

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.