

SPECIAL FEATURE TO MARK THE INTERNATIONAL YEAR OF MICROCREDIT, 2005¹

MICROFINANCE IN POVERTY REDUCTION – ASIA-PACIFIC CHALLENGES

“The International Year of Microcredit 2005 underscores the importance of microfinance as an integral part of our collective effort to meet the Millennium Development Goals. Sustainable access to microfinance helps alleviate poverty by generating income, creating jobs, allowing children to go to school, enabling families to obtain health care, and empowering people to make the choices that best serve their needs... Together, we can and must build inclusive financial sectors that help people improve their lives.” (United Nations Secretary-General Kofi Annan)

INTRODUCTION

In marking the International Year of Microcredit, this special feature reviews some of the issues associated with the opportunities created and the challenges faced by microfinance initiatives in becoming a more effective and potent instrument to serve the multidimensional needs of the poor.

Microfinance initiatives initially emerged as small loans known as microcredit provided by NGOs with a strong focus on poverty reduction. Subsequently, an increasingly wider range of financial services to the poor came to be provided by various types of organizations, termed microfinance institutions (MFIs). The services they rendered generally related to small-scale financial services such as loans, savings, insurance and money transfer services provided to poor and low-income people. MFIs have become increasingly diverse in organizational types and their associated objectives, methodologies, products, target groups and scales of operation.

Poverty reduction

The role of microfinance has gained strong acceptance as an effective tool for poverty reduction. General Assembly resolution 59/246 of 22 December 2004 on the role of microcredit and microfinance in the eradication of poverty recognizes the following points:

- The importance of microfinance in providing access to capital for people living in poverty
- The need to create inclusive financial sectors to facilitate microfinance for the poor, and particularly women, in order to mitigate their vulnerability

¹ The United Nations General Assembly designated 2005 as the International Year of Microcredit to highlight and promote recognition of the role of microfinance in the eradication of poverty and its contribution to social development.

- The importance of sharing good practices and enhancing financial sector support to pro-poor financial services in scaling up microfinance to reinforce development impact and sustainability
- The importance of collaborative efforts among all the stakeholders, including Governments, NGOs, international organizations, the private sector and civil society, in raising public awareness and knowledge of microfinance
- The potential contribution of microfinance to the achievement of development goals including the Millennium Development Goals
- The role of Governments in upscaling microfinance through, among others, developing mechanisms to promote sustainable access to financial services, removing institutional and regulatory obstacles and providing incentives to MFIs
- The role of government in the development of regulatory frameworks to ensure good governance, transparency and accountability in MFIs

Microfinance and the Millennium Development Goals²

Numerous experiences in the region have indicated that providing the poor with access to microfinance directly addresses the poverty eradication goal of the Millennium Development Goals by increasing opportunities to generate income and building capacity to smooth consumption flows. For instance, it has been reported that 90 per cent of Bank Rakyat Indonesia clients surveyed on the island of Lombok in Indonesia have moved above the poverty line, with average income increases of 112 per cent, while in India, clients of the Society for Helping and Awakening Rural Poor through Education (SHARE) had, in addition to increased economic well-being, a marked shift from irregular, low-paid daily labour to more diversified sources of income.³ A study on the Grameen Bank in Bangladesh found that the incomes of the participants in the programme (members) were higher than those of non-participants. Its members were reportedly able to rely more on savings and their own funds in crises rather than borrowing from moneylenders.

Income growth in turn facilitates access to crucial services addressed in the Millennium Development Goals, such as health care and education. Some studies, including those on the Grameen Bank, the Bangladesh Rural Action Committee and the Self-Employed Women's Association in India, found that children of MFI clients were more likely to go to school for a longer time and a higher level of education, with lower dropout rates.

Thus, access to a small loan which enables the poor to take advantage of economic opportunities, to plan and expand their business opportunities, to pay school fees or to bridge a cash-flow gap can be a first step in breaking the cycle of poverty and moving out of the poverty trap. Similarly, the ability to access a safe and convenient savings account enables them to save in order to meet unexpected expenses and plan for future investments, in such areas as inventories for

² Examples in this section draw upon Elizabeth Littlefield, Jonathan Morduch and Syed Hashemi, "Is microfinance an effective strategy to reach the Millennium Development Goals?", <http://www.cgap.org/docs/FocusNote_24.html>.

³ Microfinance Gateway, <<http://www.microfinancegateway.org/>>.

their small businesses, children's education and housing improvements. Moreover, access to financial services by poor women has reportedly empowered them in many instances as they play a larger role in income-earning activities.

REACHING OUT TO THE POOR

Microfinance initiatives have evolved over time to be more responsive to the needs of the poor, but a major issue in the promotion of microfinance initiatives remains how to extend the proven benefits of micro-level intervention to a larger and poorer population.

