SIDBI in India with more than 40 partners. The MFI networks do collect and compile MFI data, but the quality and coverage varies greatly. These data include the directories of the Nepali and Bangladeshi networks, the more analytical but limited effort of Sa-Dhan, the Indian network, and the more comprehensive effort of the PMN's *Performance Indicators Report*, although this covers a much smaller microfinance sector.

The situation of rating and regulation in the region is discussed in chapter 8. As The MIX's transparency report concludes,

a small and growing number of initiatives are beginning to pierce the veil around MFI performance in the region. In the most highly leveraged sector—India—expert ratings offer investors an accurate picture of performance and investment potential in microfinance.<sup>78</sup>

According to the report, initiatives in Pakistan and Bangladesh to improve and standardize financial statement disclosures for microfinance (1) support MFI managers in

improving the performance of their institutions, (2) increase the likelihood of appropriate investment, and (3) improve supervision by investors and regulators (where applicable). As the report argues, these initiatives have a public and a private goods element and greater support needs to be made to improve transparency because better financial disclosures and information hubs “will secure the achievements of microfinance for the region.”<sup>79</sup>

## Sustainability

As the above discussion indicates, the leading microfinance service providers in the region are also “best practice” institutions. Rather like outreach, there is a substantial concentration of sustainable operations in a few, usually large, institutions. Each country has relatively few institutions that provide microfinance services on a sustainable basis. In general, the sustainable institutions are also the largest institutions in which substantial proportions of the microfinance clients in each country are concentrated.

As discussed earlier, microfinance in [Afghanistan](#) has been promoted by a multidonor facility known as the Microfinance Investment Support Facility for Afghanistan (MISFA). The capital base for MFIs in the country has been created using MISFA (and international NGO partners) grants to cover start-up costs and operating expenses. The long-term vision of this process is to reduce grant funding gradually and for MFIs to cover expenses increasingly through operating profits. MISFA has been operating only since late 2003 and the trend so far has been encouraging: grant funding of operating expenses averaged about 70 percent of the combined income of assisted MFIs in the first year and 50 percent in the second year, and should decline to less than 25 percent during

2006. Two MFIs reached the level of having sustainable operations during 2006 and the overall indicators are quite positive with good portfolio quality—most MFIs have a PAR of less than one day (less than 1 percent) and a sufficient service charge (32 to 50 percent) to cover expenses and become sustainable within five years of beginning their operations. Only 1 of the 12 NGOs that have been funded so far by MISFA, however, can be said to be an Afghan organization managed by Afghans. All the MFIs plan to become Afghan organizations as soon as appropriate laws are in place and all of them are investing in the development of Afghan staff.

Evidence on sustainability from [Bangladesh](#) is encouraging. Much of Bangladesh's reputation as the home of microfinance (certainly in Asia) is based on the dramatic outreach achieved by the four large organizations and by the large numbers of MFIs (more than 700) in the country. Based on a sample of 16 MFIs (including ASA and BRAC and 14 other small- and medium-size NGO-MFIs), a recent study confirms the picture of overall good performance.<sup>80</sup> The study, using information reported by the 16 MFIs found that the following:

<sup>78</sup> Ibid.

<sup>79</sup> Ibid.

<sup>80</sup> Rasmussen, Alamgir, Ahmad, and Ahamed 2005.

- Average loan sizes have increased over time, leading to greater efficiency and profitability.
- Operations are efficient with a cost ratio (total expenses divided by total amount disbursed in a year) of 9 to 10 percent (weighted average). ASA leads the way with a cost ratio of only 3 percent.
- Portfolio quality appears to be good and consistent over time (on-time recovery rates exceed 97 percent).
- All the MFIs have profitable operations even after adjusting for subsidies—
  - Return on assets (ROAs) for most MFIs are in the range of 5 to 7 percent (adjusted ROAs of 3 to 4 percent), and
  - Financial self-sufficiency (FSS) of 120 percent or higher (ASA greater than 170 percent).

The difficulty of using self-reported information, however, is that definitional and accounting variations across organizations can cause result a more favorable impression to emerge than may be appropriate. An analysis of information from 14 MFIs undertaken by M-CRIL using information collected and verified by its analysts (mainly during 2003 and 2004) presents a modified picture. The 14 Bangladeshi MFIs rated or assessed by M-CRIL demonstrated the following characteristics:<sup>81</sup>

- A high weighted average OSS of 92 percent, with 5 of the 14 having OSS less than 80 percent. This indicates that the three best performing MFIs were also the largest, serving (among them) more than 70 percent of the number of total clients.
- A relatively high degree of subsidy, which is indicated by their average FSS being 71 percent (and only two, Manabik Shahajya Sangstha [MSS] and BURO, with FSS higher than 100 percent).
- Average *unadjusted* ROAs of -5.1 percent with only five reporting positive returns.
- Portfolio quality, measured by the PAR ratio (more than 60 days) at fairly good levels with just 5 of the 14 having PAR<sub>60</sub> in excess of 5 percent.

The M-CRIL information consists of weighted averages and does not cover the big four MFIs in Bangladesh, but it does include a number of the next-level MFIs (in terms of size), including BURO Tangail, Shakti Foundation, Ashrai, MSS, and Bangladesh Extension Education Services (BEES).

Essentially, the MIX report and the M-CRIL data described above confirm the overall impression that Bangladeshi microfinance has made substantial progress over the years in terms of improved performance. The excellent performance of three of the big four institutions as well as that of some of the next-level institutions like BURO Tangail, Shakti Foundation, and MSS, indicates that some 75 percent of microfinance clients in Bangladesh are served by sustainable institutions. It is also true, however, that relatively high levels of subsidy still underpin many of the hundreds of MFIs in that country. This poses a challenge to achieve full sustainability in Bangladeshi microfinance and points to the unnecessary support of a number of less viable, loss-making institutions.

More clearly, the performance of the microfinance sector in [India](#) is less encouraging if viewed from the perspective of the typical MFI, but the largest institutions that account for the bulk of the clients perform a lot better. By late December 2004, M-CRIL had undertaken 206 ratings of 131 MFIs in India. The average portfolio size of these MFIs was \$1.1 million (Rs 50 million) and the average loan size to clients was \$90 (Rs 4,029). Using a sample of 73 Indian MFIs rated between January 2002 and December 2004, the performance of typical Indian MFIs, become apparent:

- MFIs following the Grameen and individual lending models are close to reaching OSS with an average of 95 percent and 101 percent, respectively. Those working with SHGs perform less well. The average OSS of a typical MFI is 78 percent, indicating that many MFIs are not able to cover their expenses. The average OSS of SHG

<sup>81</sup> Information from the M-CRIL database. This sample does not include BRAC or ASA.

MFIs<sup>82</sup> is low at 61 percent but shows improvement from a year ago (48 percent in June 2003).

- The older (mature) MFIs following the Grameen model are most likely to feature among the commercially viable MFIs. Also, the older MFIs with links to NGOs are among the most profitable (because most of the group promotion and support costs are absorbed by the NGO).
- Although there are a large number of loss-making MFIs and relatively few viable ones, one-third of the MFIs earn profits (*unadjusted* ROA less than 0) and four have returns greater than 5 percent of their total assets. The largest MFIs account for more than 70 percent of MFI clients in India.
- As the portfolio size increases, MFIs become more capable of covering their costs through revenues and their dependence on grants and other subsidies tends to decrease.
- Political and social restrictions have constrained many MFIs from setting cost-recovering interest rates, which affects their performance. MFIs with small loans (less than \$100) are unable to achieve sustainability at the 18 to 24 percent APRs typically charged.
- There are encouraging trends over time, because rating updates reveal a picture of a mature and increasingly professional microfinance sector—
- Substantial increase (46 percent) in the outreach of MFIs during the 18 months or so between ratings;
- An increase in staff productivity and portfolio quality during this period results the following in increased profitability:
  - ▶ Improved portfolio quality (PAR<sub>60</sub> declined from 16 to 12 percent),
  - ▶ Portfolio per staff member increased from \$6,600 to \$13,700, although the average number of clients per staff member decreased from 336 to 311, and
  - ▶ OSS increased by 23 percent and FSS increased significantly by an average of 34 percent between ratings.

Although many MFIs in India have a weak equity base, their sustainability is being considerably enhanced by the aggressive tactics of some of the leading private Indian and foreign banks, which are providing them with substantial funds to manage portfolios that are carried on the banks' balance sheets. This “partnership model” enables the MFIs to increase their incomes substantially and circumvent the prudential concern of mobilizing sufficient equity to maintain an acceptable (~15 percent) CAR.<sup>83</sup>

A recent overview of the microfinance sector in [Nepal](#) found an equally difficult situation relative to sustainability.<sup>84</sup> The nine RRDBs and the microcredit development banks (MCDBs) together account for half of the total number of clients reached by MFIs in the country. The four MCDBs are profit-making institutions with ROAs on the order of 1.5 to 2.0 percent, while three of the five RRDBs are also making profits, albeit partly on the back of fund arbitrage—that is, “deprived sector” borrowing from commercial banks that is then reinvested in banks or finance companies at higher rates of interest—resulting in a positive ROA on the order of 1 percent. The midwestern and far-western banks, however, are reported to be in dire straits, although these banks are much smaller with borrower outreach at less than 10,000 each. Despite their profits, the retail development banks are struggling against deteriorating portfolio quality (necessitating increasing loan loss reserves now in excess of 5 percent) and stagnating outreach as the political situation in the country takes its toll. The financial intermediary NGOs (Financial Intermediary Nongovernmental Organizations [FINGOs]) and SCCSs report varied performance: a number of these organizations are experiencing losses and situations deteriorated as defaults increased along with the worsening political situation in 2003.

<sup>82</sup> These MFIs channel microfinance services through SHGs. The quality and performance of SHGs as a group of institutions is equally an issue but cannot be definitively discussed for lack of detailed data.

<sup>83</sup> For a further discussion of the issue of equity and leverage in Indian MFIs, see M-CRIL 2005a.

<sup>84</sup> ADB 2004.

The context and history of Pakistan have made the provision of microfinance on a sustainable basis particularly challenging, partly because of considerable pressure from government officials, elected representatives, and the press to have low interest rates. Whatever interest rates MFIs might say they are charging, nominal yield on gross portfolio numbers from 2004 for the larger MFIs shows that only three (all NGOs) had yields that were as high as commonly found in Bangladesh. The others had yields below 18 percent, a level that is more than 10 percent below that typically found in Bangladesh. At this level, it is quite difficult for MFIs to cover all their costs. Recent analysis of performance trends in the sector from 1999–2005 shows that the main factor that must change if MFIs are to become financially sustainable is to increase yields on portfolios to levels that will allow for sustainability.<sup>85</sup>

Another issue with respect to sustainability, which is more pronounced in Pakistan than in many countries, is that almost all the NGOs have multidimensional programs that provide a range of services to poor people. This often makes it difficult to allocate costs among functions to analyze financial performance by each function.

The only MFI that, to date, has become fully sustainable, with a positive adjusted ROA, is the Kashf Foundation. Kashf had a clear vision from the beginning that it would focus on microfinance only, be managed mainly by women for women, and target financial sustainability within five years of starting up. It became financially sustainable in its fifth year. This is in contrast to the larger, older organizations, including AKRSP (converted into First MicroFinanceBank in 2001) and the Orangi Pilot Project, which still have not achieved financially sustainable microfinance operations.

Donors also influence sustainability. Relative to

market size, more subsidized donor funds have gone into the sector in Pakistan over the past five years, if not even before that, than perhaps in any other country in South Asia. This is a function of the relatively early stage of development of microfinance in Pakistan. Nevertheless, most MFIs have not used these funds wisely to build sustainable operations from the start, so that subsidies were recycled into their own equity to build strong organizations over time. Most of the subsidy has, instead, been passed on to borrowers through the relatively low interest rates.

In Sri Lanka, the more than 1,500 CRBs and 7,400 registered primary societies of the TCCSs account for nearly half the market in terms of numbers of active borrowers, but many of these banks are unsustainable. The CRBs are regarded as among the more commercialized microfinance providers in the country and 80 percent of these are apparently estimated by the cooperative department to be profitable and to supply about one-third of the country's total microcredit. A "substantial proportion of the primary societies of the TCCSs (which collectively supply about 15 percent of the total outstanding microloans) provide microfinance on a profitable basis."<sup>86</sup> However, while "many of the larger and more established cooperatives have achieved profitability, most remain small and financially fragile."<sup>87</sup> Accounting practices in such institutions are not standardized, and it is not known how many of these institutions would be profitable after appropriate adjustments for loan loss provisions, write-offs, and subsidies are made.

The other large microfinance program is the Samurdhi Programme, the government's main poverty reduction activity. This is partly a conventional government lending program operated by state-owned banks, and it suffers from the usual weaknesses of government programs: subsidized interest rates and high default rates (of 30 to 50 percent). This results

<sup>85</sup> Burki, Bano, and Chen 2006.

<sup>86</sup> Charitononko and de Silva 2003.

<sup>87</sup> Ibid.



from the high degree of political influence in the credit decision-making process. The other part of this program consists of the approximately 1,000 SBSs with some 1.8 million members. The scheme as a whole is reported to have an impressive number of active loans (some 350,000) and high on-time recovery rates, and to charge interest rates of around 3 percent per month, which should cover operating costs. Although recovery rates are uneven, the scheme has a credit guarantee scheme and two insurance schemes to secure its operations.<sup>88</sup>

Overall for South Asia, the MFI level is variable. All countries have high levels of subsidy from foreign donors (Afghanistan, Bangladesh, and Pakistan) or from governments (Sri Lanka and, to some extent, India) and eroding net worth of cooperatives (India and Nepal). Problems with efficiency in microfinance service delivery, particularly in terms of ineffective management and control systems as well as poor recovery performance, are compounded throughout the region by “social control” of interest rates. Politicians (and bureaucrats) in all countries are known periodically to raise the bogey of “high” interest rates in microfinance without reference to the clear economies of scale in microfinance service delivery.

Currently, action against MFIs resulting largely from the interest rate bogey has become a major impediment to the growth of microfinance in India's leading state of Andhra Pradesh and is an area of concern in other countries of the region as well. Pressure on microfinance interest rates has come in recent years from politicians in Bangladesh and Pakistan and from the Maoist insurgents in Nepal. In this context, it is perhaps not surprising that there is no flagship commercial bank in the region, such as Bank Rakyat Indonesia, Khan Bank of Mongolia, or ACLEDA Bank of Cambodia.

To the extent that achieving an overall reduction in interest rates in microfinance is a

desirable objective, the evidence suggests that this cannot be effectively or efficiently accomplished simply by imposing interest rate caps—whether mandated or socially imposed. The usual response of microfinance service providers to perceived limits on interest is to maximize their yield on portfolio by introducing complex variations in pricing,

- Establishing methods of calculating the interest rate—reducing balance or flat charge
- Charging upfront fees such as loan processing fees or passbook charges
- Varying the payment frequency—monthly, fortnightly, weekly—which affects the effective yield obtained from the loan
- Expecting security deposits from clients for which they pay low or no interest

In practice, therefore, while attempts to impose such caps have created some downward pressure on the pricing of microfinance loans, the actual effect has been limited. Thus, although MFIs in India have, for a number of years, felt the pressure to reduce their nominal interest rates and certainly to limit such rates to around 20 percent per year, M-CRIL's database shows that, across 89 of the leading MFIs, the effective interest rate charged is in the range 12 to 36 percent with the typical MFI charging 24.6 percent and the weighted average effective interest rate amounting to 25.2 percent per year.

In Bangladesh, in January 2005 the apex wholesaler (PKSF) capped on-lending interest rates for its MFI partners at a 12.5 percent flat rate compared with the country's average flat rate for microfinance of 15 percent. All except PKSF's two largest partners, BRAC and ASA, accepted the new ceiling. Together, however, these two large MFIs constituted almost two-thirds of PKSF's portfolio and more than 40 percent of the overall market in Bangladesh. The net effect of this has been the emergence of a three-level interest rate structure in that country, with Grameen Bank at the lowest rate of 10 percent flat, PKSF partners at 12.5

<sup>88</sup> Ibid.

percent flat, and BRAC and ASA at 15 percent flat.<sup>89</sup> The 14 Bangladeshi MFIs rated by M-CRIL typically charge an effective rate of 32 percent with a weighted average of nearly 29 percent in the range (24 to 45 percent).

