

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 Asia¹ 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.² 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.*³

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.

¹This 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.

²Montgomery and Weiss 2005.

³Rutherford, 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.⁴

⁴EDA 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	
<p>LIKES</p> <ul style="list-style-type: none"> ■ 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)^a enables easy access to credit for farmers for at least the first year 	<p>DISLIKES</p> <ul style="list-style-type: none"> ■ 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 <i>panchayats</i>^b 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.⁵ 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.⁶

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.

⁵ 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.

⁶ 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.⁷ 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.,⁸ 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

⁷ Rutherford 2000.

⁸ 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.⁹ 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,

⁹ 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.¹⁰ 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.

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

¹¹ 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.¹²

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)¹³ to poor people, and over 20 years, provided financial assistance of around Rs 250 billion (\$5.6 billion) to roughly 55 million families.¹⁴ 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.¹⁵

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

¹² For a more detailed discussion, see Sinha 2000.

¹³ All dollars are U.S. dollars (\$) unless otherwise noted.

¹⁴ 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."

¹⁵ 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.

¹⁶ 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 2005.¹⁷ 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"¹⁸ 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.¹⁹

¹⁷ 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.

¹⁸ "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.

¹⁹ 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.²⁰ 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

²⁰ 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.²¹ 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

²¹ 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.