Supply-driven poverty lending approach

The emergence of microfinance initiatives in poverty reduction is aimed at bridging the gap between the reluctance of the formal financial sector to provide financial services to the poor and the unmet demand of the poor, which can otherwise only be met through an informal system, which is often inconvenient, insecure or exorbitantly expensive.⁴ As exemplified by microcredit experiences in South Asia and Latin America in the 1970s, this poverty lending approach focuses on poverty reduction through the provision of microcredit and other complementary services without collateral to those denied access to formal financial services, particularly poor women. Successful experiences with microcredit initiatives have provided evidence contrary to the conventional view of the formal financial sector that there is no demand for financial services among the poor and that the risk associated with the poor is high since they have neither collateral nor proven capacity to repay loans and interest. The noteworthy experience of the Grameen Bank in Bangladesh has been replicated in many countries in the region.

Demand-driven and financial system approach

It has become increasingly evident that the supply-driven microcredit approach cannot reach a wide range of potential clients, leaving out many non-microentrepreneurs.⁵ It has also become clear that there is effective demand by the poor for access to savings, with an increasing number of institutions mobilizing voluntary savings from low-income households, which in turn increases the ability of financial institutions to provide microfinance services without a subsidy. Against this background, a financial system approach developed as a more market-based concept of microfinance, focusing on demand for financial services on the part of poor borrowers and savers, while setting the price of the services to ensure cost recovery and financing loans from locally mobilized savings and other commercial sources, as exemplified by the transformation of the Bank Rakyat Indonesia Unit system from a channelling agent for subsidized credit for agricultural lending to a microfinance entity serving a wider population. Its commercially successful operations provided more evidence contrary to the conventional perception of the financial sector that small financial schemes for the poor are not profitable as the costs of handling small accounts are high. This approach provided scope for reaching a wider population of poor people while achieving institutional financial self-sufficiency.

⁴ For example, effective interest rates from moneylenders can be as high as 100 per cent per month.

⁵ E. Littlefield, "Building financial services for the poor", *Finance for the Poor*, vol. 4, No. 2, June 2003.

Breadth and depth of outreach

Breadth of outreach

One of the important challenges throughout the various experiments in microfinance initiatives is to provide access to as many poor people as possible. Although microfinance initiatives have increased their outreach over the years and many MFIs have even shown the potential profitability of financial services for the poor, there is still a large unmet demand for microfinance and an estimated 400-500 million poor and low-income people worldwide still do not have access to microfinance.⁶ So far, only a handful of organizations in Asia are serving more than a million poor clients.⁷ If microfinance is profitable as is often claimed, why have MFIs not expanded their operations dramatically and why have commercial banks not tapped into the microfinance market more aggressively?

For MFIs one of the constraints in extending outreach is the limited availability of funding resources. To ensure sustainable provision of services as well as expansion of operations, MFIs need an injection of funds from external sources or have to generate funds through their microfinance operations. For institutions which rely on donor funding and subsidies for their finances, the scope for extending the breadth of outreach depends on the availability of additional funds. For many NGO MFIs, the limitation of their scale also relates to the regulatory framework that restricts NGOs to accessing domestic or international capital markets. As NGOs are not permitted to offer savings services in many countries, they cannot mobilize deposits as a way to finance other financial services such as lending. NGO MFIs appear to have achieved significant scale in countries where the regulatory framework has been made suitable for MFIs or has allowed them to flourish unregulated.⁸

The limited scale may also indicate the need for further efforts to match methodology or selection of financial products with the specific needs of potential clients. For instance, the provision of saving services has long been unavailable despite the needs of the poor. For those in remote areas, difficulties in gaining physical access to microfinance facilities may have discouraged potential clients. The poorest reportedly prefer individual loans to group-based schemes packaged with training or regular meetings.⁹ Thus, microfinance products and services that respond to the specific needs of the poor would increase the breadth of outreach while they have to be weighed against the cost of delivery.

Moreover, the limited scale may be due to the fact that the effective provision of microfinance to low-income clients is resource-intensive and developing countries do not have enough of the resources required. Human resources, including a capacity for strategic management, may be one of the important resource requirements. Only when management resources are strategically applied to

⁶ "Implementation of the first United Nations Decade for the Eradication of Poverty (1997-2006) and preparations for the International Year of Microcredit, 2005" (A/59/326).

⁷ Based on data provided by the Microcredit Summit Campaign in "Appendix 1: microcredit institutions whose figures on poorest* and total clients as of December 31, 2003 have been verified", <http://www.microcreditsummit.org/pubs/reports/socr/2004/en_app1.pdf>.

⁸ Heather Montgomery and John Weiss, "Modalities for microfinance delivery in Asia and Latin America: lessons for the People's Republic of China", <http://www.iadb.org/laeba/downloads/WP_29_2004.pdf>.

⁹ N. Fernando, "Microfinance outreach to the poorest: a realistic objective?", *Finance for the Poor*, vol. 5, No. 1, March 2004.

a sufficiently large scale of microfinance operations of any type will microfinance provision be able to cross the threshold and achieve the scale, seen in Bangladesh for example, where some estimates suggest that the number of borrowers at MFIs exceeds 10 per cent of the total population.¹⁰ Thus, for most large commercial banks, the heavy commitment of management time involved in setting up a microfinance programme against the modest financial returns expected¹¹ may be seen as unattractive compared with other investment options.