Although the average interest rate charged has declined slightly in Bangladesh as a result of PKSF's cap, there has not been a significant decline in the overall interest rate paid by clients. The most likely result of the interest rate cap (expected by Bangladeshi MFI leaders) is that MFIs will fail to reduce the number of service providers in the market. This would result in the average MFI in Bangladesh being larger and more efficient but lacking a guarantee that the benefits would be passed on to clients in terms of lower rates. According to the MFIs interviewed for the CGAP Focus Note, "do not expect microcredit interest rates to decline much in the next five years."<sup>90</sup>

Essentially, Bangladesh is a market with substantial competition and heavy overlapping of operational areas, but relatively little price competition. However, the CGAP study concludes that price is not the only consideration for clients who place a lot of value on quality of service, flexible product characteristics, and the availability of small loans.

Imposed price controls are risky because they limit the flexibility of providers to offer appropriate products to a diverse range of clients. Indeed, if prices are set too low, providers are likely to avoid making smaller loans to poorer clients or to exit the market altogether.<sup>91</sup>

The Focus Note's analysis of competition in three markets, Bolivia, Uganda, and Bangladesh, indicates that "to achieve a sustained interest rate decline, *sufficiently large providers must have sufficient incentive and*

*sufficient ability to reduce rates*" in terms of the relationship between their yield and operational efficiency.<sup>92</sup>

Despite the impression of culpability created by their problems with interest rate pressure, South Asian MFIs do, in fact, charge rates that are low by international standards. This is in line with their historical and philosophical poverty reduction agenda. In the context of sustainability, therefore, these microfinance practitioners can draw some encouragement from a recent survey undertaken by the Washington-based MIX Market. Information collected from 121 MFIs by the MIX is presented in figure 6.2. The survey shows that, based on the information submitted by MFIs,

as with total outreach, Bangladeshi MFIs lead the sector in profitable outreach, and profitability is not confined to a few market leaders. In a sample of 43 institutions, 35 earned positive returns, representing 96 percent of total outreach. Those that did not cover costs served far fewer clients. In India, Sri Lanka, and Nepal, profitable MFIs represent a smaller majority of clients, on average 75 percent of the respective totals.<sup>93</sup>

According to the MIX survey,

In Pakistan and Afghanistan, the majority of clients in this sample lack access to sustainable institutions. Youth and program design explain much of this dearth. In the two years since microfinance first took hold in Afghanistan, no institution has yet broken even, even though one—BRAC Afghanistan—currently has a large, growing national base of clients...(where as) only 42 percent of Pakistani MFI (clients) covered in this sample had access to sustainable microfinance service providers.<sup>94</sup>

<sup>89</sup> Porteous 2006.

<sup>90</sup> Ibid.

<sup>91</sup> Ibid.

<sup>92</sup> Ibid.

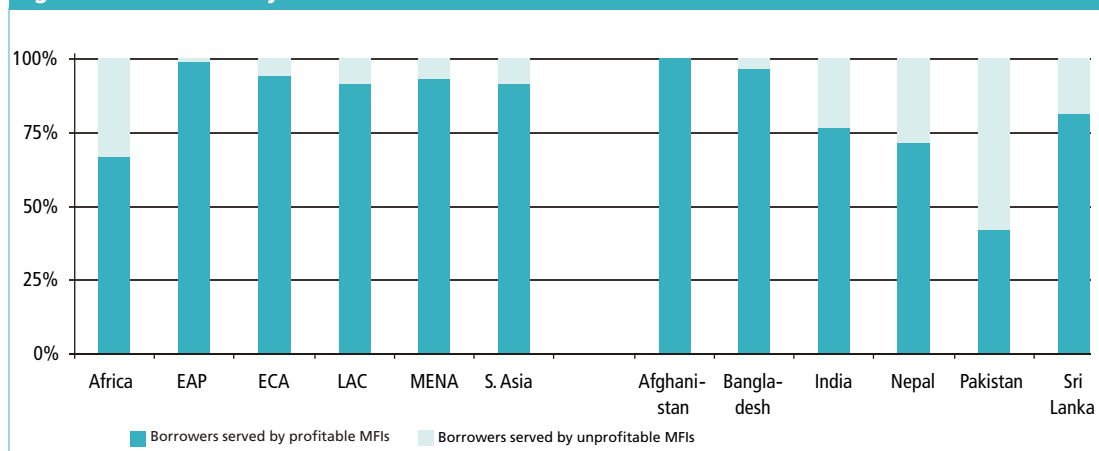
<sup>93</sup> The MIX 2006.

<sup>94</sup> Ibid.

Thus, although the performance at the individual MFI level may be problematic, perhaps inevitably it is the more sustainable

MFI that is achieving substantial growth and serving larger and larger proportions of MFI clients over time.

**Figure 6.2. Sustainability and Outreach in South Asian Microfinance**



Source: The MIX 2006.

Note: EAP = East Asia and Pacific; ECA = Europe and Central Asia; LAC = Latin America and the Caribbean; MENA = Middle East and North Africa.

Information on three of the big four MFIs in Bangladesh—available from the MIX and presented in table 6.1—shows ASA and BRAC reporting excellent performance, while even that for Grameen Bank indicates positive returns. Information for leading MFIs from other countries of the region is also presented in the table. Most of the leading independent microfinance service providers in the region are sustainable and performing well. Both Khushhali Bank and NRSP in Pakistan are government-related institutions, constrained by political compulsions, while SEEDS in Sri Lanka operates in a political environment that is even more highly charged than elsewhere in the region. In each country, these are not only the largest MFIs but also among the fastest growing institutions accounting for significant proportions of the overall clientele. The picture of financial health emerging from this table, therefore, puts the future of microfinance in a number of countries of the region in a positive perspective.

Based on information emerging from an intimate knowledge of most of these institutions,<sup>95</sup> it becomes apparent that the key to their success lies in an interplay of factors, including the quality of leadership, governance, and management, on the one hand, and the nature of the political and regulatory environment, on the other. Without a supportive political and regulatory environment, it is impossible for MFIs to provide sustainable financial services. MFI leaders must have the vision to aim for growth and sustainability as well as the capability to oversee the development of the products and systems necessary to handle larger numbers of clients and volumes of funds in an effective and efficient manner.<sup>96</sup>

<sup>95</sup> Based on ratings conducted by M-CRIL in all five countries, evaluation and appraisal studies of BRAC, and considerable exposure to the activities of ASA.

<sup>96</sup> Such systems include MIS, tracking of overdue loans, internal audits, and other controls, cash management, and financial planning.

**Table 6.1. Performance Indicators for the Leading MFIs in South Asia**

Name of MFI	No. of Borrowers (thousands)	Portfolio (million US\$)	Growth of Outreach	PAR (30 days)	OSS	ROA	OER
<b>Bangladesh</b>							
ASA	2773	201.1	30%	1.7%	269%	15.0%	6.0%
BRAC	3994	243.1	14%	8.3%	117%	3.3%	11.5%
Grameen Bank	3700	337.7	29%	8.0%	101%	0.2%	6.0%
<b>India</b>							
BASIX	90	13	53%	4.8%	103%	0.0%	15.1%
SML	369	39.1	87%	0.3%	117%	3.2%	15.9%
Spandana	386	54.6	251%	0.0%	193%	8.4%	3.7%
SKS	74	7.4	197%	4.6%	104%	1.3%	12.1%
<b>Nepal</b>							
Nirdhan Bank	46	5.1	53%	10.3%	106%	-0.2%	12.7%
SBB	40	3.6	22%	3.0%	130%	4.1%	12.5%
<b>Pakistan</b>							
NRSP	126	20.7	43%	3.2%	85%	-2.4%	9.2%
Khushhali Bank	168	23.5	84%	6.4%	53%	-4.6%	8.2%
Kashf Foundation	68	8.1	14%	0.7%	187%	9.0%	7.7%
<b>Sri Lanka</b>							
SEEDS	63	28	11%	1.1%	90%	-1.4%	6.6%

Source: Authors' compilation.

Note: ASA = Association for Social Advancement; BASIX = Bhartiya Samruddhi Investments and Consulting Services Ltd.; MFI = microfinance institution; NRSP = National Rural Support Programme; OER = operating expense ratio; OSS = operational self-sufficiency; PAR = portfolio at risk; ROA = return on asset; SBS = Samurddhi Banking Society; SEEDS = Sarvodaya Economic and Enterprise Development Services; SKS = previously Swayam Krishi Sangam; SML = SHARE Microfin Limited.

To conclude, in the practice of microfinance, the lessons from the South Asian experience are that a reliance on subsidized funding is inevitable in the early stages of the activity (as indeed are start-up losses in any new venture). Based on the performance of hundreds of MFIs in the region, if the environment and leadership conditions (indicated above) are in place, an MFI is most likely to become profitable after some three years' operations, serving some 20,000 clients and resulting in a portfolio between \$2 and \$3 million. The overall performance of MFIs in the region is

improving as the awareness of the concept of sustainability in microfinance grows. However, the speed of the improvement varies among countries at different points in time and is dictated by political pressures and the regulatory environment as much as by the awareness of good practices. Over the next few years, because the effort to create awareness of good practice is well advanced, the immediate challenge for microfinance in the region is posed by the political environment. This issue is discussed further in later chapters.

## Depth of Outreach and Sustainability

Data on the poverty profile of microfinance clients are not readily available because definitions and measures of poverty are not so clear. Most analysis has relied on proxy indicators (such as loan size) or rested on the assumption that all those outside the formal financial sector are the target group for microfinance.

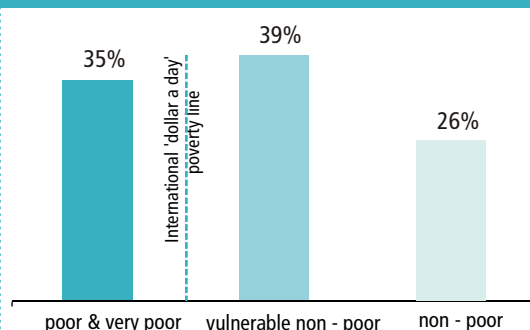
The Rural Financial Access Study commissioned by the World Bank in India examined data from SHGs in the two states of Andhra Pradesh and Uttar Pradesh. Based on statistical analysis, the study concluded that there was a “positive relationship” between *poorer* households—the second and third quintile from the bottom—and SHG membership. It also found a positive relationship between SHG membership and the *poorest* households (although this was not statistically significant).<sup>97</sup>

Another major study of the impact of MFI operations in India used qualitative (participatory rural appraisal [PRA] wealth ranking) and quantitative methods (index-based ranking, income estimate) of poverty assessment to report on the poverty profile of recent clients (less than two years old) from 20 MFIs across 9 Indian states.<sup>98</sup> A little over one-third of client households were estimated to be living below the international “dollar a day” poverty line (see figure 6.3). MFIs in India were reaching a mixed clientele that included poor and non-poor in similar proportions as reflected in the local community profile (for example, in a sample village, where 22 to 28 percent of the households are poor, around 25 percent of the MFIs clients in that village are poor).

For MFIs seeking sustainable poverty outreach, the strategy to diversify into poor and non-poor households is practical. As more MFIs commercialize and scale up their services, the

critical question will be to determine the optimum proportion of clients of different poverty levels that ensures long-term sustainability and the mission to include the poor.

**Figure 6.3. Poverty Profile of Recently Joined Microfinance Clients in India**



Source: Sinha and Brar 2005.

Financial sustainability and poverty outreach data collected from 20 MFIs in India (in 2002 and 2003) as part of the Rural Financial Access Study and 6 MFIs in Bangladesh during 2004 are presented in figure 6.4. Poverty outreach is shown in percentage terms (as a proportion of recent clients). The quadrants are shown with FSS at 75 percent or “near financial sustainability” and poverty outreach at 40 percent. The data, excluding the outliers, do not show a significant correlation between FSS and depth of outreach.<sup>99</sup>

Extending financial services to the poor does not appear to affect FSS adversely, because at least 8 of the 26 MFIs are approaching financial sustainability and have deep outreach. Five of these MFIs are Grameen model MFIs (four from India and one from Bangladesh). The remaining three are SHG model MFIs from India.

From this perspective, it is interesting to consider what factors support an effective combination of poverty outreach and sound

<sup>97</sup> Srivastava and Basu 2004.

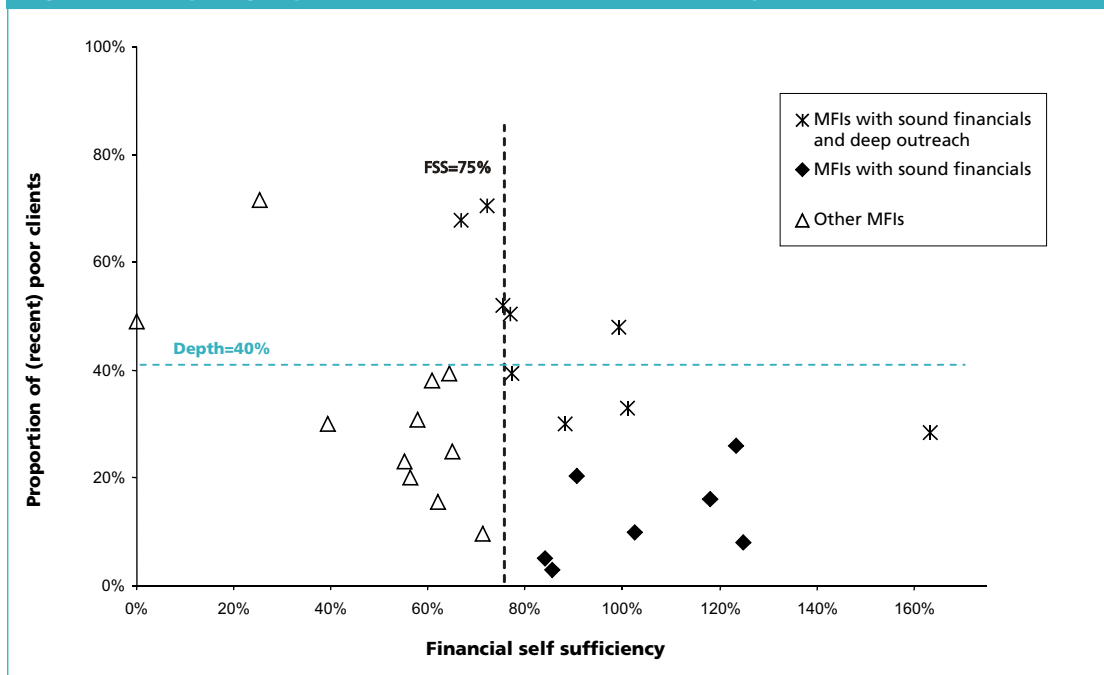
<sup>98</sup> EDA 2004.

<sup>99</sup> This discussion is extracted from Sinha and Brar 2005.

financial performance. As discussed earlier, the economic profile of an MFI's clientele tends to reflect the local community profile. MFIs with a high proportion of poor clients are located in poorer regions, or, if located in a more developed region (such as the south of India), their focus is on poorer rural areas or urban slums. The two MFIs with the deepest outreach are located in two of the poorest regions of north/northeast India (Eastern Uttar Pradesh and Assam).

Alternately, large MFIs (more than 50,000 borrowers) serve substantial numbers of poor clients (more than 5,000) by virtue of their size of operations. These MFIs may not have specific targeting criteria but succeed in including poor as well as non-poor among their clients. In the above sample, three such organizations (two Grameen model and one SHG model) have 9,000 to 15,000 poor clients.

**Figure 6.4. Comparing Depth of Outreach and Financial Sustainability**



Source: Sinha and Brar 2005.

Note: FSS = financial self-sufficiency; depth = 40 percent poor or an estimated total number of poor clients greater than 5,000.

Table 6.2 summarizes the key operational parameters for the three categories of MFIs included in figure 6.3. The data show that MFIs that combine deep outreach and strong financials, on average, charge higher interest rates to their clients (with an average APR of 29 percent compared to an average APR of 22 percent for other MFIs). This is combined with more efficient operations (a high staff productivity ratio and, consequently, a lower operating expense ratio with a larger clientele) and excellent portfolio quality.



Thus, M-CRIL's data from MFIs in India and Bangladesh indicate the following:

- There is no clear trade-off between FSS and poverty outreach. A number of MFIs are close to reaching financial sustainability without achieving this level of poverty outreach. At least an equal number have achieved—or are close to achieving—both, especially if the numbers of poor likely to be served by larger programs are included.
- Two different MFI strategies appear to enhance depth of outreach: the location of operations in poorer areas and scaling up to include a substantial number of poor clients within a large overall program; (criteria for household targeting does not appear to be implemented consistently enough to make a difference).
- Small loan sizes and lower interest rates do not ensure poverty outreach; and, because the majority of households in South Asia do not have access to formal financial services, this lack of access by itself is not a strong enough indicator of poverty.
- MFIs that balance poverty outreach with sound financial performance can run efficient operations with excellent portfolio quality.

