

# 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.

### Financing Structures

MFI 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

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.

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.



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.