Depth of outreach – reaching the poorest – alternative perspective

Another important challenge of microfinance is how to reach the poorest. There are various views on the relevance of microfinance for the poorest and corresponding opinions on how to reach this group effectively.¹²

One view is that microfinance cannot reach the poorest on a sustainable basis. The extreme poor may not benefit from microfinance and would be better served by other poverty reduction and social protection measures.¹³ Many of the poorest with no capacity to generate income would require grants, employment and other services, rather than microcredit, which can make the extremely poor even more vulnerable, not less. According to this argument, the cost of providing microfinance to the poorest is so high that MFIs may not be able to sustain the service without cost recovery while the poorest would not be able to afford such a high cost.

This view, however, is contested by the argument that lack of poverty reduction measures and social protection are the core issues of poverty and the required services for the poorest are not readily available.

The above view, which would exclude the poorest from the microfinance target group, contrasts with the view that microfinance can reach and benefit even the poorest of the poor on a sustainable basis and on a large scale. It holds that there is a vast effective demand for microfinance services among the poorest and “...the reality in most poor countries is that the poorest are already saddled with incredible debt at usurious rates from local moneylenders. This is the fundamental predicament that microfinance institutions have effectively addressed for nearly three decades now.”¹⁴ This view is supported by the experience of an increasing number of MFIs with a strong focus on reaching the poorest, which have reported successful results in reaching the poorest without jeopardizing financial sustainability. Yet the rapid increase in outreach to the poorest depends on the funding agencies’ financial support to those MFIs, as exemplified by the view of the Microcredit Summit that donors should direct more funds to microfinance to reach the poorest.¹⁵

¹⁰ P. Honohan, “Financial sector policy and the poor: selected findings and issues”, World Bank Working Paper No. 43, <http://www1.worldbank.org/finance/assets/images/0821359673_Financial_Sector_Policy_and_the_Poor.pdf>.

¹¹ Ibid.

¹² N. Fernando, loc. cit.

¹³ M. Robinson, *The Microfinance Revolution: Sustainable Finance for the Poor* (Washington, World Bank, 2001).

¹⁴ Unpublished letter to the editor in response to the *New York Times* article, “Debate stirs over tiny loans to world’s poorest” (29 April 2004, by Celia Dugger), and the ensuing editorial, “Microcredit’s limits” (5 May 2004), <<http://www.microfinancegateway.org/content/article/detail/19028>>.

¹⁵ Sam Daley-Harris, “State of the Microcredit Summit Campaign Report 2004”, <<http://www.microcreditsummit.org/pubs/reports/socr/2004/SOCR04.pdf>>.

However, there is a less optimistic view about large-scale sustainable provision of microfinance for the extreme poor. Reaching the poorest may be inherently more costly, as the size of transactions is much smaller and thus the operational cost per transaction is far higher. Risk factors associated with the poorest may also be higher as they are likely to be exposed to risks stemming from multiple interlocking disadvantages. It is questionable to what extent the poorest can afford to pay a higher price for microfinance services to cover the higher operational costs, although some feel that the poorest can pay, as otherwise they would have to resort to informal sources to finance their needs, which could be expensive. In this view, the scope for sustainable provision of microfinance to the poorest on a large scale is limited, while there is still much room to explore innovative approaches that combine livelihood protection with livelihood promotion to expand the outreach to the poorest, such as the Income Generation for Vulnerable Groups Development programme in Bangladesh,¹⁶ and external financial support can facilitate experiments.

MICROFINANCE INITIATIVES IN THE REGION

Around 2 billion people, or 70 per cent of the world's poor, were living on less than 2 dollars a day in the region in 2001.¹⁷ The region also has a large number of MFIs. Estimates by the Microcredit Summit Campaign indicate that more than half of the MFIs in the world are located in Asia. In 2003, there were 1,600 MFIs in Asia, serving almost 90 per cent of world's MFI clients or 71 million clients consisting of 49 million of the poorest. Among the poorest, more than 80 per cent of clients are women.¹⁸

The Asia-Pacific region has a wide variety of experiences in microfinance experiments. The successes and challenges of these various experiences have been debated in the light of various criteria and there is no agreed model of microfinance that satisfies all. Thus, this section highlights some experiences in the region to flag the diversity of microfinance initiatives in Asia and the Pacific.