**Table 6.2. Comparing Key Operational Parameters**

Parameters	Overall	Strong Financials and Deep Outreach	Strong Financials	Other MFIs
Number of MFIs	26	8	7	11
Annual percentage rate (APR)	26.2%	29.0%	29.9%	21.8%
Staff productivity ratio	117	320	132	101
Operating expense ratio (OER)	20.0%	15.1%	17.0%	26.1%
Portfolio at risk (PAR) greater than 60 days	10.4%	4.3%	8.9%	15.8%
Number of borrowers	14,129	25,528	15,285	5,104

Source: Sinha and Brar 2005.

It is apparent from this discussion of the link between depth of outreach and financial sustainability suggests that the view often held by government, some donors, and the public that reaching poorer people requires subsidies may not always be true. In fact, well-managed profitable organizations (such as BRAC and Kashf) that are committed to the double bottom line are doing more to increase the depth of outreach than other MFIs, even those with substantial subsidies. Ultimately, what may be required to increase the depth of outreach are not subsidies, generally and indiscriminately applied to large poverty reduction programs, but rather “smart subsidies” that can be used by efficient MFIs to cross-subsidize services specifically designed to serve the poorest families.

Equally important, is the provision of all the types of services that low-income clients need (deposits, insurance, money transfers, pensions, or, indeed, credit) and the appropriate design of such services to serve those needs in a way that makes a real contribution to improving client's lives and livelihoods. Efforts to determine the extent to which this takes place and the extent to which low-income clients are actually reached are made through studies of the impact of microfinance programs. The world of microfinance is increasingly focused on conscious measures to assess and improve the social impact of these programs. Experience with impact studies and social performance measures is discussed in chapter 7.

# Impact and Social Performance:

## Seeking the double bottom line

Microfinance is promoted as a service that has the potential to make a significant impact on the reduction of poverty in all its dimensions. The facility of small savings deposits, small and increasing amounts of credit available at a reasonable cost with easy repayment installments, microinsurance for loans and life as well as for crops and health care, and transfer services all support the growth of enterprises, increase employment and incomes, smooth consumption, and strengthen coping strategies. Given the fact that women are the majority client, microfinance can promote women's empowerment in a context in which men usually are the financial agents. These aspects relate to poverty reduction, understood not only in terms of income or expenditure levels, but also in terms of social dimensions, reduced vulnerability, and new opportunities. They also relate to the Millennium Development Goals (MDGs), thus microfinance is often cited as a key part of the global strategy to meet the MDGs.

This chapter presents the evidence for such impact, briefly discusses some drawbacks in research methodology to measure impact, and considers recent trends in the approach to impact assessment and social performance assessment.

A survey of microfinance programs in South Asia yields a long list of impact studies.<sup>100</sup> But impact data used in this chapter are drawn fairly selectively with a view toward the following:

- Present *credible* evidence from studies that use fairly rigorous research methods and avoid bias in the results, impact being defined as change that can be at least plausibly associated with, if not attributed to, involvement in a microfinance program.
- Demonstrate the contribution of microfinance programs in *different countries* toward attainment of the MDGs. Much of the evidence reported here comes from India, Bangladesh, and Pakistan. There were two studies available from Sri Lanka<sup>101</sup> and one published impact study from Nepal.
- Reflect current impact findings from more *recent* research work, with the exception of some important studies from Bangladesh.

Many of the studies focus on microcredit and therefore may be seen as an assessment of the impact of loans rather than of the range of financial services now associated with microfinance. However, at the time these studies were undertaken, microcredit was the focus of most microfinance programs. Savings products were less of a service and more a compulsory feature, with withdrawals allowed only when a client left the program. Voluntary withdrawable savings, insurance, and other financial services are a relatively recent introductions. The increasing range and variety of microfinance services will indeed add to the methodological challenges of assessing and differentiating their impact.

There is also increasing interest in assessing the impact of microfinance linked to other

<sup>100</sup> A recent detailed review of microfinance impact studies worldwide can be found in a study sponsored by Grameen Foundation USA (Goldberg 2005).

<sup>101</sup> The two impact assessments from Sri Lanka cover the Agromart Microfinance Program (funded by HIVOS) and SEEDS (funded by NOVIB). Findings and limitations were similar to those discussed in this chapter.

nonfinancial services, exploring whether such services are necessary to enhance the effects of a financial service. Few studies consider this, partly because few microfinance programs have, until now, provided such services or links to a significant number of their clients. Nevertheless, it seems most likely that the deeper the outreach of a microfinance

program (the more underdeveloped its operational area and the poorer its clients), the more relevant provision of a package of services will be (such as business links and support, skill development, and health and education inputs), although such services will not necessarily be provided directly by the MFI.

## Microfinance Impact Indicators

The MDGs provide a useful framework to measure and report on impact.<sup>102</sup> Table 7.1 shows how the set of poverty reduction outcomes articulated in the MDGs can be related to commonly used indicators in microfinance impact studies. This is especially true of the first indicator (*eradicate extreme poverty and hunger*), to the extent that microfinance does reach the poor and the “extreme poor” directly or indirectly, and the third (*promote gender equality and empower women*), because the majority of microfinance clients are women. The indicators relate to direct outputs of microfinance services (*accumulation of savings, use of credit, use of special loans, insurance*) as well as to the potential effects of increased income resulting from the productive use of microfinance.

### Impact of microfinance on poverty

The poverty impact of microfinance is approached in a number of ways. One approach is to look at a *reduction* in overall household poverty by using a measure of household income or expenditure or by applying a broader measure such as wealth ranking by incorporating different indicators to reflect various dimensions of poverty. A second approach is based on an understanding of the vulnerability to risk and shock of poor households and investigates a household's

ability to maintain consumption levels despite fluctuations in overall income. Both of these approaches are important, with the first depending on a longer time frame for impact and the second able to capture shorter-term effects of microfinance. A few studies are based on examining dropouts who may represent “missed opportunities.”

Studies from the 1990s of MFIs in Bangladesh (ASA, BRAC, Grameen, and other MFIs using the Grameen model) reported that client households in both rural and urban areas improved income levels by 8 to 40 percent as a result of the use of microcredit and acquired physical assets (productive and household) and financial assets (cash savings) in significantly higher proportions than nonclients.<sup>103</sup> Similar results emerged from a World Bank study using panel data from a 1991–92 baseline followed by a 1998–99 resurvey of clients from three major microfinance programs (Grameen Bank, BRAC, and the Bangladesh Rural Development Board) to calculate increased annual household expenditure of Tk 20 on each additional Tk 100 of credit provided to women.<sup>104</sup> The same study showed (1) a small reduction in poverty, (2) an 18 percent decline in poverty in program areas compared with a 13 percent decline in nonprogram areas, and (3) a substantial contribution to consumption smoothening, with microcredit reducing variability of consumption across lean seasons for 50

<sup>102</sup> The MDGs are as follows: (1) eradicate extreme poverty and hunger; (2) achieve universal primary education; (3) promote gender equality and empower women; (4) reduce child mortality; (5) improve maternal health; (6) combat HIV/AIDS, malaria, and other diseases; (7) ensure environmental sustainability; and (8) develop a global partnership for development.

<sup>103</sup> For example, BIDS 1990, IMEC 1995, Rahman 1996.

<sup>104</sup> Khandker 2005, updating Khandker 1998. By comparison, the study found that male borrowing did not increase household expenditure at all, which seems surprising. Are men perhaps less likely than women to report their expenditure fully?

percent of clients, although the overall consumption level of clients remained the same.<sup>105</sup>

An impact study of the SEWA Bank in India compared client household incomes between 1998 and 2000. It showed that credit services

raised household income by increasing revenues of microenterprises supported by loans. Over the two years, fewer clients than nonclients reported reduction in consumption levels. Yet, while some client households moved out of poverty, some slipped back, resulting in a slightly increased poverty rate (40.9 percent

**Table 7.1. Microfinance Impact Indicators**

Levels and Indicators of Impact	Link to MDGs			
	1 eradicate poverty and hunger	2 universal primary education	3 gender equality and women's empowerment	4, 5, and 6 reduce child mortality, improve maternal health, combat other diseases
<b>Household: Economic</b>				
⇒ Increase in savings	✓			
⇒ Increase in household and housing assets <sup>a</sup>	✓			
⇒ Consumption smoothening/improved diet <sup>a</sup>	✓			
⇒ Reduced dependence on moneylenders	✓			
⇒ Reduced overall incidence of poverty	✓			
<b>Household: Social</b>				
⇒ Increased decision-making role for women			✓	[✓]
⇒ Increased participation by women in own or household enterprise			✓	
⇒ Improved school enrollment rate for children <sup>a</sup>		✓	✓	
⇒ Increased spending on health care				✓
<b>Enterprise Supported by Microcredit</b>				
⇒ Increase in productive assets	✓			
⇒ Improved profits	✓			
⇒ Increased employment (self, within client household)	✓			
<b>Wider Effects</b>				
⇒ Improved social capital network for women			✓	[✓]
⇒ Increased hired employment in enterprises	✓			
⇒ Other multiplier effects—forward and backward links from increased enterprise activity and consumption <sup>b</sup>	✓			

Source: Authors' compilation.

Note: a. These may be the direct effect of microfinance (use of a microloan, withdrawal of savings, or, in the case of health expenditure, microinsurance) or the result of increased income, or both.

b. Not yet documented.

<sup>105</sup> Pitt and Khandker 1998; Morduch 1998.

in 2000 compared to 39 percent in 1998).<sup>106</sup>

A more recent study<sup>107</sup> of 20 MFIs in India reported that on practically all indicators of a comparison with nonclients showed significant benefits to clients, with a more significant impact on poorer households (see table 7.2).

**Table 7.2. Poverty-Reducing Effects of Microfinance (poor clients of Indian MFIs)**

	Client	Nonclient	Difference
% acquired a productive asset in previous year	36%	14%	21%
% with multiple sources of income	67%	50%	17%
Dependency ratio <sup>a</sup>	2.70	2.93	-0.23
% reporting increase in household income	45%	26%	19%
% with savings	98%	28%	70%
% borrowed from money lender in previous year	36%	53%	-19%

Source: EDA 2005.

a. Total number of members per earner in the household.

In 4 of the 20 MFIs, it was possible to compare the wealth ranks of long-term clients with recent clients. The comparison indicates a movement of client households into less poor wealth rank categories. Nevertheless, 30 percent of long-term clients (averaging five years with a microfinance program) were still poor, confirming that the potential effects of moving *out of* poverty do not accrue to all clients and can take considerable time. And dropout rates were slightly higher for the very poor (8 percent) compared with other wealth ranks (less than 6 percent).

The same study, which covered different models of microfinance (SHG, Grameen, and individual banking), suggests that direct poverty-reducing effects are more evident in

the Grameen model, which combines substantial poverty outreach with a focus on credit for direct investment. In MFIs that offer larger loans through an individual banking approach catering to relatively better-off clientele, the use of microcredit in small enterprises that hire nonfamily labor can have an indirect poverty effect by supporting income-earning opportunities for nonclients. The study also found that 25 percent of supported enterprises in such MFIs were employing hired labor.

Results compiled from various impact studies of the SHG-bank link program in India report a substantial economic benefit accrued to member households, although a comparison with a control group of nonmembers is made in only one of the three studies cited.<sup>108</sup> In all three studies, SHG members reported that the average increase in family savings and household asset values was between 30 and 50 percent two to three years after joining the group. Another study of the clients of a Grameen model MFI documents a marked shift in employment patterns of clients, from irregular, low-paid daily labor to more diversified family business as a result of SHARE loans.<sup>109</sup> Using microcredit, livestock was the most widely acquired productive asset in client households.

In [Pakistan](#), a survey of around 3,000 clients and nonclients of Khushhali Bank reported higher incomes and sales for rural clients dependent on agriculture and for urban clients with family-run microenterprises, compared with nonclient households. In rural nonfarm and animal enterprises, clients showed higher value assets but no increase in income.<sup>110</sup> Another survey of PPAF clients showed a small reported increase in income of borrowing households compared with nonborrowers.<sup>111</sup> Higher incomes enabled the borrowers to

<sup>106</sup> Chen and Snodgrass 2001.

<sup>107</sup> EDA 2005.

<sup>108</sup> GTZ 2005.

<sup>109</sup> Todd 2001.

<sup>110</sup> Montgomery 2004.

<sup>111</sup> PPAF 2004.

invest more in their houses and spend more than two times as much on house repairs compared with nonborrowers.

The abovementioned studies report evidence of the role of small loans in enabling clients to reduce their dependence on irregular income sources and improve their ability to sustain consumption when faced with income shocks. Thus, there is evidence for the contribution of microfinance to the reduced vulnerability of client households, although evidence for overall poverty reduction is less clear-cut.<sup>112</sup> In general, however, and this is not usually quantified, the contribution of microfinance depends on the starting point, or relative poverty level, of each client household as well as the type and quantity of microfinance accessed. Context issues affect the impact of a financial service alone, for example, risks faced by low-income households (monsoon in India's rainfed regions, floods in Bangladesh, illness and the high cost of medical care, and the high cost of social obligations, such as dowry), differences in economic sectors and market access, and the challenges of building higher earnings, especially for women.

### Impact of microfinance on gender equality and women's empowerment

MFIs in South Asia have mainly targeted women, and this strategy may in part be *instrumental* in empowering women. Men are not attracted by small amounts of savings and credit, while women are interested and willing to attend group meetings, and also are perhaps more amenable to thrift and repayment discipline. Nevertheless, there is an underlying assumption that providing women, rather than men, access to financial services, especially as part of a mutually supportive group, is in and of itself a step toward gender equality, with an expectation that this can, in turn, be empowering. In the context of the poverty

reduction goal, women are seen as more likely than men to use their earnings for the benefit of their household. The latter would clearly depend on whether women do increase their “own” earnings and make decisions on the use of those earnings.

Several studies have focused on the impact of financial services on South Asian women, although with varying interpretations, reflecting a tension among different measures of empowerment. Indicators such as self-confidence, status in the family, and role in decision making are positive but difficult to assess in practice, being subjective and liable to change with age and family status. Other indicators appear to be more objective, for example, “control” over the loan and ownership of assets, but these indicators reflect a more individualized notion of women's empowerment and have less positive results in much of South Asia where a strong patriarchal culture limits women's roles.

Studies in [Bangladesh](#) have documented a positive impact for women, personally, within the household, and in terms of community participation.<sup>113</sup> Indicators of empowerment include personal mobility, ability to make small and large purchases, involvement in household decisions, communication between husband and wife, political and legal awareness, and involvement in as well as access to social networks. Generally speaking, a woman's contribution to household income and ownership of assets has been a significant contributing factor toward her increased self-worth and improved family status.

Other studies<sup>114</sup> have looked at the issue of women's “control” over loans and their involvement in microenterprises, and challenged the notion of empowerment through microcredit. This approach is reflected in a review of impact studies from [Pakistan](#) that found that most women borrowers have

<sup>112</sup> Compare Zaman 2004.

<sup>113</sup> Pitt, Khandker, and Cartwright 2003; Kabeer 1998; Hashemi, Schuler, and Riley 1996; Todd 1996.

<sup>114</sup> Goetz and Sen Gupta 1996.



only partial control over loans or hand them over entirely to male relatives.<sup>115</sup> The review also compares microcredit programs with women and men clients and comments on the much smaller number and amount of loans provided to women. This may not mean, however, that benefits are nonexistent. Some researchers emphasize the idea that household members, men as well as women, pool their investments and may jointly participate in investment and other decisions. Within existing socioeconomic structures, women benefit from being one of the channels of credit to the household, even if the credit is employed in a male-run enterprise in which women may have little involvement. Studies of Grameen and BRAC borrowers suggest that even if women do not have control over the loan amount, they are still “more empowered” than women who have not borrowed at all.<sup>116</sup> However, other researchers who define empowerment as “an expansion in the range of potential choices available to women” rule out the automatic assumption of a direct correlation between empowerment and women's access to credit.<sup>117</sup>

In [India](#), studies of the SHG-bank link program<sup>118</sup> report an increase in the self-confidence and decision-making ability of women after participation in group credit and savings activities. More women members were self-confident after joining the groups and were able to make a greater contribution to the family income compared with nonmembers.