South Asia

South Asia, seen as the birthplace of microfinance, houses a wide range of microfinance institutions, including many large MFIs experimenting with various microfinance schemes.¹⁹

A hallmark microfinance initiative in the region is the microcredit scheme pioneered by the Grameen Bank in Bangladesh, which demonstrated the possibility of reaching out to the poor on a large scale. Many MFIs, mostly NGO MFIs in the subregion, have either replicated the approach of

¹⁶ This programme of Bangladesh Rural Action Committee, building on the Government's safety net programme, provided foodgrain to hard core poor women to cater for their immediate consumption needs, packaged with skills training on poultry and livestock raising, etc., as well as a savings and credit service to buy chickens. "Two-thirds of these women have reportedly 'graduated' from absolute poverty to becoming microfinance clients, and have not slipped back into requiring government handouts", <http://www.cgap.org/docs/FocusNote_21.pdf>.

¹⁷ See chapter I of this *Survey*.

¹⁸ Sam Daley-Harris, loc. cit. Poorest is defined here as those in the bottom half of those living below their country's poverty line or below \$1 a day.

¹⁹ According to the Microcredit Summit Campaign, out of 179 validated MFIs in Asia, 144 are in South Asia and half of them are in Bangladesh.

the Grameen Bank or developed their own variants with more flexible products and methodologies. In addition to various experiments, many Governments in the subregion have attempted to upscale their microfinance initiatives, for example, through establishing wholesale banks for MFIs and linking microfinance initiatives with the formal financial sector.

The novelty of the Grameen Bank in Bangladesh, which first started as an action experiment in the 1970s, was that it targeted poor women and had a group lending mechanism that allows a number of individuals to provide collateral or guarantee a loan through a group repayment pledge, giving an incentive to repay through peer pressure. In addition to group responsibility for loan repayment, a contribution of savings was one of the conditions prior to the disbursement of loans. The Grameen Bank experience showed the contribution of microfinance to income generation by the poor while achieving a significantly high repayment rate. It had grown to become a specialized commercial bank with 4 million members with outstanding loans of \$283.95 million by the end of December 2004.²⁰

Many replicators in the country and the region have been inspired by the Grameen Bank experience. For instance, Credit and Savings for the Hard-Core Poor, a network of 20 microfinance organizations in Asia, is explicitly aiming for Grameen Bank-type replications to provide credit and savings programmes targeting poor women. Within Bangladesh itself, several NGOs were induced to innovate on the basis of the Grameen Bank methodology.

Some NGO MFIs have also grown into large scale MFIs with more commercially focused operations. For example, the Bangladesh Rural Action Committee and the Association for Social Advancement (ASA) in Bangladesh have demonstrated that NGO MFIs can achieve financial self-sufficiency while serving a large number of the poor. ASA focuses on individual clients instead of a group approach and emphasizes the mobilization of voluntary savings and pricing its financial products to cover its operational costs.²¹ It is reported to have served over 2 million poorest clients by the end of 2003, with an average outstanding loan balance of \$90.

While some MFIs have grown into large-scale operations, most MFIs in the subregion remain small. Yet some Governments have begun to link the small-scale microfinance scheme to the formal financial system. For instance, the National Bank for Agriculture and Rural Development in India, an offshoot of the Reserve Bank of India, has played a central role in promoting self-help groups and linking them to the formal banking system through its banks/self-help groups linkages programme, which had served 11 million people by end of 2003.²² Under the programme the poor organize self-help groups for lending and saving and mature groups are linked to the formal banking system. The Small Industries Development Bank of India has taken a similar approach, working with a close network of NGO partners.²³

²⁰ Grameen Bank monthly update, December 2004, <<http://www.grameen-info.org>>.

²¹ S.H. Choudhury and M. Kamal, "ASA: profile of a successful microfinance institution", <<http://devnet.anu.edu.au/online%20versions%20pdfs/57/1357Choudhury.pdf>>.

²² Sam Daley-Harris, loc. cit.

²³ Pascal Marino, "Five years on: the Microcredit Summit Campaign and the development of microfinance in Asia and the Pacific", <http://www.fdc.org.au/publications/20030523_57.html>.

Government initiatives to link formal institutions and microfinance are also found in Bangladesh. With the substantial growth of NGO MFIs in the country, the Palli Karma-Sahayak Foundation was established by the Government as a wholesaler of microfinance funds in the country. It provides loans to partner organizations, around 200 NGO MFIs. By February 2004, it had disbursed a total of about \$277 million among 4.55 million poor borrowers through its partner organizations.²⁴

In some countries, government initiatives to promote microfinance led to the creation of an MFI to play a leading role in microfinance initiatives, such as the Pakistan Poverty Alleviation Fund, an apex organization to provide wholesale funds/credit lines and grants to NGOs, and Khushali Bank, a microfinance retail bank, in Pakistan. The Government facilitated the establishment of Khushali Bank, which is owned by 2 public sector, 12 private sector and 2 foreign banks²⁵ and has a major share (95 per cent) in lending. It has a network of 40 branches and 70 service centres across 41 districts.²⁶

Private investments in microfinance are another innovation linking private banks with MFIs that is in its nascent stage in many countries. Securitization of loans, guarantees, lines of credit and other instruments are used to promote private capital in microfinance. For instance, in India, ICICI Bank, which is a private bank wholesaling to MFIs, has securitized loans of Bhartiya Samruddhi Finance Limited and SHARE by releasing equity funds for the organizations to lend to clients.

East and South-East Asia

There is a vast diversity of schemes and levels of development of microfinance in East and South-East Asia, while direct credit programmes are also prevalent. The experiences in the region range from large-scale microfinance schemes involving formal financing institutions and initiatives led by central government programmes and associated NGOs to initiatives with a strong NGO presence.

Some examples in this region have shown the potential for formal financial institutions to be involved in microfinance on a large scale. The Bank Rakyat Indonesia Unit system in Indonesia is often viewed as a hallmark example of large-scale, financially sustainable provision of microfinance by a formal financial institution. Its unit *desas* (“village units”), originally established as a government-subsidized agricultural credit programme, were transformed into full-service rural banks that provide a wide range of flexibly priced products, with profitability the primary criterion of success. They succeeded in attracting a large number of clients, serving 29.9 million savers and 3.1 million borrowers at the end of 2003,²⁷ although along with the transformation their client base has changed from poor farmers to members of the semi-urban and rural population with regular

²⁴ Palli Karma-Sahayak Foundation, “Microcredit programs in Bangladesh: giving the poor a chance”, <http://www.pksf-bd.org/Microcredit_bangladesh.htm> (February 2005).

²⁵ “The road map for development of microfinance sector in Pakistan”, <http://www.adb.org/Documents/others/PRM_Supplement/Microfinance_Development_Road_Map_PAK.asp?p=prnews>.

²⁶ State Bank of Pakistan, *The State of Pakistan's Economy - First Quarterly Report 2004-2005*, <<http://www.sbp.org.pk/reports/quarterly/FY05/first/index.htm>>.

²⁷ Microfinance Information Exchange, <<http://www.mixmarket.org/en/demand/demand.show.profile.asp?ett=93&>> (March 2005).

incomes. The Bank for Agriculture and Agricultural Cooperatives in Thailand is another example of a large, financially sustainable and formal institution playing a major role in providing microfinance services. It is owned by the Government and through a reform process shifted its focus from short-term agricultural loans to non-farm micro and small enterprise lending as well as deposit services. It served 2.7 million active loan clients in 2002 and 9.6 million savings accounts and reportedly over 90 per cent of farm households were registered as its clients. The high number of savings and loan accounts compared with low outstanding balances suggests the outreach of its services to the poorer clientele.²⁸ The experience of rural credit cooperatives in China also shows the potential for large-scale mobilization of small savings by formal financial institutions. The nationwide network of cooperatives, under the control of the central bank, mobilizes significant amounts of rural savings. It reportedly holds deposits amounting to \$210 billion or 12 per cent of the total deposits of Chinese financial institutions in 2001. Savings from rural households account for 80 per cent of the deposits in the cooperatives.²⁹

In addition to financial assistance to rural areas that has been traditionally provided by government programmes, there have been microfinance initiatives by Governments and associated NGOs drawing on microfinance experiments in other countries. For example, in China, the central bank has initiated programmes that have given selected rural credit cooperatives increased flexibility in such areas as interest rates and their products in order to encourage loans to poorer households. Various levels of the Government have also experimented with lending to households as part of the poverty alleviation programme, applying such microfinance methodologies as group mechanisms and instalment repayments. Official microcredit schemes were reportedly operating in more than 600 counties of 22 provinces by 1998, with the largest programmes reaching over half a million households.³⁰

In Viet Nam, the Viet Nam Bank for Agriculture and Rural Development, formerly the agricultural credit arm of the State Bank of Viet Nam, provides loans to poor households and private businesses using joint-liability groups such as the Viet Nam Women's Union or the Farmers' Association and the Viet Nam Bank for the Poor. As an indication of its substantial outreach, it had reportedly provided over 30 per cent of rural households with access to its loans by 1998.

Many microfinance initiatives have been led by NGOs in the subregion. For example, in the Philippines, where the Government actively promotes microfinance initiatives with a supportive legislative environment, a number of NGOs have established MFIs, with some of them transformed into regulated microfinance institutions. The Center for Agriculture and Rural Development (CARD), for instance, transferred part of its loan portfolio to establish CARD Rural Bank (CARD Bank) while it continues to operate as an NGO. The Microfinance Council of the Philippines reports that as at the end of December 2003, its 21 MFI members served a total of 578,000 borrowers, with five large members each serving an average of 62,000 active borrowers.³¹

²⁸ Pascal Marino, loc. cit.

²⁹ Sun Ruomei, "The development of microfinance in China", <<http://topics.developmentgateway.org/chinamicrofinance/rc/filedownload.do~itemId=323395>> (February 2005).

³⁰ Kieran Donaghue, "Microfinance in the Asia Pacific", *Asian-Pacific Economic Literature*, vol. 18, No. 1, pp. 41-61.

³¹ Microfinance Council of the Philippines, *Performance Monitoring Report, 2003*, <<http://www.microfinancecouncil.org/download/Performance%20Monitoring%20Report%202003.pdf>>.