Similarly, a baseline study of 20 MFIs<sup>119</sup> in India comments on the supportive approach of the SHG model in which women members may develop the capacity to manage group financial transactions themselves, with opportunities for social networking. Nevertheless, cultural differences were found to affect the scope for women's empowerment and economic activity, being less restrictive in the south of the

country compared with the north, and less restrictive in urban areas. This study also comments on the fact that programs that include women and men clients lend more to men than to women, something that women clients also noted.

A study from [Nepal](#) also considers a SHG approach under the Women's Empowerment Programme (WEP), which combined savings-led microfinance with a strong literacy curriculum that covered group strengthening, business development, empowerment, and community activism. The evaluation found that more than two-thirds of women reported an increase in their household decision-making role (sending a daughter to school, buying and selling property, family planning, and children's marriage). This increased role was attributed to WEP meetings held several times a week that used literacy materials to emphasize the potential for change. The majority (90 percent) were engaged in an income-generating activity after joining WEP, usually a household enterprise rather than an individual enterprise, compared with less than one-third before membership in the group.<sup>120</sup>

Evidence of social action through women's groups comes from a forthcoming study of SHGs in India that reports examples, at the village level and across village clusters, of women who are gaining the confidence to become involved in community affairs (lobbying for and managing village infrastructure, water supply, and schools) and taking action on issues of social justice (dowry, widow remarriage, bigamy)<sup>121</sup>. Such actions are possible when the supporting agency promotes awareness on social issues, providing guidance on options and group strategies to facilitate mobilization across SHGs, as in the newly forming federations.

<sup>115</sup> Hussein and Hussain 2003.

<sup>116</sup> Hashemi, Schuler, and Riley 1996.

<sup>117</sup> Personal communication with Naila Kabeer.

<sup>118</sup> GTZ 2005; Holvoet 2004.

<sup>119</sup> EDA 2005.

<sup>120</sup> Ash and Parrott 2002.

<sup>121</sup> Frances Sinha, et al 2006a.

Studies from different countries of the region report increasing decision-making roles of women clients, and the beginning of social networking and group-based action at the community level, especially in the SHG model, although neither outcome is automatic. At the household level, earlier concerns of whether women own their savings or control (or are at least involved in) the use of their microloans are being replaced by a more fundamental realization of the barriers that women face in accessing markets and of the low returns to their labor, relative to men. In other words, microfinance is contributing to some increase in women's role within existing patriarchal limits. Gender equality will have to wait; however, if more girls are sent to school, then another useful contribution will be made.

### Impact of microfinance on children's education

Does microfinance contribute to building the human capital of the next generation by making it possible for poor families to send their children to school? Evidence that is does is by and large positive, although school attendance is affected by the proximity of schools, especially schools for girls. The available studies also predate the availability of microfinance products, specifically for education (for example, education loans or savings products).

A 1996 study of two villages in [Bangladesh](#) showed that all of the girls from Grameen Bank client households had received some schooling, compared with 60 percent in nonclient households. A longitudinal study conducted in BRAC's operational areas from 1992 to 1995 also reported a higher rate of improvement in basic competency of children in BRAC member households compared with nonmembers.

Studies from [India](#)<sup>122</sup> report slightly higher enrollment and literacy levels of sons and daughters of women borrowers, in comparison with children of nonclients. This appears to be more significant at the primary school level and for the very poor, with some evidence that women's group membership can lead, in particular, to more daughters attending school.

In [Pakistan](#), the study of microfinance clients of Khushhali Bank shows higher expenditure on schooling, especially for girls, and children of clients were more likely to remain enrolled in schools longer than their counterparts in nonclient households.<sup>123</sup> However, this positive impact was not found for all borrowers, but only for women borrowers in NGO-supported groups, where the NGO also ran an education program. This finding reflects some of the Indian studies and underlines the relevance of “microfinance plus” and the availability of a school for girls.

Although few in number, the evidence from different studies indicates that microfinance can boost children's education in low-income households, especially for girls, if schools are available. This is an indirect contribution of microfinance rather than directly linked to the provision of microloans or savings products specifically to meet the costs of schooling, although there is some “fungible” use of credit for this purpose.

<sup>122</sup> EDA 2005; Chen and Snodgrass 2001; Holvoet 2004.

<sup>123</sup> Montgomery 2004.

## Impact of microfinance on health

Assessing health outcomes is a specialized exercise that microfinance impact studies usually have not attempted. One or two studies have assessed household nutrition and a few have explored links between microfinance and the use of health services or expenditure on medical care as a proxy or strategy for improving health.

Drawing on the World Bank longitudinal data set from [Bangladesh](#) (referred to in section 7.2), an analysis of the health component showed that microcredit to women had a significant impact on two out of the three measures of nutritional status of girls and boys (height for age and upper-arm circumference)<sup>124</sup>. In another study, the number of BRAC client households using sanitary latrines increased from 9 percent in 1993 to 26 percent in 1996, compared with nonclient use staying at 9 to 10 percent.<sup>125</sup>

The study on SHGs in [India](#)<sup>126</sup> reported that SHG members accessed better health care facilities after joining the program, resulting in higher expenditure for medical care. The study of Khushhali Bank clients in [Pakistan](#) shows similar results. Client households have significantly higher expenditures to access medical services from trained doctors compared with nonclients.

In summary, the evidence shows that access to microfinance has led to a number of positive outcomes, including building financial and social capital of women clients and their families, contributing to household coping strategies in case of vulnerability or shocks, and supporting women's empowerment within existing social structures. In terms of poverty reduction, there is positive evidence on a number of dimensions, economic and social, although that evidence needs to be

strengthened through clearer analysis of different starting points, or the level of poverty of a client's household when she joins a program. Where such analysis has shown relatively lower benefits for the very poor, if not their exclusion, this has led to the development of new programs outside microfinance, for example, BRAC's IGVGD and targeting the ultrapoor (TUP) programs, as well as the design of more flexible services within microfinance.

Poverty is complex and its reduction is likely to take place only over the long term and from a combination of factors. Expectations for what microfinance can or cannot achieve should be realistic and open to the fact that microfinance may not only work directly through targeting the poor as clients, but also indirectly through building the enterprises of the relatively better-off who employ the poor and contribute to market growth, although impact studies do not show the latter largely because of the emphasis on the direct approach. In either case, contextual factors such as physical security, functioning institutions, and macroeconomic stability, even timing of monsoons in the region, can critically influence the scale of impact that can be achieved through the provision of savings and credit services. Similar contextual and cultural issues apply to the goal of gender equality, although this does not emerge from the literature as a key concern.

<sup>124</sup> Pitt, Khandker, Chowdhury, and Millimet 2003. The same positive findings were not found for men, for whom, as noted earlier, the data did not show an increase in household expenditure as a result of borrowing.

<sup>125</sup> Hussain 1998.

<sup>126</sup> GTZ 2005.

## Impact Assessment Methodologies and Drawbacks

Despite the large number of impact studies recently conducted in the region, only data from a select few have been cited in this report. Issues of methodology, analysis, and attribution continue to be the bane of most impact studies. Common pitfalls in impact research that are discussed in the literature were repeated in most studies surveyed for this paper and need not be repeated,<sup>127</sup> but in addition, the following points that can undermine analysis are often overlooked.

- **Control Group and Selection Bias**—Impact is statistically defined as the difference between a treatment group (microfinance clients) and a nontreatment group (a control group of nonclients), assuming that on all factors other than the treatment the two groups are the same. However, this “sameness” is difficult to establish given the likelihood of selection bias. Clients self-select and may have certain unobservable characteristics, such as entrepreneurial aptitude, that incline them to join a microfinance program in the first place, in addition to which there might be “nonrandom” program placement in that MFIs select the areas in which they operate. It is important to correct for selection bias and this can best be done through econometric analysis using panel data. Panel data, however, are not easy to come by. Many studies rely on a single visit, comparing clients with a control group of nonclients at one point in time, thereby increasing the risk of selection bias. Other studies rely on recall, comparing now with before joining the program, often over a long period of three years or more, which carries its own risks of inaccuracy and possible bias.
- **Statistical Analysis**—Many studies do not report tests to establish statistical validity of the results, that is, whether the difference observed between client and control groups is by chance or is a difference due to the provision of financial services.
- **Significant versus Substantial Differences**—Even when statistical tests are reported, for the results to be meaningful, one must see whether the difference is substantive. For example, a recent impact study from Pakistan reported a difference of 3 percent between the mean income of borrowers and nonborrowers. The difference may be statistically significant because of the size of the sample, but it is hardly substantial.
- **Impact versus Output**—It is important to distinguish conceptually between impact and outputs of microfinance. For example, if a client uses microcredit to purchase a buffalo, the animal is certainly a new asset and a potential source of additional income, but it represents an output, not an impact, as long as the loan is not repaid.<sup>128</sup>
- **Impact on Whom?**—A subgroup analysis of clients often reveals a more in-depth and nuanced picture. Many studies do not relate impact findings to the key parameter of interest (the household poverty level). All the clients are assumed to be poor, which, as seen in the previous chapter, is not usually true. To be meaningful, and especially to interpret the results in terms of poverty reduction, impact findings must be disaggregated to reflect differences between poor and non-poor clients and analyze reasons for observed differences. A similar disaggregation of nonclients as a comparison group also reduces selection bias.
- **What about the Utility?**—The econometric analysis in the most rigorous impact studies is complex and often disputed, is too expensive to be carried out regularly, and takes too long to have any meaningful influence on the program. Apart from this, however rigorous and robust the findings, the relationship or impact pathway mapping the various components of the microfinance process to the impact domains is not well specified or researched. Thus, rather generalized conclusions are reached about microfinance impacts that serve an important function as far as “proving” is concerned, but they fail to throw much light on what type of microfinance (model, product, and so on) is more important for which dimension of poverty alleviation and impact. The relationship between program activities and impact indicators is often not made explicitly. Thus, such research fails to be helpful in providing inputs for programmatic actions to attain the desired impacts or in enhancing them.

<sup>127</sup> Meyer 2002; Hulme 1999; Ravallion 2005.

<sup>128</sup> See conceptual framework in figure 7.1.

Recent trends in assessing the impact of microfinance point in two directions:

- **Researcher Focused**—This approach continues the tradition of external, donor-funded studies using sophisticated econometric methods. It differs from earlier studies by using a randomized study design to account for possible biases that affect study results.<sup>129</sup> This rigorous approach addresses all possible biases by randomly selecting treatment groups (those who receive microfinance) and control groups from a potential population of microfinance clients (those who are selected but delay joining to allow the study to take place). This is an important tool for assessing impact and may be particularly relevant for assessing the impact of microfinance innovations. However, a drawback is inherent in the design: it may be difficult to keep the time difference between baseline and end-line stages between one and two years. For example, a study currently under way in India is limited to one year. This will limit the extent of possible impact and will be measurable to one or two

loans and some savings.

- **Practitioner Focused**—This trend reflects a break away from proving techniques to an approach that focuses on the elements that are likely to lead to improved impact. The emphasis is on practical, focused, and simpler research guided and used by the microfinance service provider to assess whether they are achieving their social objectives. It includes a client monitoring and market research approach to profile different client segments and to understand client needs and capacities, feeding into a process of tracking outreach to target specific groups and of designing services that meet client needs appropriately. This trend started with the design of the United States Agency for International Development—Assessing the Impacts of Microenterprise Interventions (USAID-AIMS) tools, continued with the development of market research tools for microfinance by MicroSave, and has developed as a framework for Social Performance Management by MFIs by the Imp-Act Consortium.<sup>130</sup>

## From Impact to Social Performance

Traditional impact studies, although still important and relevant in certain circumstances, are costly and time-consuming, and often result in findings that are too general, although they nevertheless do not go undisputed. Rather than trying to prove an end result, an alternative approach is to unpack the pathway to impact, shifting the focus to managing and reporting on the steps that are likely to lead to positive social outcomes. This idea is linked to the concept of “social performance” defined as “the effective translation of mission into practice”<sup>131</sup> and is intended to complement the now-established systems for financial performance. Initiatives around social performance and social reporting are currently somewhat experimental, but as they develop, they are

likely to provide an invaluable and relatively low-cost means of keeping track of and reporting on social mission in microfinance. Two of these recent approaches are discussed below.

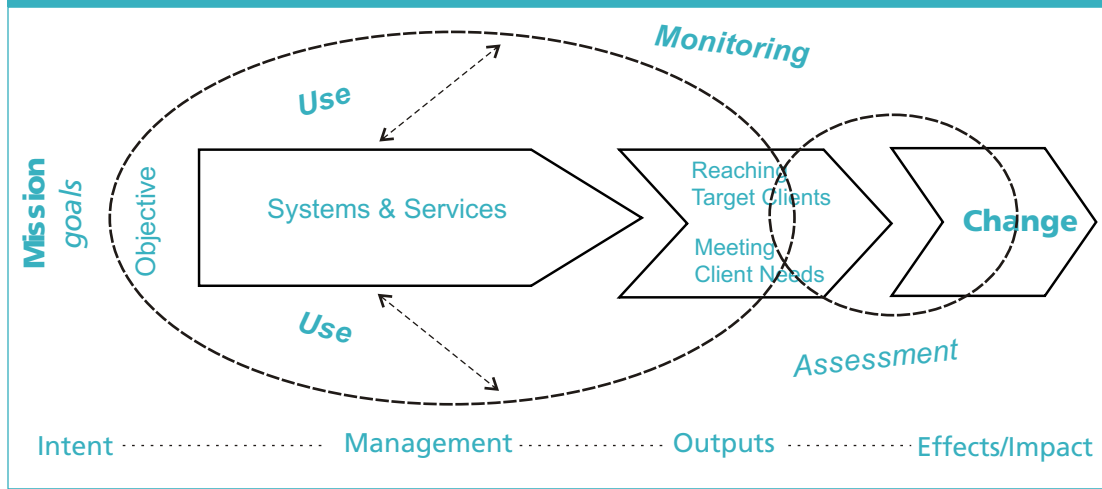
A **social performance management** (SPM) system is owned and implemented by the MFI. SPM includes regular tracking of three social goals: reaching target clients, meeting client needs in line with their capacities, and achieving change, or impact, through the application of relatively simple research and monitoring tools. The information collected is reported to the organization for decision making to align procedures and policies and adapt services to improve performance if necessary (see figure 7.1).

<sup>129</sup> Duflo and Kremer 2005.

<sup>130</sup> The Imp-Act Program was supported by the Ford Foundation and CGAP, and led by the Institute of Development Studies, University of Sussex, United Kingdom, working with 30 MFIs around the world. The Imp-Act approach is currently promoted by a consortium, which includes the following: in Asia, EDA Rural Systems and Reach India in India; CARD in the Philippines and elsewhere; IDEAS and the Microfinance Centre, Warsaw.

<sup>131</sup> Sign-on letter of the Social Performance Task Force 2005.

**Figure 7.1. Framework for Social Performance Management in an MFI**



Source: Authors

Client-level data allow an MFI to weigh its performance against its social mission and objectives. A key element of SPM involves the systematic tracking of social and economic conditions of clients at the time they join the MFI. For a poverty-focused MFI, such a system allows the organization to monitor its client entry profile. Simplified poverty measurement tools are being introduced for MFIs to assess client poverty levels at entry (for depth of outreach) and over time (for change).<sup>132</sup> In the context of rapidly scaling up MFIs, this could prove invaluable to track the mission.

A few of the more established MFIs already have this sort of tracking system in place: Cashpor is well known for its housing index, Grameen has used 10 indicators of poverty, and BRAC has a well-established research division from which a number of studies have emerged. Under the Imp-Act program, MFIs in Nepal and India have used their own client-level research to compare poverty outreach across different branches and to reassess their objectives and services with reference to their target clients' needs.<sup>133</sup> In these examples, the core social mission of the organization is poverty reduction and SPM enables them to track progress toward this goal.

## Social Rating

While SPM systems are internal to the organization, **social rating** is a recently introduced tool for external appraisal of social performance. It covers all the steps of the impact pathway shown in figure 7.1 and is based on the premise that most MFIs (and the donors and investors who support them) have a social mission. A social rating covers the steps involved in translating this social mission into practice. The different steps evaluated are the

organization's social mission and systems, depth of outreach (poverty level of clients, operations in less developed areas), and feedback from clients on MFI products and services. By covering the steps leading to change, the social rating is a good predictor of impact. Social rating also includes an assessment of "client protection" and transparency as an important dimension of social responsibility.

<sup>132</sup> For example by the Grameen Foundation, United States, through its Poverty Progress Index, derived from national household expenditure surveys in each country.

<sup>133</sup> Copestake, Greeley, Johnson, Kabeer, and Simanowitz 2005.