The role of NGO MFIs is also significant in Cambodia, where the low level of development of the formal commercial system, particularly in rural areas, requires MFIs to play a major role in the financial system. Approximately 55 credit programmes operating in Cambodia reportedly had an outreach of 450,000 households as at February 2002.³² Some NGO MFIs have been transformed into regulated financial institutions, such as ACLEDA Bank, which has been licensed as a commercial bank, and Ennathian Moulethan Tchonnebat, which has been transformed into a regulated non-bank MFI.

North and Central Asia

The role of microfinance emerged in the subregion as the countries went through the transition process from State-managed economies to market-oriented economies accompanied by increased poverty and unemployment. Thus, the target group for microfinance is the poor, many of them literate and well-educated, who lost their jobs relatively recently in the market transition process and are newcomers to microenterprise, unlike in most of the developing countries, where millions of poor people have traditionally earned a living in small informal businesses.

In regional reviews by the Consultative Group to Assist the Poor, microfinance institutions operating in the subregion are divided into four distinct types; credit unions, NGO MFIs, commercial banks and microfinance banks.³³

Credit unions, which had a long history of providing financial services to the large segments of society without access to mainstream banks, have been revived and redeveloped as part of the transitional process. They are member-owned and offer savings and credit services to members. In 2001, there were reportedly 62 credit unions in the Russian Federation and 206 in Kyrgyzstan serving 26,000 and 12,500 members respectively.

NGO MFIs emerged in the subregion during the transition process, with growing recognition of the role of microfinance as a tool to reduce the subregion's increasing unemployment and poverty. Most of the NGO MFIs provide low-income micro entrepreneurs and the self-employed, with access to credit and other services, often using group-lending methods. Many NGO MFIs operating in the subregion are relatively small. For example, as at September 2001, about 320 NGO MFIs in six countries (Kazakhstan, Kyrgyzstan, Mongolia,³⁴ Tajikistan, Turkmenistan and Uzbekistan) were serving 80,000 borrowers and 17,000 depositors, accounting for outstanding loans of \$76.5 million and deposits of \$2.8 million. Relatively larger-scale NGO MFIs in the subregion, such as FINCA in Kyrgyzstan, the Constanta Foundation in Georgia and the Mercy Corps Women's Microcredit Programme in Kyrgyzstan, still did not serve more than 20,000 borrowers as at the end of 2002.

³² NGO statement to the 2002 Consultative Group Meeting on Cambodia, <<http://www.ngoforum.org.kh/Development/Docs/ngo-2002/32.htm>>.

³³ Microfinance Centre, *The State of Microfinance in Central and Eastern Europe and the New Independent States*, <<http://www.cgap.org/assets/images/TheStateOfMicrofinance.pdf>>.

³⁴ Mongolia is included because of its similar demography and topography although it is not geographically part of Central Asia.

Commercial banks have been providing specialized lending services for micro and small enterprises. This approach was introduced as a potential means of rapidly scaling up microfinance in the subregion using bank networks of retail branches. This “downscaling” approach has not proved to have significant outreach, particularly to low-end clients, partly owing to the timing of its introduction, which coincided with widespread bank restructuring and reform and lower-than-expected profits. One of the few successful examples is Sberbank in the Russian Federation, which has developed a downscaling programme of significant scale, serving 10,000 clients with a gross outstanding loan portfolio of \$47.5 million in September 2001. It is reportedly running profitable operations at the branch level.

The microfinance banks are fully regulated, for-profit commercial banks and have been the last to develop in the subregion. Microfinance banks aim to balance both commercial and social goals, offering a broad range of products and services while providing loans to micro and small enterprises as their primary business purpose. For example, Xac Bank in Mongolia transformed itself from an NGO into a regulated microfinance institution serving over 6,500 clients. The Microfinance Bank of Georgia had nearly 16,000 clients with a portfolio of \$23 million in September 2001, while KMB-Bank in the Russian Federation had 7,400 clients with a portfolio of \$78 million.

Pacific islands

Microfinance in the Pacific island countries is still in the embryonic phase, with no sustained success stories of microfinance initiatives for poverty reduction. Given the dominance of subsistence economies with no pressing need to engage in small-scale production and trading, the strong culture of redistribution within the extended family or community and the dispersed and isolated populations of the island States, the relevance of microfinance to poverty reduction and other development goals is open to debate. Nevertheless, with an increasing incidence of poverty, many parts of the Pacific subregion are developing informal market-based sectors and thus microfinance is becoming increasingly relevant, in particular savings mobilization³⁵ and loans for consumption smoothing to meet customary obligations and seasonal cash needs without having to sell productive assets necessary for the people’s livelihoods.

Microfinance in the Pacific subregion, as elsewhere in the ESCAP region, is provided through a range of formal and informal sources, such as development and commercial banks, government agencies, village banks, self-help groups, NGOs, friends and relatives, and moneylenders.³⁶ Examples of these microfinance providers exist across the Pacific. There have been attempts by some development banks, such as the Tonga Development Bank, the Cook Islands Development Bank and the Development Bank of Western Samoa, to develop specific lending programmes for borrowers located in isolated regions and the outer islands. Most countries in the Pacific have varying numbers of credit unions in both urban and rural areas. For example, the Bougainville Microfinance Scheme in Papua New Guinea is a savings-based programme built on credit union principles.

³⁵ Mobilization of savings is stressed in “Microfinance in the Pacific, lessons learned and directions for future development”, <http://www.fdc.org.au/programs/130_microfinance/20041027_101.html>.

³⁶ Pascal Marino, loc. cit.

Some NGOs and government projects are using the Grameen Bank as their microcredit model, including Liklik Dinau Abitore Trust in Papua New Guinea, the Women's Social and Economic Development Programme in Fiji, the Vanuatu Women's Development Scheme,³⁷ and the Solomon Islands Microcredit Scheme for Disadvantaged Women. Semi-formal microfinance, such as revolving loan fund schemes, has generally been seen in Papua New Guinea and the outer islands of Kirabati, Cook Islands and Tuvalu. Yet the most common forms of microfinance in the Pacific appear to be those in the informal sector, including family and friends, commercial moneylenders, traders and shopkeepers.

There have been some achievements by several organizations in savings mobilization and loan repayment, but not in operational self-sufficiency. In addition to the organizational sustainability of MFIs in the Pacific islands, the distinct environment of isolated island States with low populations and limited market bases suggests that the MFIs need to respond to a demand for microfinance services which are different from those in other parts of the ESCAP region. Thus, effective microfinance methodologies for the Pacific region need to be explored.

CHALLENGES OF MICROFINANCE

Microfinance initiatives have great potential to make a significant contribution to the lives of the poor. As shown in the previous section, the Asian and Pacific region has seen the development of diverse MFIs. Countless good practices of MFIs in various forms across the region have been widely reported,³⁸ although this paper does not go into detail on those experiences. Instead, in this section it attempts to examine the factors that constrain the microfinance initiative. Despite growing empirical evidence of the promising contribution of microfinance, the scale of operations has remained small in general and has not grown as quickly as many feel it should. What are the challenges in enhancing the contribution of microfinance initiatives to ensure further poverty reduction? The earlier section highlighted the issue of reaching out to the poor, which is the core of the challenges associated with microfinance. This section reviews a number of areas which have a direct bearing on reaching out to the poor.

Sustainability of microfinance

Financial sustainability of microfinance

Sustaining the provision of microfinance services is an important goal of any microfinance operation. Thus, how to achieve institutional sustainability has become an important issue for many MFIs, as reliance on subsidies and donor funding may not continue indefinitely. One of the key questions relates to the balance between the financial sustainability of MFIs and their social goals. Financial sustainability can range from recovery of operational costs and achievement of operational self-sustainability to financial self-sustainability and go further to profitability as in commercial

³⁷ Robyn Cornford, " 'Microcredit', 'microfinance' or 'access to financial services': What do Pacific people need?", <http://www.fdc.org.au/publications/20020307_42.html>.

³⁸ See, for example, <<http://www.microfinancegateway.org/>> for various resources on microfinance.

operations. The extent of financial sustainability and profitability, in turn, depends on the cost and price structure of financial products and services, which are determined in the light of each MFI's social goal. Subsidization is certainly an important source of funds, "...but should be not seen (and is not seen by many microfinance enthusiasts) as essential to the health and sustainability of a microfinance industry",³⁹ in particular if subsidies are designed to support the set-up costs of MFIs or educational and other ancillary programmes provided in connection with microfinance.

One side of the argument is that commercial viability is a practical solution to increase outreach to the poor on a large scale. Some MFIs became "for-profit" institutions and found themselves serving a larger population of the poor, such as the Bank Rakyat Indonesia Unit system, which serves an estimated 3.1 million active clients.⁴⁰ Some financially sustainable NGO MFIs were transformed into regulated financial institutions with scope for a sustainable increase in the depth and breadth of outreach by increasing access to lendable funds from commercial sources and permission to offer a broader range of financial services. For instance, SHARE in India has made such a transformation and increased the number of its borrowers more than 10 times in five years.⁴¹

However, some MFIs view financial sufficiency as a trade-off with their social goals. For instance, "...it is clear that the main reason for Grameen's lack of financial sustainability is its decision not to charge a high enough interest rate (Grameen's rates are lower than those of self-financing MFIs.) ... Despite the higher loan losses experienced in recent years, a high-interest Grameen would surely be potentially sustainable; the current slight-loss-making strategy is a management choice."⁴² These MFIs are also concerned that microfinance operations focusing on profitability tend to serve those who are relatively better off and neglect the poorer population.