Together, social ratings and credit ratings allow for an assessment of performance against the so-called double bottom line. By benchmarking social mission and systems of different organizations, social ratings, alongside credit ratings, will contribute to increased transparency in the microfinance sector. Social investors and donors can use these ratings to facilitate the flow of funds to MFIs that are starting up or relatively weak on financial parameters but strong on social parameters. M-CRIL in India is the first rating agency to provide a specifically designed social rating service to MFIs. M-CRIL has now undertaken seven social ratings and is likely to undertake several more in South Asia in the near future, including in Afghanistan, Pakistan, and Sri

Lanka.<sup>134</sup> Other specialist rating agencies, including Microfinanza and Planet Rating, are developing such a service and have undertaken a few ratings in other parts of the world.<sup>135</sup>

In the future, as more MFIs introduce SPM, social rating could be used to audit the SPM process and findings to verify that it is done systematically, the information is valid, and there is effective reporting within the organization, and to advise whether the process can be improved. At present, until more MFIs introduce SPM, social rating can provide an independent assessment of poverty outreach and appropriateness of products and services based on a field sample of clients.<sup>136</sup>

## Social Protection and Safety Nets

As discussed above, financial services for low-income clients are an important tool to be used in consumption smoothening for vulnerable families and to enable the poor to take advantage of new livelihood opportunities. But microfinance by itself is not a panacea for poverty. With some notable exceptions, microfinance has been limited in its reach and usually has not provided services to the poorest and the destitute. The destitute, people without means of sustainable livelihood who are so vulnerable that they require food aid or employment, have until now mostly been excluded.

Recent efforts to increase the depth of outreach through effective targeting, better understanding of client needs, and more client

responsive products have been promising.<sup>137</sup> Yet, it is also increasingly evident that many of the very poorest may not be able to use credit effectively. Loans to those who are trapped in extreme poverty may not immediately help to establish sustainable livelihoods that generate enough earnings to meet repayments, possibly leading to further impoverishment, increased vulnerability, and overindebtedness. Savings products may be more appropriate for helping such households manage their money better, but on their own it is unlikely they would break the vicious cycle of poverty.

The poorest clients that microfinance has difficulty reaching are precisely the focus of another important development strategy, safety nets. Although considerable overlap

<sup>134</sup> Samples of M-CRIL's social ratings and the importance and impact of linking it with credit rating can be seen from the samples of the first such report undertaken for Bullockcart Workers' Development Association (BWDA), an MFI in South India, and may be found on the M-CRIL Web site (available at [www.m-cril.com](http://www.m-cril.com)).

<sup>135</sup> Various approaches for social reporting and rating have been developed separately and include those of Comité d'Echanges de Reflexion et d'Information sur les Systemes d'Epargne-credit (CERISE), Social Performance Indicators Initiative ([www.cerise.com](http://www.cerise.com)); USAID (under its Accelerated Microenterprise Advancement Project); and Accion International.

<sup>136</sup> As reflected in the Global Reporting Initiative. Available at [www.cerise.com](http://www.cerise.com).

<sup>137</sup> The evidence, however, of the promise of more client responsive products delivering on better depth of poverty outreach is sketchy. A recent study comparing the depth of poverty outreach of an urban microfinance provider in Bangladesh offering a range of flexible financial products and more traditional microfinance providers working in the same area does not find much difference (Cortijo 2005). Another recent study (Sinha et al 2006a) on poverty outreach of a set of microfinance institutions in Bangladesh, which designed new products to target the extreme poor, finds that around 11 percent of the clients are extremely poor, which is not significantly different from the industry average in Bangladesh (Matin 2006). These results could be specific to the Bangladesh context given a generally good depth of poverty outreach performances of the industry from which further deepening of poverty outreach through microfinance only route could be difficult.

exists among the people that microfinance and safety nets seek to serve, the microfinance discourse has generally ignored safety nets. Microfinance practitioners often equate safety nets to grants and subsidies that distort markets and hamper efforts to become sustainable. In turn, safety net experts commonly associate microfinance with credit that creates indebtedness and increases poor people's vulnerability. There is, however, a real possibility of harnessing the creative experiences of these two development strategies through a "link model." Microfinance from the top going down and safety nets from the bottom going up create the potential space to reach the poorest. Deliberately and carefully linking microfinance and safety nets offers some scope for reducing poverty among the absolute poor.

### The link model

The premise of the link model is that the destitute, and even the very poor, need grants for survival. These people additionally require financial services, however, just like anyone else. Although time bound, finite grants provide the "breathing space" needed for survival and exploring livelihood opportunities, and savings services build up microinvestment funds. Some programs provide skills training during this period. As the grant program phases out, participants are prepared to pursue independent economic activities and "graduate" to become clients of regular microfinance programs. The following two examples of successful links between microfinance and safety nets in Bangladesh demonstrate how the link model could work.

## Case 1: Combining Public Works Employment with Financial Services

The Rural Maintenance Program (RMP) of CARE Bangladesh was started in 1982 as a public works program that provided employment to destitute rural women. Women are recruited for a fixed four-year period. They receive wages and participate in a compulsory savings plan, setting aside a portion of their wages as savings. During the four years, women receive training in numeracy, human rights, gender equity, health, nutrition, business management, and income-generating activities. Women also receive information on microfinance and on local MFIs and are encouraged to approach MFIs for working capital and expansion needs after they complete the RMP.

CARE has successfully met the twin challenges of targeting the poorest and successfully graduating participants. The lower-than-market wage rate paid to the women serves as a screening mechanism to ensure that only the neediest apply. The intensive training coupled with the savings requirement and microfinance information prepares women to start small

business activities with appropriate skills and some seed capital.

More than 40,000 women are engaged in the RMP at any one time and around 10,000 exit every year. While not all women succeed as microentrepreneurs, the RMP has an impressive track record. Three years after the end of the program cycle, 79 percent of graduates continue to be self-employed in microenterprise activities. A CARE Bangladesh Household Security Survey, conducted in early 2005, indicates that 63 percent of RMP graduates remain members of NGOs even three years after graduation.<sup>138</sup>

Some of the key lessons learned from this program are as follows:

- Start with an employment program first, a labor-intensive public works program useful to the community
- Set wages lower than market rates to screen the target group
- Start collecting savings early in the program
- Provide complementary training/life skills

<sup>138</sup> E-mail from Dr. Phillip Tanner, Program Coordinator, RMP.

## Case 2: Linking Food Aid to Microfinance

The IGVDG Program, a collaborative food security intervention of the Government of Bangladesh, the World Food Program (WFP), and BRAC, targets destitute rural women who have little or no income-earning opportunities. The IGVDG Program is built on a government safety net program that provides free food grains for an 18-month period to destitute, female-headed households that are at the highest risk of hunger. BRAC organizes the women into groups, collects savings, and provides skills training. Program participants receive small loans (\$50) when their skill training is completed so that they can try out small income-generating activities. By the time the cycle of free food grains ends, participants have accumulated savings that can be used as capital for investment, received training, managed credit, and engaged in some kind of entrepreneurial activity. In addition, they will have gained confidence through group participation.

The results of the IGVDG Program are impressive. In all, the program has provided food grain assistance in connection with the government safety net program, savings services, and credit services to 1.6 million destitute women since its inception. Nearly two-thirds of these participants have graduated from absolute poverty to become microfinance clients who have not slipped back into requiring further government assistance. Surveys of IGVDG clients report increases in client incomes and basic material assets, and a reduction in begging.<sup>139</sup>

Some of the key lessons learned from this program are as follows:

- Use appropriate screening to ensure that only the destitute are targeted, especially female-headed households
- Start with food aid, although food aid distribution should be handled by a separate

professional distribution agency, not by a financial institution

- Start collecting savings early in the program cycle
- Provide complementary training/life skills
- Provide very small loans for simple, easy economic activities

These two cases suggest ways in which links can be established between grants and microfinance programs. They show how the appropriate sequencing of activities can lead to positive development outcomes. Starting with grants to meet immediate consumption needs and building microassets, these programs then link to financial services, enabling destitute client groups to move up a ladder of incrementally cumulative livelihood gains.

Each partner in these linked programs has its own comparative advantage. Mixing functions will compromise the effectiveness of the link model. A safety net institution or a program that provides grants would not have the technical knowledge to provide sustainable financial services. Similarly, an MFI must impose strict financial discipline to become sustainable. Providing grants that do not require repayment would send mixed signals to MFI clients, who are constantly reminded of the need for on-time repayments. The link model works only when each partner concentrates on its area of expertise, but does so with a common understanding of the needs of vulnerable and destitute clients. Success in such a program is about being operationally separate but conceptually joint.

<sup>139</sup> Matin and Yasmin 2006; Hashemi 2001.

# Systems That Support Microfinance:

Toward a democratic, inclusive financial sector

As discussed in chapter 1, microfinance in South Asia grew out of a concern for poverty and a desire to provide the poor with the means to accumulate productive assets. Yet, after nearly 30 years of a gradually growing but lately intensive effort, microfinance has reached a poverty coverage of only 17 percent of the poor families in the region (see table 2.2). While this outreach level is high in a couple of countries, the overall performance is undoubtedly low. It is apparent that to make microfinance more effective, and to increase its outreach in increasing incomes of poor families (or at least providing them with relief), microfinance must have an effective set of support structures and systems.

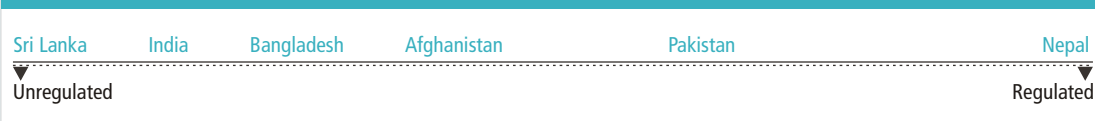
Because stable financial systems are the backbone of modern economies, the provision of financial services is invariably controlled by the central banks of each country, albeit to various degrees. Access to microfinance services is likely to be influenced by the vigor of central banks in controlling that system and by the facilitative provisions of the regulatory mechanism. The extent to which that system facilitates its use can be influenced by the activities of networking organizations and their ability to lobby for supportive regulation.

Similarly, the extent to which the flow of funds within the financial system reaches and

augments the flow of funds in microfinance is likely to be affected by links with the formal financial system an aspect that would entail a support infrastructure such as rating systems, credit bureaus, and apex funding organizations. And to reinforce the activities of microfinance service providers, reduce the cost of operations, and increase outreach to areas lacking conventional physical infrastructure, technology can play a catalyzing if not a revolutionizing role. To understand this, the role of technology in the growth of microfinance in South Asia needs to be examined.

Today, in South Asia, the status of appropriate support structures is highly variable: Nepal and Pakistan have introduced microfinance-specific regulatory frameworks while other countries are at various stages of discussion. All countries have well-established apex organizations, although their coverage is far higher in Bangladesh, in particular, and India; Pakistan and India have particularly active microfinance networking organizations. Although rating activities are well established in the region, coverage is extensive mainly in India and, to some extent, in Bangladesh. In each country, some aspect of these support structures needs to be built and developed further (and occasionally created from scratch).

**Figure 8.1 Relative Microfinance Regulation in South Asia**



Source: Authors' creation.

## Microfinance Regulation in South Asia

In the matter of regulation, the countries of South Asia lie along a continuum. As indicated by the regulations in place, the position of the six countries covered by this paper relative to each other is depicted in figure 8.1. The continuum ranges from virtual *laissez faire* in Afghanistan to a substantial degree of regulation (at least on the statute book) in Nepal.

### Afghanistan

Even at this early stage in the development of the microfinance sector in Afghanistan, there is considerable diversity in the types of organizations that provide services. While much of the focus has been on NGOs, one commercial bank provides microfinance services (and two more plan to enter the sector), a single leasing company provides some microleasing services, a private company has provided microfinance services through support to agriculture input supply dealers, and a few credit unions have been established.

The current legal framework for financial services outside of licensed commercial banks is incomplete, and leasing, credit unions, and finance companies exist in a legal vacuum. The central bank, Da Afghanistan Bank (DAB), has so far concentrated most of its limited resources on establishing and regulating a commercial banking sector. There is a banking law under which 13 local and international banks have been licensed, but other financial sector laws will take time. In the meantime, some of the 14 MFIs that have active programs are mobilizing deposits from their members and recycling these funds in their loan portfolios. In July 2006, DAB approved deposit-taking MFI (DMFI) regulations under the “exceptions clause” in the Banking Act. These DMFI regulations were developed in consultation with the microfinance sector and apply only to MFIs that are mobilizing voluntary deposits, not to those with compulsory savings that act as collateral for loans.

The DMFI regulations mention a variety of institutions, including NGOs, finance companies, credit unions, and cooperatives. So far, though, the only existing institutions that mobilize voluntary deposits are the credit unions. But given the peculiar nature of credit unions, it is not clear how they can fit under the DMFI regulations and ultimately it might be better to establish other regulations specific to credit unions as has been done in many other countries. In the past, DAB considered preparing an NBFI framework law, under which MFIs as well as other financial institutions could be registered; for now, however, it has opted to go with the DMFI regulations under the Banking Act. The Ministry of Finance is not in favor of such a framework regulation for a disparate range of financial institutions and instead would like to see specific laws for each type of financial activity (cooperatives, insurance, leasing, and so on).

The Banking Act requires that banks first be formed as Afghan companies before they can receive a banking license, so each type of organization that applies under the DMFI regulations will require some form of underlying legal entity. The NGOs that dominate the microfinance sector are already registered under the new NGO law adopted in 2005, but given the growing negative public perception of NGOs in Afghanistan, the government had a strong preference that NGO-MFIs be established as “companies.” Because new regulations governing the establishment of companies are still under consideration, the government made a special decision in early 2006 to allow NGO-MFIs to be set up as “nondistributive” companies under the existing 1955 Commercial Code (although this code makes no mention of “nondistributive” companies) and to register with the Afghanistan Investment Support Agency. This suits government interests, because it means that the MFIs will not legally be NGOs, something that the government would like to

avoid, and also addresses the MFIs' interests in being categorized as entities that can migrate over time to become DMFIs regulated by the central bank, or even commercial banks with a microfinance focus.

## Bangladesh

In 2000, Bangladesh formed a committee to oversee the drafting of a regulation for microfinance. The committee was chaired by the governor of Bangladesh Bank and included leaders from some of the best-known MFIs. A draft regulation was submitted to the government in March 2005 and was eventually recommended to Parliament, although in a considerably altered form. In July 2006, the Parliament approved the Micro Credit Regulatory Authority Act under which a separate regulatory authority will be established to oversee the operations of NGO-MFIs. This act also provides legal cover, which was previously missing, for the microfinance activities currently being undertaken by NGO-MFIs, including mobilizing deposits from members.

The committee proposed a regulation that would cover the microfinance activities of NGOs and microfinance programs of government ministries, while allowing for the creation of microfinance banks. It proposed five tiers for banks, from the national level down to the district level, the former requiring paid-up capital equivalent to an NBF and the latter requiring very little paid-up capital. Both the NGOs and the microfinance banks would be regulated by a new regulatory commission, not by the central bank. The cabinet, however, decided to leave government ministry programs out of the regulation and did not favor the creation of microfinance banks, believing that this could open the door to unscrupulous operators and questioning the capability of any regulator to oversee a large number of small institutions. Thus, the act that was approved in 2006 only includes requirements for NGO-MFIs.

Given that many NGOs have large microfinance programs, that the laws under which they are established are not intended to cover financial service activities, and that the authorities presently have little capacity to oversee these NGOs, creating a new legal environment will provide a stronger legal base for NGO-MFI activities. This should facilitate their access to commercial funding and improve their transparency and accountability. At the same time, some elected representatives and government officials would like to reign in the NGOs, which would not be conducive to scaling up and improving the performance of the microfinance sector.

Some stakeholders in Bangladesh see the next step in the evolution of the sector as allowing MFIs to mobilize public deposits (voluntary deposits from nonmembers) rather than depending on other sources of funds to scale up. NGO-MFIs already mobilize large amounts of deposits from their members, but becoming a microfinance bank would enable MFIs to mobilize deposits from the general public, something that Grameen Bank has done successfully. While the cabinet has expressed concerns about opening the door for microfinance banks, experience from Nepal, Pakistan, and Cambodia shows that, in the restrictive conditions normally applied to such separate microfinance regulation, there is little incentive for entities without a commitment to microfinance to enter the field. Thus, the danger of the regulator being overwhelmed by entities that qualify for such regulation is minimal.

## India

The past six to seven years have seen substantial advocacy for microfinance regulation in India. Starting with the formation of Sa-Dhan, an association of microfinance institutions in 1999, advocacy for microfinance regulation intensified over the years until the finance minister's 2005 budget speech formally committed the government to present a microfinance legal framework to Parliament.