Commercialization of microfinance

As discussed above, commercialization is increasingly seen as a practical solution to the problem of limited sustainability and outreach. In addition, the introduction of commercial principles in their microfinance activities responds to concerns over the lack of accountability and transparency for which MFIs have often been criticized. These issues are partly attributed to the facts that MFIs often have no owners whose capital is at risk and that NGOs' assets cannot be seized easily in case of default. The result is that this provides little incentive to ensure accountability and little security to lenders.⁴³ The advocates of the commercialization of MFIs feel that although the term "commercialization" may be interpreted as an anti-poor approach evoking connotations of exploitation and exclusion of the poor, the purpose is simply to ensure good financial practices, efficiency and financial discipline⁴⁴ and thus benefit the poor.

³⁹ P. Honohan, loc. cit.

⁴⁰ As at end-December 2003 (<http://www.microcreditsummit.org/pubs/reports/socr/2004/en_app1.pdf>).

⁴¹ For transformation of NGO MFIs, see, for example, N. Fernando, *Micro Success Story? Transformation of Nongovernment Organizations into Regulated Financial Institutions*, <<http://www.adb.org/Documents/Studies/miorofinance-success/micro-success.pdf>>.

⁴² P. Honohan, loc. cit.

⁴³ N. Fernando, loc. cit.

⁴⁴ Nimal Sanderatne, "Provocative issues in commercialization of microfinance", *Finance for the Poor*, vol. 3, No. 1, March 2002.

Commercialization would require the establishment of some kind of performance standard relating to portfolio quality, efficiency, sustainability and outreach.⁴⁵ It thus raises some concern over the potential impacts on the poor since MFIs may establish standards that can work against the case-specific needs and characteristics of poor clients.

Microfinance as an integral part of the financial system

Microfinance has become more mature and dynamic, offering a wider range of financial services such as loans, savings, insurance and remittances for poor and low-income people. It is increasingly diverse in its organizational types and their associated objectives, methodologies, products, target groups and scales of operation. Along with the growth and evolution of MFIs, formal financial institutions are also becoming increasingly involved in microfinance operations. These developments have led to the view that a strategy for developing microfinance, including a regulatory and monitoring framework, has to be an integral part of the financial sector strategy rather than being treated in isolation to achieve sustainable provision of financial services to a much wider and poorer population.

Impact of microfinance

It is now widely accepted that microfinance makes a positive contribution to poverty reduction efforts. However, access to microfinance does not automatically lead to increased earnings, nor is it a panacea for poverty reduction, since the creation of income-generating opportunities through access to finance assumes a certain economic environment and entrepreneurial capacity of the poor. To what extent has microfinance contributed to poverty reduction then? Qualitative as well as quantitative assessment of both the positive and negative impacts of microfinance would be a particularly challenging task where diverse MFIs themselves are evolving to meet the diverse needs of the poor and make a dent on the poverty situation.

Various studies, in both qualitative and quantitative terms, have attempted to assess the impact of microfinance on the well-being of the poor, with the results generally indicating positive impacts. They support the view that access to finance provides the poor with opportunities to invest in income-generating activities, smooth consumption and thus reduce their vulnerability to income fluctuations during emergencies. Yet there are many uncertainties associated with assessing the impact, such as the extent to which microfinance contributes to pulling people out of poverty on a permanent basis and the extent of outreach to the poorest.⁴⁶ The magnitude of the impacts of microfinance on the overall poverty situation is also not clear. For instance, despite the large amount of outreach to the poor reported in Bangladesh, the poverty situation has not improved dramatically. Furthermore, as is the case with quantitative impact assessment in general, the extent of the impacts drawn from various studies is bound to have a number of technical measurement

⁴⁵ Antonino L. Alindogan, Jr., "Commercialization of microfinance", *Finance for the Poor*, vol 3. No. 3, September 2002.

⁴⁶ For example, the Microcredit Summit (<www.microcreditsummit.org>) has attempted to verify the data reported by its members (MFIs) on the outreach to the poorest clients and the proportion of female clients among the poorest, although its coverage may be limited and there will be a certain amount of self-selection bias in reporting MFIs.

biases, which may make it impossible to draw clear conclusions. For instance, one of the challenges is establishing effective control-group mechanisms that can create a counterfactual, i.e., comparing the situation with microfinance with the situation without it. Moreover, it has been felt that the design of microfinance products would serve as a “self-selection” bias towards the poor, i.e., more attractive to the poor than the well-off, with many of the products characterized by small loan size, higher interest rate than the market rate, short loan duration, weekly repayment and dependence on mutual guarantees. Yet this self-selection process is seen to favour those who are relatively better off and pose a lower risk of default. Thus, despite various efforts to assess the impact of microfinance, the reliability of the impact assessment is still open to debate.

CONCLUSION

Microfinance initiatives have gained importance through their role in poverty reduction efforts. As they aim to increase the depth and breadth of outreach on a significant scale, various questions arise as to what changes are required to achieve such upscaling, what regulatory requirements foster an enabling environment in support of further development of microfinance initiatives, whether MFIs have to be transformed into different entities and how these changes affect the poor and the poorest.