The drafting of this framework is in its final stages and it will be presented to Parliament in the winter session of 2006-07.

The framework, earlier proposed as an amendment to the NABARD Act,<sup>140</sup> is now to be presented as a standalone piece of legislation. The proposed Act mandates the establishment of a Micro Finance Development Council (MFDC) “for promotion, development and orderly growth of the micro finance sector...” It also mandates the creation of a category of microfinance service provider – the microfinance organization (MFO) – recognized, regulated, supervised, and promoted by NABARD. The MFDC would advise NABARD on the formulation of policies and measures to ensure the orderly growth and development of the microfinance sector. MFOs would be NGOs (societies, trusts, and cooperatives) that are “formed for the purpose of providing micro finance services...” and have net owned funds (net worth) of at least Rs 500,000 (\$11,100). The supervision proposed consists mainly of “setting sector related benchmarks and performance standards pertaining to methods of operation, management and governance, including model codes of conduct of business for Micro Finance Organisations engaged in the provision of thrift services and micro finance services.” For now, both types of companies (for-profit NBFCs and not-for-profit Section 25 companies) have been omitted from the Act on the grounds that these are already under the ambit of regulation by the RBI. Coverage of these under the new Act, therefore, is deemed by the government to be unnecessary.

During the long process of discussing, and agreeing on, a regulatory framework for microfinance in India, the RBI's main concern was with the need to control the entry of unscrupulous operators into the formal financial system. The RBI was concerned that such operators would creep in through the backdoor as microfinance operators, and collect and then embezzle the deposits of the public, especially low-income families. Should

this happen, the regulator would get the blame. As it is, the central bank has its hands full regulating and supervising large numbers of financial institutions, including the following:

- 27 scheduled commercial banks in the public sector with some 45,000 branches
- 55 private Indian and foreign commercial banks with some 5,000 branches
- 196 RRBs with another 14,000 branches – as rural subsidiaries of the public sector commercial banks
- 1,800 (single-town) urban cooperative banks, more than two dozen state-level cooperative banks at the apex of more than 350 district cooperative banks and nearly 100,000 primary (village-level) cooperative societies
- As many as 7,000 registered NBFCs

According to the RBI, allowing for the creation of regulated microfinance entities would open the floodgates to large numbers of institutions, increasing the magnitude of its task and multiplying the risk to the financial system if the operations of existing MFIs are accorded the legitimacy implied by the central bank. Against this backdrop, the government's acceptance of a limited regulation of MFIs that offer thrift services to members rather than the public is a promotional measure that could have far-reaching implications for the financial inclusion of many more poor people. However, the exclusion of companies from this legislation means that a dual regulatory regime is likely to emerge whereby the best MFIs transform into NBFCs in order to have access to the equity and large volume of debt funds available to such institutions while the less successful MFIs are subject to a relatively lax regulatory regime that inspires limited confidence. Discussions on the proposed Act are ongoing at the time of writing (November 2006) and the final form of the legislation is yet to be fully determined.

At the same time, the Indian government's engagement with the issue of microfinance and

<sup>140</sup> This statute established the National Bank for Agriculture and Rural Development in 1982

the need to increase the outreach of banking services to low-income clients has led to the RBI investing more energy in new ideas. In January 2006, the RBI officially floated the idea of “business correspondents” for the banking sector in India to disburse and recover “small value credit,” collection of small deposits, microinsurance, and pension products as well as remittances and other payment instruments.<sup>141</sup> The circular specifically lists NGOs-MFIs as the entities that may act as business correspondents and provides for the banks to pay a reasonable fee to them while prohibiting them from charging customers any fees for services rendered directly by correspondents. In some other countries, for example Brazil, this approach has considerably expanded outreach of financial services to poor and underserved households.

## Nepal

Nepal was the first country in the region to introduce specific regulations for the microfinance sector: the Development Banks Act was passed by Parliament in 1996 and the first Financial Intermediary Societies Act (FISA) was passed in 1999. Unfortunately, Nepal's attempts at regulation have been characterized more by confusion than by clarity in its strategy to pursue a poverty agenda. Microfinance regulation evolved from official attempts to promote a poverty agenda through the Nepal Rastra Bank's (NRB's) sponsorship of the five RRDBs. The RRDBs were established beginning in 1992, initially under the Commercial Banks Act, and had majority NRB shareholding and significant contributions from the commercial banking sector, albeit virtually on the instructions of the central bank.

The purpose of the RRDBs was to provide financing to the poor in Nepal, initially in the *terai* (plains) areas, but with the hope that they would later be able to expand into the middle hills if not the high mountain areas. The potential demonstrated by the first RRDB in

the eastern region was sufficient to generate interest in more development banks being established and led to the introduction of the Development Banks Act 1996. This act allowed for the creation of more such banks with private equity and established the Nirdhan Utthan Bank as the first private development bank in Nepal. There are now four such private retail development banks, all established by leading NGOs and all operating in the *terai*.

The promulgation of FISA in 1999 came as a logical extension of this development. FISA was intended to introduce the concept of the “limited banking license” as a way to legitimize the financial services activities of NGOs registered as societies or cooperatives. The limited banking license gives its holder the right to provide microcredit to “low-income families” and to collect the savings of such families described as “members.” There were 49 NGOs and 19 cooperative societies holding limited banking licenses under the provisions of this law in late 2005.

FISA has been a major source of confusion in the regulation of microfinance in Nepal. The act says nothing about the collection of savings from the general public and has led to confusion with the Cooperatives Act, which is more liberal regarding membership and does not include income or account size limitations. It specifically prohibits the collection of deposits from nonmembers, which FISA does not. This has placed cooperatives that are limited banking license holders in a legal limbo with regard to deposit-taking. The main attraction of the limited banking license for cooperatives has been the stamp of legitimacy conferred by central bank supervision. At the same time, this stamp of assurance does not seem to have benefited NGOs, which have not been successful at raising voluntary deposits from members, let alone from the general public.

The original version of the act included a clause that implied NRB underwriting of the loans awarded to societies that were licensed

<sup>141</sup> RBI 2006.

by the act. This clause is thought to have been introduced by the government under pressure from some of the leading international NGOs working in Nepal, although it was dropped in 2003 after vociferous objections by the central bank.

Whatever the history of regulation in Nepal, the advent of the licensing of microfinance activities has not presented opportunities for fraudulent operators; the number of registered institutions is small and few have been shut down for financial impropriety.

In the meantime, to compound the confusion, the central bank has recently proposed yet another microfinance law that would result in the creation of a “super apex” organization to be run entirely by government officials and be responsible for a multitude of activities, including licensing, regulation, supervision, financing, development promotion, research, and overall poverty alleviation through microfinance. With conflicting functions and overlapping responsibilities, such an institution would place all MFIs and cooperatives at the mercy of the proposed “Microfinance and Cooperative Center” with few safeguards to mitigate the problems likely to arise.

## Pakistan

In 2000, microfinance was elevated to be a core aspect of the government's poverty reduction program. Thus, the introduction of the Microfinance Institutions Ordinance 2001, under which microfinance banks are licensed, was driven by a poverty reduction agenda rather than being focused on building an inclusive financial sector to include poor people in the mainstream. The ordinance restricted microfinance banks to provide loans only to poor people, defined as those with incomes below the income tax floor, and restricted loan size to a maximum of PRs 100,000 (\$1,700), too low to enable clients to easily make a transition into the mainstream financial sector and well below the amounts

commercial banks are willing to lend. Recent modifications to the law made in 2006, however, provide for greater flexibility and empower the regulator to continue to make changes as required.<sup>142</sup> The ordinance particularly aims at creating special microfinance banks at four levels—national, provincial, regional, and district—each with different capital requirements that are well below the requirement for commercial banks.

The ordinance is not concerned with NGO microfinance programs and relates only to MFIs that wish to mobilize deposits. The microfinance banks are licensed and regulated by the SBP under specially designed prudential regulations. The regulator has adopted an open approach to the sector, including the creation of a microfinance consultative group chaired by the SBP and composed of representatives from the sector.

By late 2005, there were six microfinance banks with more in the pipeline, although the largest of these banks, Khushhali Bank, was established in 2000 under a special ordinance for that purpose before the Microfinance Institutions Ordinance was adopted. First MicroFinanceBank was licensed immediately after the ordinance was passed in 2001 and, to date, it is the only case of an NGO program “transforming” into a microfinance bank. Two district banks in Karachi district were licensed in late 2004 and are in the early stages of establishing their operations. In August 2005, another national-level license was granted for a bank that began operations in late 2005. In early 2006, another national-level license was granted.

The primary reason the government encouraged microfinance banks was to more rapidly scale up microfinance outreach. So far, however, only Khushhali Bank has achieved significant outreach, and the NGO sector still has more loan clients than the microfinance banks. But considering that demand is largely unmet, and that it will take huge amounts of funding to satisfy that demand over the next

<sup>142</sup> Ahmed 2006.

decade or more, microfinance banks that mobilize deposits and can more easily access commercial funding have the potential to take a large share of the market, if they have good business models.

Only one microfinance bank has begun to mobilize deposits to any extent, and even that bank has found it costly to open flexible savings accounts for poor people. It is not clear whether poor people want to retain liquid assets in any quantity; many seem to prefer investments in livestock, housing improvements, other fixed assets, and consumption spending. Regarding loans, the restrictions on loan size reduce the flexibility microfinance banks have to offer the same range of products as commercial banks and other financial institutions.

Other than Khushhali Bank, the microfinance banks have had more limited access to soft money than NGOs, and if they are profitable, their profits are taxed at 43 percent, the same as commercial banks. The fact that most of the investors are not looking for returns does constitute a significant subsidy. Only one of the microfinance banks established thus far expects to generate much in the way of returns to investors for the foreseeable future. In fact, financial performance until now would not attract investors seeking even a modest return on their investments. Neither of the banks that have been operational for the past few years had a positive adjusted return on equity in 2004. Projections made for the most profitable MFI in Pakistan, an NGO that has been considering transformation into a microfinance bank, show that internal rates of return would be around 5 percent annually, whereas even socially minded international investors usually target returns of 10 percent.

Investors in Pakistan have largely been motivated by “corporate social responsibility” or similar reasons, resulting in little motivation to act in a commercial manner or hold the microfinance banks accountable to achieve better financial or outreach performance. The government encouraged the commercial banks

to invest PRs 1.7 billion (\$285 million) to capitalize Khushhali Bank, and some commercial bank executives have said that they invested out of a sense of national responsibility.

## Sri Lanka

The main issue in the practice of microfinance in Sri Lanka is the crowding out of private sector initiatives and impediments on the path to sustainability. These impediments result from a series of government-promoted development programs that back up the panoply of institutions (for example, SBSs and CRBs), which are characterized by operations supported by market-distorting subsidies. The cooperatives, the largest suppliers of microcredit and savings services to low-income clients, are inadequately regulated and supervised and lack a legal framework in which to legitimize or supervise the activities of NGOs. Even the ban on the supply of deposit services by unregulated NGOs is not enforced. The commercial banks, meanwhile, are only minimally engaged in microfinance. As a result, there is a high degree of laissez faire in the provision of microfinance services in the country.

In 2006, the long-discussed Micro Finance Institutions Act was finalized and will likely up for approval soon. It provides a lot of flexibility to establish various sizes of MFIs, which can act as banks (for example, they will be able to mobilize deposits). Barriers to entry, such as minimum paid-up capital, have been set at low levels. The act allows for NGO-MFIs to mobilize deposits once they have received the regulator's permission. Furthermore, it states that the Central Bank will regulate cooperative societies that are engaged in microfinance. All of this puts a large burden on the regulator. So far, however, no regulation beyond the existing supervision by the societies' registrars is proposed for the SBSs. These groups constitute an important part of the government's antipoverty agenda and are virtually an untouchable element of the country's

development framework. Yet, because these societies dominate the microfinance landscape, regulation that excludes them is virtually meaningless. At the same time, the Central Bank has not shown a lot of enthusiasm for regulating a microfinance sector populated with a large number of institutions that are not transparent or well managed.

### Conclusions on microfinance regulation in South Asia

It has become fashionable in South Asia for the microfinance sector and governments to draft, consider, and adopt special microfinance regulations. All six of the larger countries in the region have a microfinance regulation in place (Bangladesh, Nepal, and Pakistan), are

considering a draft law (India and Sri Lanka), or have developed special regulations under the banking law (Afghanistan).

Table 8.1 summarizes the status of regulation of the major institutional types engaged in providing microfinance services in South Asia. As the table shows, only Nepal has a comprehensive microfinance regulatory mechanism in place, however faulty it may be. Apart from Nepal, Bangladesh and Pakistan have specific microfinance frameworks in place, although only the latter allows for microfinance banks to set up. In India, the idea of allowing such banks has been specifically rejected by the respective governments, whereas Sri Lanka's cooperative banks are really independent initiatives without central bank oversight.

**Table 8.1. Regulation of Institutions Engaged in Microfinance in South Asia**

	NGOs in Microfinance	Cooperatives / Credit Unions <sup>a</sup>	Non-bank Microfinance Companies	MF/Rural Development Banks in MF
<b>Afghanistan</b>	REG	REG	REG	n.a.
<b>Bangladesh</b>	REG	Cooperative regulation	n.a.	Rejected by government
<b>India</b>	TBR	Cooperative regulation, TBR	REG	Rejected by government
<b>Nepal</b>	REG	REG	—	REG
<b>Pakistan</b>	UNR	Cooperative regulation	—	REG
<b>Sri Lanka</b>	TBR	Cooperative regulation	—	UNR

Source: Authors' compilation.

Note: REG = already regulated; TBR = to be regulated in the foreseeable future (or under discussion); UNR = unregulated; n.a. = not applicable; — = non-bank microfinance companies don't exist in these countries.

a. Refers to cooperatives that are active as modern microfinance entities rather than conventional agricultural cooperatives.

From a regulators' perspective, regulation should take the broadest possible approach and not be based on narrow interests, particular products, or narrowly defined special institutions. In fact, the main goal should be to increase access, not limit it, maintaining a balance between the autonomy financial institutions need to operate effectively and sufficient accountability to ensure that financial service institutions remain strong. The purpose is to increase access, not be prescriptive about

financial products, and to ensure clear, transparent reporting and accountability. The regulatory approach in Latin America since the mid-1990s, for example, focuses on access, allows for a wide range of financial service providers, sees financial service provision primarily as a business activity, and regulates by exception, allowing service providers a fair amount of leeway until there is a proven need to regulate exceptional circumstances.



By contrast with Latin America, South Asia's approach to regulation focuses on the special microfinance niche that has emerged over the past 30 years. It is designed for special, relatively narrowly defined MFIs, views microfinance as primarily being a socially oriented poverty reduction tool, and uses an extensive set of rules based on this particular view of microfinance. In a sense, this approach recognizes the success of the microfinance sector in South Asia over the past 30 years as a poverty alleviation tool and tries to embed that history in the law and regulations. In the region of the world with some 40 percent of the world's poor, this is perhaps appropriate.

Nevertheless, this approach is not particularly forward looking and does not consider the changes the sector will undergo with the introduction of new approaches, institutions, and technologies, for example, allowing banking correspondent relationships as in India or changing banking regulations to allow for mobile telephone banking. It focuses on a special niche market instead of looking at the big picture, and it enshrines the importance of MFIs instead of microfinance.<sup>143</sup> The only exception to this approach is Afghanistan, the most recent entrant to the microfinance industry and the only country that explicitly recognizes microfinance as a mainstream financial activity. Afghan MFIs are but one form of microfinance service provider in a sector in which other mainstream financial institutions, including banks, leasing companies, and credit unions, already provide microfinance services.

While it is still too early to judge the impact of this “rush to regulate,” the examples of the Pakistan and Nepal laws show that a specially designed microfinance banking regulation intended to rapidly scale up outreach and introduce a wide range of microfinance services will not necessarily succeed in achieving either one of those objectives. The growth in the number of microfinance service providers presents regulators with a dilemma. In one sense, they want to control the practice

of so-called banking activities, while at the same time, they are reluctant to get too involved. As witnessed by the lack of central bank regulation and any other form of effective regulation of cooperatives, central bank regulators have historically been loathe to take on the regulation of a very large number of organizations, especially organizations they do not understand well. Thus, Pakistan is reluctant to allow for too many microfinance banks and Bangladesh, India, Nepal, and Sri Lanka have created or are proposing to create special regulatory bodies, outside the central bank, just for microfinance. Yet, there is no example in the world of special regulatory bodies for microfinance having been particularly successful.

All of this raises the questions of why regulation is needed and at what stage of evolution of the sector might it best be introduced. On the one hand, there is little reason to impose prudential regulations on NGO microfinance service providers unless they are taking and intermediating deposits. On the other hand, most countries already have several laws, such as banking, NBFIs, and cooperative laws, which were specifically intended to provide financial services to the poor.<sup>144</sup> Between these two approaches, there needs to be consideration of what else is needed to scale up, deepen, and diversify outreach. New regulations for NGOs, primarily because of deposit mobilization from members, were adopted in 2006 in Afghanistan and Bangladesh, and laws are being considered in India and Sri Lanka. Yet, there is an increasing sense worldwide that MFIs mobilizing deposits from members need not be regulated like banks, since the risks are considerably different and may not represent a threat to the overall financial system because the institutions are typically very small. This has been taken into account by the regulator in Afghanistan.

From the point of view of the MFIs, the main reason for wanting regulation is to mobilize deposits from the public, both to provide

<sup>143</sup> To quote Vijay Mahajan, the head of BASIX in India, “microfinance is important, MFIs are trivial.”



savings services that poor clients value and to have a source of funds that is not dependent on donors, government, or commercial organizations. If this is the main reason, however, it might be easier and more useful to amend existing laws than to create new, specialized laws. Both governments and central banks, although keen to pursue the poverty agenda through financial services to low-income clients of MFIs, are fearful of the impact this could have on the security of depositors' funds and on the public's perception of the government's commitment to its financial security, particularly in relation to the poor. They are, therefore, generally unwilling to accede to any such measures. The one exception is Afghanistan, where lessons learned from other countries are being applied early in the evolution of microfinance, resulting in more generalized regulations that fit into the overall financial sector.

In theory, India's banking correspondent model diminishes the argument for regulation to facilitate deposit collection by MFIs, because it will make the service of small deposits, particularly passbook savings accounts, available to low-income clients, along with microcredit and other microfinance services. In practice, it will take some time to work out the mode of operations of the business correspondent model because the level of fees and a series of rules governing such operations will need to be determined. More important, the cost of business correspondents being borne by the banks substantially increases the latter's operating expenses. Indeed, there is no reason to expect that the expenses incurred by banks in financial service delivery to low-income clients will be any lower through the business correspondent model than it is through the SHG-bank link model. On the contrary, to the extent that group liability and transparency of operations is a significant risk-mitigating factor in the link model, its absence in the business correspondent model could become an important impediment to the latter's growth. The banks' outreach of

microfinance services through the business correspondent option is unlikely to increase any more significantly than it has through the link model. By November 2006, almost 11 months after the announcement of the business correspondent option, the measure remained dormant as banks were unable to obtain any serious response from potential correspondents (NGOs, MFIs, and others) to the low-value offers for such services. As with the bank-SHG link model, it is likely that banks will extend financial services via this model to the point at which the marginal real cost of operations equals the marginal return on appearing to be a socially responsible institution; it is unlikely to go further. While substantial numbers of low-income clients will be served, this does not negate the potential value of facilitating the collection of deposits by MFIs at the same time, leaving the regulation conundrum unresolved.

The general consideration that has determined the agenda of the frameworks adopted in Bangladesh and proposed in India is the fear of unscrupulous operators hijacking the measures proposed to siphon off the deposits of poor families. The experiences of Nepal over the past seven years and, more recently, Pakistan do not portend any significant number of fly-by-night companies that would undermine the credibility of genuine microfinance service providers.

Overall, microfinance regulation in South Asia has been primarily concerned with the poverty agenda. A country's approach to regulation will have considerable impacts on the future of microfinance, not the least of which are how access will be increased, who will be reached, what services will be provided, what kinds of institutions will provide those services, and how an inclusive financial sector will take shape. The rejection of microfinance development banks as important elements in the financial system by the governments of Bangladesh and India, at this stage, can be seen as a reflection of the focus on the

<sup>144</sup> India's Regional Rural Banks Act, 1976, is a specific law in this matter.

poverty issue. Nevertheless, in a long-term context, this approach presages an emerging concern for the “missing middle,” where microenterprise finance becomes as important as capital formation for low-income families. To this extent, the concept of tiered regulation may be counterproductive, resulting only in a niche market for financial services for low-income clients rather than an inclusive financial

landscape. In the long run, it may be far more effective to allow and enable freedom in pricing for banks as well as MFIs and encourage competitive market development for financial services. The combination of tiered regulation and greater freedom in pricing gives Indonesia and the Philippines far more inclusive financial sectors than any country in South Asia.

### The Role of National Microfinance Associations

A recent paper estimates that national microfinance associations are active in more than 60 countries around the world and are playing an increasingly important part in the development of national microfinance sectors. The paper describes four main roles that associations played over time:

- **Advocates:** taking on a prominent role in dialogue with the financial sector, government bodies, and organizations outside the country
- **Standard-setters:** proactively promoting financial transparency and codes of conduct
- **Service providers:** offering fee-based services to members and nonmembers such as training, credit bureau information, and technical assistance
- **Funding channels:** directing funds to retail MFIs

Five countries in South Asia have national associations, while Sri Lanka is in the early stages of a second attempt to form a viable national association. The first such association in South Asia was the Credit and Development Forum (CDF) in Bangladesh, established in 1992. The Pakistan Microfinance Network (PMN) was formed in 1997, the Centre for Micro Finance (CMF) started in Nepal in 1998, Sa-Dhan began in India in 1998, and the nascent Afghanistan Microfinance Association (AMA) began in 2005. In addition, one regional network, International Network for Alternative Financial Institutions (INAFI), works out of Bangladesh and includes some of the national associations in its membership,

but it has not been a particularly visible or influential network.

All of these associations have taken on the role of advocates for the industry with various degrees of skill and success. This role has become even more important as most countries in the region are in the process of creating new regulations for microfinance, although national associations have not always been organized to influence this process as much as might have been useful. Sa-Dhan and the PMN have been more successful in advocating for the industry because of their reputation and credibility with the government, donors, and the main MFIs. Sa-Dhan, in particular, has achieved some success in helping to move the Indian Government from a position of ignoring microfinance as an activity to the verge of a national regulatory framework for microfinance. Bangladesh's CDF, while being well known, has suffered from repeated management changes and has not been able to establish the level of influence enjoyed by the other two among decision makers in government, banks, and donor agencies or even with their own members. The larger MFIs in Bangladesh have tended to take independent positions on microfinance and undertaken their own advocacy.

The PMN's most important role so far has been as a standard-setter through, among other activities, its Performance Indicators Report on member MFIs. Sa-Dhan has had a standards subgroup from the start, has

published performance and transparency standards for its members, and has educated members on this topic. Other associations are moving into doing this as well, mostly in terms of promoting financial transparency.

The only association that has attempted to act as a funding channel is CDF, which has worked with a commercial bank to channel funds to small NGO-MFIs. CDF is best known for its annual microfinance statistics report that, in 2004, included more than 700 MFIs.

All have conducted research and published position papers, as well as provided services to MFIs and other institutions, primarily training. While Nepal's CMF has attempted to perform the advocacy and other roles, it has remained largely confined as a service provider, perhaps partly because it has more the character of a consultancy company than a member-based association. While all the associations have played a service provision role, this role has changed over time as more and more private sector service providers emerge. The larger, more active associations have all received donor funds, although they have also used service provision to generate income in addition to generating small amounts of income from membership fees, but no association has been able to become financially independent of donor funding.

Each member-based association has its own rules for membership and has increased membership over time. Membership is commonly based around a core group of NGO-MFIs, although some associations also include individual members, organizations that provide services to MFIs, and even banks, government officials, and regulators. The PMN includes commercial banks, microfinance banks, and leasing companies in its membership besides NGOs, because its goal is to represent all the main retail MFIs, not just NGOs. Sa-Dhan has a similar membership profile.

While the associations in South Asia have emerged out of the NGO-MFI sector, it is clear that they will have to evolve in several ways if they are to keep up with the changes that are

taking place, increase their value to the industry, and strengthen their ability to influence positive change.

- First, they will need to broaden their vision to focus on the wider picture of creating inclusive financial sectors to address the gap in access that still exists in most countries.
- Second, as different kinds of organizations enter the market, they will need to reach out to and include new players, especially regulated, commercial financial institutions of various kinds, if they are to continue to influence policy and practice at a national level. If they do not do this, a dual association structure might emerge, such as exists in Bolivia, with one association for regulated MFIs and another for NGOs, a situation that could weaken the influence a unified association can have.
- Third, there is a growing sense of the need for associations to play a greater role in promoting transparency, especially financial transparency, and setting standards for conduct in the industry to help improve MFI performance and sustainability as well as increase the microfinance service providers' credibility with the public, regulators, policy makers, donors, and investors. Since 2004, Sa-Dhan has been drawn into such a role as objections have arisen in the governments of some of the southern states of India about the interest rates and collection practices adopted by a few of the leading MFIs. The national microfinance associations will need to play a more proactive and preemptive role in such matters if such problems are to be prevented. Until now, the tendency has been for some associations to focus on easier roles of documentation, research, and capacity building to the relative neglect of the essential role of advocacy and adherence to codes of conduct affecting behavior and performance.

## Links in South Asian Microfinance

### Apex funding institutions

Microfinance apex institutions have played a significant role in the development of the sector in South Asia, primarily by providing loan funds as well as operational grants, mostly to NGO-MFIs, although they have also provided capacity building support to MFIs and played a role in setting standards for the industry, in some cases acting as a quasi-regulator for the sector.

Several countries in South Asia have a history of such apex institutions playing a role in the development of the microfinance sector. What is now known as the National Development Trust Fund (NDTF) was established in Sri Lanka in 1990. The PKSf was set up in Bangladesh in 1991, the RSRF in 1993, the RMDC in 2000 in Nepal, the PPAF in 1999, and MISFA in 2003. In India, a series of apex funds was established by the national government directly (Rashtriya Mahila Kosh, the national women's fund), by state governments (state-level women's development corporations and minorities development corporations), and by national development banks (the SIDBI Fund for Micro Credit and the Micro-finance Development Fund of NABARD). Each one was first established sometime in the mid-1990s and evolved over time into a full-fledged fund. Preceding all of these funds was the FWWB fund established by SEWA Bank in 1993.

With the exception of some of the Indian apexes, all of these funds were established by the government and most have received significant donor support. NDTF, PKSf, and MISFA have focused exclusively on microfinance, whereas PPAF has funded other kinds of development activities as well. SIDBI and NABARD as national development banks have played a much wider role in the financial sector, but SIDBI's SFMC, in particular, functions as a separate unit with an exclusive microfinance role. With the exception of

NDTF, which has remained relatively small and has not been a particularly influential force in Sri Lanka, and the politically vulnerable RMK as well as state-level institutions in India, apexes have played a relatively dominant role in the development of their respective national microfinance sectors. In India, NABARD has presided over the rise of the large SHG-bank link movement, while SFMC has played a key role in the promotion of the microfinance sector, building on an agenda first established by FWWB. PKSf played a key role in the growth of the very large NGO microfinance sector in Bangladesh, although by 2003 its proportionate contribution to NGO revolving loan funds had declined to about 20 percent. PPAF came into existence at the same time the government elevated microfinance to national importance in Pakistan and became the primary source of funding for NGO-MFIs. MISFA has, thus far, been hugely influential in the start-up of the microfinance sector in Afghanistan.

There is little doubt that the key role played by the leading apex funding institutions was especially necessary and useful in the early stages of the development of microfinance in South Asia. Their track record of performance in their promotional roles has been mixed and questions about their continuing relevance have been raised as the industry evolves.

Most apex institutions have defined their primary role in terms of reducing poverty rather than developing an integrated, inclusive financial systems to serve poor people. This has been cast in the context of the poverty agenda of national governments and has provided the justification for the large amounts of government and donor funding provided to them. The often unstated premise has been that there is a market failure in terms of financial services for the poor, requiring the use of initial subsidies to stimulate the provision of microfinance services. Because apexes were created by governments and

donors, even if some are legally and operationally autonomous, they tend to reflect the agendas of their founders more than the interests of the MFIs, poor clients, or the sector as a whole. For example, there was initially more focus on the sustainability of the apex than the MFIs, as well as the imposition of high transaction costs. The use of extensive reporting requirements based on apex, donor, or government “needs” sometimes is a substitute for a clear focus on MFI performance, especially financial performance. Examples of questionable apex policies and practices include the following:

- Use of subsidies beyond the needs of the start-up phase. This can delay sustainability and make it difficult to create a level playing field that might encourage other types of service providers and the use of market-based funding mechanisms (most countries).
- Interest rate caps (Bangladesh and Sri Lanka, with indirect pressure exerted in other countries)
- Low loan size caps (Pakistan, Sri Lanka, and Bangladesh)

While these apexes play a significant role in supporting the initial growth of microfinance outreach, in most cases have large amounts of funding, and have even become sustainable entities themselves, there is a danger of continuing for too long in the mold in which they were created. If the original purpose was to overcome a market failure and jump-start the growth of microfinance, should apexes have a sunset clause?

Except partly in the Indian case, there is little evidence thus far that, having played their original valuable role, apex funding institutions have done much to help MFIs graduate to become market players no longer requiring subsidized funds. In fact, subsidies are often used to tie MFIs to the apex for the long term rather than to help them move on. There is also a question of whether the role of apexes needs to change as microfinance sectors mature. For example, this could include financing a wide

variety of service providers and offering a much wider range of services than the limited credit products that have been the bread and butter of apex programs. This becomes relevant as increasing numbers of MFIs become profitable and are able to go to the market for their funding, and as technology changes the way services can be provided to poor people.

Nevertheless, two leading Indian apexes may demonstrate a way forward. As discussed in chapter 4, SFMC's role as the primary funder to India's NGO-MFIs has been largely overtaken by ICICI Bank and other private commercial banks, while SFMC has gradually shifted its focus to promoting the start-up of smaller MFIs in some of the poorer parts of India. Simultaneously, SFMC has increasingly encouraged the downscaling of NBFC and cooperative bank portfolios, thus promoting greater inclusion in the financial sector and at the same time pursuing the poverty agenda more effectively. Similarly, having initially encouraged the commercial banks to become engaged with SHG lending, and having provided refinance as well as capacity building support to them, NABARD now finds that refinance is in much less demand. The program continues to grow under its own steam, however, because government-owned commercial banks are keen to pursue it to burnish their image with government and the public. In reality, though, this amounts to the banks having adopted the original poverty agenda rather than serving as an example of inclusion and mainstreaming of SHG lending.<sup>145</sup>

In South Asia, apex funding institutions have played an important role in scaling up microfinance but have had a smaller impact on promoting sustainable MFIs. Except in some limited situations, they have mainly pursued a poverty agenda without contributing significantly to the wider vision of an inclusive financial sector that is now emerging.

<sup>145</sup> The interest rate politically acceptable under the SHG link program (12 to 14 percent) simply is not sufficient to enable the banks to lend to these groups on a scale that goes beyond a very small proportion (5 percent) of their portfolio.



## MFI rating

Rating addresses the problem of information asymmetry between lenders and investors, on the one hand, and MFI performance and capabilities, on the other. Thus, MFI rating can be a key factor in establishing links between MFIs and the investment community. South Asia is one of the worldwide pioneers in the field of MFI ratings: Micro-Credit Ratings International Limited, based in India, is one of the first group of three microfinance raters established internationally and accredited by the Inter-American Development Bank (IDB)-CGAP Rating Fund.<sup>146</sup> M-CRIL emerged out of the microfinance assessment and appraisal expertise developed by EDA Rural Systems Private Limited, a poverty and livelihoods consultancy. From the start, M-CRIL positioned itself as an international agency and conducted its first commercial rating in Bangladesh. By November 2006, it had conducted 387 ratings in 14 countries, of which about 300 were in India and another 44 in other South Asian countries. The dominance of India in this rating profile is attributable to SFMC, the most active of the apex funders, which adopted ratings as an essential part of its appraisal mechanism for lending to MFIs. With increasing investor interest in MFIs, however, there is also now a growing independent MFI market for ratings.

Based on M-CRIL's success, and encouraged by SFMC, Credit Rating and Information Services India Limited (CRISIL), a corporate rating agency based in Mumbai,<sup>147</sup> launched an MFI rating service in 2001. CRISIL has undertaken some 50 ratings so far, mostly in India. In addition, JCR-VIS, a corporate rating agency based in Pakistan, recently launched a microfinance rating service that subsequently formed a joint venture with Microfinanza, an Italian-based specialized microfinance rating agency that had not previously been active in South Asia. JCR-VIS has undertaken a few

ratings in Pakistan so far, largely through a recent SBP requirement that microfinance banks be rated annually if they take deposits or have been in existence for three years; it also rated a microfinance bank in Afghanistan.

Given the availability of widely accepted professional expertise in the field of microfinance rating, South Asia is well positioned to facilitate links between MFIs and investors. Indeed, the past couple of years have seen a widening investor profile in South Asian microfinance, particularly in India, with the advent of individual investors, international funds, and venture capital initiatives. These developments have begun to attract other corporate rating agencies, as well as specialized rating agencies based in other regions, to consider entering the South Asian market.

## Credit bureaus

Like rating agencies, the purpose of a credit bureau is to overcome information asymmetries. While in the rating case, the asymmetry is related to the lender understanding and being assured of the performance of the borrower, in the case of the credit bureau, the service provides the lender with information about the extent and historical record of the borrower's indebtedness. Rating occurs at the investor to MFI level, whereas credit bureaus address the asymmetry at the MFI to retail client level. Over the past couple of years, the possibility of establishing credit bureaus has become a common discussion in microfinance. Credit bureaus with a microfinance focus have been, or are being, established in a number of Latin American countries (El Salvador, Bolivia) and in Africa (Uganda).

In South Asia, serious consideration of establishing such a bureau for microfinance has

<sup>146</sup> The other two raters are MicroRate and Planet Rating. Chronologically, M-CRIL was the second microfinance rating agency to be launched (trial ratings began in early 1998 and it conducted its first commercial rating in September of that year).

<sup>147</sup> Now a subsidiary of Standard & Poor's the international rating agency.



taken place only in Pakistan (by the national network, PMN). While this initiative is at an early planning stage, the problem of establishing unique identifiers for microfinance clients could take a while longer to solve. In Bangladesh, PKSF is developing a database of the client profile of the MFIs it supports, but this initiative has a long way to go to become a useful borrower credit information system. Until biometric identification systems become available at a reasonable cost, the possibility of providing credit bureau services in the region

may need to wait. The relationship between cost and technical innovation for microfinance is a critical one, as discussed in the following subsection. Many MFIs have so far seen little reason to use and pay for credit information services, because their own approaches allow them to find new clients and manage risk reasonably well, although most do not have operations that are significantly influenced by competition with other MFIs.

## The Role and Potential of Technology

Technology has considerable potential to reduce delivery costs and expand the scale of financial services for poor people. Using low-cost hardware and ubiquitous mobile phone networks, banks and MFIs may find it possible to deliver financial services less expensively than was earlier possible, even in rural areas. Such initiatives in the Philippines, South Africa and Brazil, in particular, appear to have successfully included more low-income people in the mainstream banking system, and these initiatives are increasingly attracting attention from commercially oriented microfinance providers in South Asia.

Still, banks and MFIs in the region are only beginning to consider the potential of technology. Most MFIs, which have specialized in serving poor people, are still putting in place basic information systems that track lending operations and can automate accounting and management reporting. These systems are the foundation for more advanced technology applications, such as bankcards for use at ATMs and point-of-sale (POS) devices, and mobile telephone banking. Although some organizations, such as ASA in Bangladesh, have grown large using manual instead of computerized information systems, most MFIs face constraints to growth because their information systems cannot track ever-larger numbers of transactions and branch accounts.

Some leading MFIs with relatively stable information systems have experimented with more advanced technologies during the past several years. These experiments, by MFIs such as SKS and BASIX in India, generally took advantage of more advanced information system technologies, such as handheld computers, to achieve greater staff productivity in the field. Loan officers used the devices to record client and loan information. However, most such attempts were discontinued or were not scaled up when it was found that manual operations achieved similar levels of efficiency over time. Advanced MIS implementations have been successful when the technology is used as part of a core process, or for multiple purposes, and justifies its costs. SafeSave's use of handheld devices in urban Dhaka is one such example.

Commercial banks typically have a strong case for using technology to deliver financial services to poor people and can usually allocate greater resources and expertise to technology implementation than MFIs. This is true of banks in South Asia that have increasingly become interested in serving low-income people, such as ICICI Bank in India and Hatton National Bank in Sri Lanka. These banks lack a rural distribution channel or find that their rural branches are not well-suited to handle poor customers and small transactions.

Typical branch hours of operation, processes, and costs preclude serving individual microfinance customers. The same is generally true of bank branches in urban areas.

Technology can enable alternative channels for banks to serve poor customers, particularly in rural areas. ICICI Bank in India is trying to develop low-cost ATMs to disburse and collect cash in rural areas. The bank is seeking to reduce costs and improve efficiency for its MFI partners by creating a single information system platform that all MFI partners can use and by automating cash transactions in the field. Instead of having loan officers collect and travel with cash, MFIs will be able to issue smart cards to customers and enable payments at rural retail outlets equipped with card readers. Banks in Bangladesh and Sri Lanka are exploring similar technology options to reduce the cost and risk of handling cash. In Pakistan, Tameer Bank, a newly established microfinance bank with an urban focus and a consumer finance approach, has introduced biometric identification technology and ATMs in its branches and is exploring the use of mobile telephone technology to expand and improve its services.

Everywhere, and in each case of technology application, the main issue is the extent of efficiency gain achieved from introducing the technology relative to the cost incurred. Although thus far the cost has outweighed the gain, as in all modern technology applications, the trend is positive. With further innovation, it will not be long until technology applications could have a revolutionary impact on microfinance and could build a more democratic, inclusive financial sector. This is especially true for mobile telephone technology because coverage levels are already ahead of western countries and growing rapidly, even in poorer populations, and could

introduce a whole range of new players into the microfinance sector. There are already plans or initiatives under way in Bangladesh, India, Pakistan, and Sri Lanka to use mobile telephone technology to increase access to financial services for poor people.<sup>148</sup>

<sup>148</sup> One of the more interesting initiatives to employ technology to increase outreach and reduce costs might begin soon in the Maldives. The government is working with the two mobile telephone companies and the largest commercial bank to see whether they can establish a mobile telephone payment system. The Bank of Maldives already makes extensive use of ATMs, including mobile ATMs for remote islands, but mobile telephone banking, along with the introduction of POS units connected over the same telephone system, will considerably expand access in a country that has 200 inhabited islands with small populations, especially because mobile telephone coverage extends to almost every household. In this case, high mobile telephone coverage levels combined with sparse populations living at considerable distances from each other ensure that the application of new technology will make a significant difference in increasing access to the general population, including poor households.

# Conclusions and Future Perspectives

Microfinance in South Asia gathered considerable momentum over the past 25 years. The microfinance movement challenged conventional financial sector and government thinking, in the process fundamentally altering the financial landscape in favor of the poor. A growing microfinance sector with an increasingly wide range of products and more sophisticated support structures has improved access to financial services for many people previously excluded from the system. This has occurred largely through the creation of an alternative financial system, a parallel world of financial instruments and support mechanisms with tenuous links to the “mainstream world” of sophisticated financial markets. While the emerging financial landscape is more inclusive than before, microfinance clients and practitioners are still largely regarded by the formal economy as a curiosity more than a real business opportunity.

## Microfinance Today

There is **considerable opportunity for microfinance outreach** to grow to meet the still substantially unmet demand for microfinance services. Poor families alone number around 86 million, without taking into account the borderline poor and other low-income clients, while client outreach so far amounts to no more than 35 million, including some non-poor low-income clients. Aggregate demand for microcredit is conservatively put at \$15 billion compared with estimated outstanding microfinance loans of just \$2.3 billion in 2005.

Despite great progress over the past few decades, **outreach to the poor is still limited**. It is estimated that about 17 percent of poor households in South Asia are served by microfinance. Coverage ranges from good in Bangladesh and Sri Lanka (where at least 60 percent of the poor have access to microfinance) to poor in Afghanistan and Pakistan (less than 10 percent), with coverage in India and Nepal falling in between but closer to the low end. Outreach growth rates are particularly high in India, Pakistan, and

Afghanistan; Nepal is faced with stagnation because of the country's disturbed political conditions.

Each country has **different institutional structures for microfinance**. Afghanistan, Bangladesh, and Pakistan are dominated by MFIs; Sri Lanka and Nepal have substantial outreach by cooperatives. In India, SHGs are dominant, although MFIs also make a substantial contribution. All countries except Bangladesh and Afghanistan have links with the commercial banking sector, although examination reveals that the number of links is quite small compared with each bank's total assets and is motivated more by corporate social responsibility and public recognition than by business considerations.

The **financing structure** of MFIs has substantial donated equity in Afghanistan, Bangladesh, and Pakistan, while debt is an important source of funds in India and Nepal. Although some of the debt financing comes from commercial banks, much of it originates in the apex funds established by each country, often

backed by donors. Deposits make a significant contribution everywhere, particularly in Sri Lanka where this funding source drives the community-based institutions that provide virtually all the microfinance outreach. Voluntary deposits in Sri Lanka imply a greater degree of commercial financing than do the compulsory deposits generated by MFIs in other countries. Throughout the region, strengthening links with the commercial sector remains a major challenge.

**Products offered by MFIs have shown increasing flexibility** based on growing responsiveness to client needs. Not only is there increasing experimentation with more flexible credit products, but deposit products have also been more widely offered in more flexible ways to the extent allowed by regulatory constraints. In addition, insurance services have gained some momentum (especially in India and Bangladesh), there is some engagement with money transfers (Bangladesh, Pakistan, and India), and microleasing has emerged (Bangladesh and Pakistan).

The sustainability and performance of MFIs reflect a common pattern. **A relatively small number of increasingly efficient institutions are responsible for a large proportion of the increase in outreach**, but the majority of institutions are relatively weak and are propped up by subsidies from donors and governments. Sound research on depth of outreach is relatively limited, but this seems to indicate that there are no clear trade-offs between sustainability and poverty outreach. Evidence from India and Bangladesh shows that MFIs can balance poverty outreach with sound financial performance, in the process managing efficient operations with excellent portfolio quality.

**Microfinance yields significant benefits to clients**, in comparison with nonclients, and has a greater impact on poorer households. Given the methodological difficulties in impact measurement and the high cost of sound research, there is a shift towards managing and

reporting on the steps that are likely to lead to impact rather than on proving end results alone. Both social performance management by MFIs and social rating by external rating agencies could constitute a useful and relatively low-cost means of keeping track of and reporting on the achievement of microfinance's social mission.

There is **growing interest in regulation** throughout the region, although generally as a separate activity from the regulation of the overall financial system. In some cases, the regulation includes establishing separate regulatory institutions apart from the central bank. While appropriate regulation can help strengthen and expand the provision of services to poor people and lend the legitimacy to MFIs that comes from formal recognition, it is not clear that regulation initiatives are as enabling or "inclusion oriented" as they could be.

**Apex funding institutions have played a key role** in all countries except Sri Lanka, where most microfinance services are not provided by institutions that the apex supports. Although their role has been important and influential in the early stages of microfinance development (PKSF in Bangladesh being the most prominent example), with the exception of some experience in India, these institutions have not been successful in moving MFIs away from subsidies and toward greater use of commercial funding sources. Nor have they taken on a major role in promoting change (for example, supporting the introduction of new products or the use of new technologies).

**MFI rating has become well established** in the region with one specialist institution and two corporate rating agencies engaged in the activity. Credit bureaus are increasingly discussed.

**Experimentation with technology has been limited** to a few leading MFIs, although mobile telephone technology holds considerable promise for the future. The main issue in these experiments is whether efficiency gains from introducing technology outweigh the costs.

## Future Perspectives

Microfinance provides most of the access to financial services available to low-income people in South Asia, but it is still largely separate from the financial system, with few examples of direct service provision to the poor by mainstream commercial institutions. And despite the growing discussion about and enthusiasm for developing a seamless inclusive financial sector, there is little evidence that this is happening yet. Only in India are there significant examples of bank involvement in microfinance. This includes the link models with MFIs, the large and growing bank-SHG links, and involvement in the market of several large commercial banks. Several local and international social investment funds offering debt and equity products are active in India, something that has not taken off elsewhere in the region. But even in India, aside from the bank-SHG model, which has its own special characteristics, evidence of mainstreaming is still limited to a relatively small part of total outreach.

In some countries, major impediments need to be removed before an inclusive financial sector can develop. In Sri Lanka especially, the dominating presence of very large government-subsidized microfinance programs impedes the growth of well-managed MFIs and commercial banks that want to enter the sector. In Pakistan, most NGO-MFIs and microfinance banks are not profitable and do not charge interest rates that would support profitable operations, largely because they still receive significant donor- and government-funded subsidies. Recently in India, competition between subsidy-oriented government programs and MFIs has resulted in a state government placing pressure on financially sustainable MFIs to lower their interest rates to unsustainable levels. This sends an obvious message to banks that might otherwise consider retail products for microfinance. Reforms are needed to remove impediments before a healthy, inclusive financial sector will be able to emerge.

The microfinance movement of the past few decades has fundamentally changed the financial sector, a change process that is gathering momentum. And there are opportunities to take the microfinance movement to the next stage of its development, a stage in which a more inclusive financial sector can be shaped to better serve the needs and interests of the poor.

Evidence suggests that for the next few years at least, most of the growth in microfinance will come from [a few large, profitable, specialized institutions](#) that might in some ways rival smaller banks in their respective countries. This primary focus on strong, growing institutions at the heart of serving the poor has been achieved in Bangladesh, and there are signs of it emerging in Pakistan, India, and Afghanistan. Such institutions will be able to gain greater legitimacy by having well-managed, efficient, and profitable operations; by becoming regulated; and by growing links with mainstream commercial institutions. Furthermore, such large institutions will offer more flexible loan and deposit services, will add other financial services such as insurance and money transfers, and will have the strength to reach out to poorer people, including through links with safety net programs, and more remote regions. Conversely, there is little to suggest that large commercial banks will take on a much greater role in direct service provision to poor people.

The dominant institutions that do emerge over the next few years will have access to and make more use of [commercial sources of funding](#). Links with commercial banks and social investors will become increasingly important, not only affording these institutions a source of funds to support their donor- or government-dependent growth, but also bringing more discipline, transparency, and accountability to their operations. At the same time, the development of enabling regulatory environments should allow good MFIs to

increasingly mobilize deposits from their members as well as others. This is beginning to happen in Bangladesh and Afghanistan, and such opportunities should expand to other countries. But to grow and be able to use more commercial sources of funds, the environment will also need to allow for market-based pricing. Instead of interest rate controls, the way to reduce interest charges paid by low-income clients lies in the proven formula of opening opportunities for investment by removing the idea that there is a socially acceptable interest rate for lending to the poor. At the same time, by putting substantial resources into improving the management capacity of MFIs, they can increase their efficiency and reduce their costs. In South Asia, this could lead to the cost of microfinance to the client settling at an effective rate of 21 to 24 percent per year and outreach throughout the region expanding to 50 to 60 percent of the poor in less than a decade. Bangladesh has made considerable progress in this direction.

Greater interest in [regulation](#) holds out the prospect of increasingly mainstreaming microfinance within the larger financial sector. This involves improving existing regulations, advocating for or creating new regulations, setting up new regulatory bodies, and improving transparency and self-regulation. Although there is a lot of activity, more experience and clear thinking are needed to channel these efforts in ways that will lead to good enabling environments. One of the most constructive regulation initiatives has been adopted in Afghanistan, where microfinance is in its infancy, while the country with the best microfinance performance, Bangladesh, has so far only gone part way to create regulation that will enable the sector to make an even greater contribution. Regulatory changes such as the recent approval by the RBI to allow correspondent banking relationships and the interest in several countries to allow mobile telephone banking are examples of initiatives that could help commercial banks downscale their services and become more active in bridging the gap between commercial banking

and microfinance.

[New technologies](#) promise new ways to improve efficiency and expand outreach faster. Already, some MFIs are using ATMs and handheld computers, but more significant changes might become possible as mobile telephone outreach and Internet access expand more widely and become less expensive. This could lead to new kinds of microfinance service providers that are based on mobile telephone banking.

Another step in the region's financial liberalization could occur if the wider political and social environment changes to recognize that economies of scale exist in financial service delivery—cost is inversely proportional to the size of accounts. Central banks and finance professionals will need to take the lead to urge politicians and media to help change the conservative economic environment relative to the poor. Without such liberalization, the process of microfinance evolution is likely to slow down as it hits the barrier of sustainability, particularly if the formal sector reaches a point at which the marginal return to corporate social responsibility falls below the losses associated with microfinance service providers and low-income clients. That point has not been reached yet, although in India some banks are already testing its limits. As long as engagement with low-income clients in South Asia is largely a matter of social responsibility, financial inclusion will remain a dream.



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