

Introduction

The massive earthquake and tsunami that devastated countries around the Indian Ocean on December 26, 2004, brought international attention into sharp focus on South Asia. While initial relief efforts and rebuilding will be funded by billions of dollars in grants and soft loans, microfinance institutions will play a key role in the longer-term economic recovery for millions of poor people who lost everything.

Existing MFIs and non-governmental organizations are already playing a role in the disaster aftermath, and their history in the region will allow them to move quickly to assist the rebuilding process. The disaster is likely, however, to also provide more evidence of the vast gap between supply and demand of financial services for the poor.

The relatively long history of microfinance in South Asia presents both opportunities and challenges for commercial microfinance.

Many people think of Grameen Bank of Bangladesh when they think of microfinance – as a pioneer and prominent institution in the sector, Grameen influences microfinance throughout the region and around the world. Its “peer group” lending model is the standard through much of South Asia. Grameen alone is reported to have disbursed more than \$4.6 billion in microcredit since its founding in 1976, and has 3.8 million borrowers in Bangladesh.

Government and NGO support of microfinance has allowed MFIs to expand in South Asia, but that same support may have also limited the influence of commercial concerns in the sector, more so than in other regions like Latin America. However, we now see the beginning of a trend toward more commercial microfinance in South Asia, especially India.

While the reach of existing microfinance institutions in Bangladesh and other countries of the region is relatively good, a recent report on the commercialization of microfinance from the Asian Development Bank begins by noting, “the gap between the potential demand for, and the actual supply of, microfinance services remains large.” The ADB report estimates that throughout Asia and the Pacific, 95 percent of 180 million poor households do not have access to institutional financial services.

This paper examines developments in microfinance in South Asia, the current state and prospects for commercial microfinance, the growing role of so-called “apex organizations” to fund microfinance institutions, and their implications for commercial investors.

Developments

In 1976, when Muhammad Yunus started what was to become Grameen Bank by loaning \$27 to women in a village outside the university where he taught economics, it would have been difficult to imagine where it would lead. Today, microfinance institutions around the world attempt to replicate the Grameen model, which centers around lending networks in small communities such that individuals feel compelled to repay their loans so that the community at large doesn't lose its favorable credit status. And at home in Bangladesh, Grameen is both a well-established and dominant institution and still a pioneer – branching out into for-profit businesses beyond banking, and looking for new ways to help bring the poor out of poverty as evidenced by its new program to provide loans to beggars.

More important for the growth of commercial microfinance, Grameen has demonstrated that making small loans to the poor can be a profitable business – although its evolution from a donor-backed enterprise to a totally self-financed operation with excess capital did take more than 20 years. “We have done something that put a big question mark next to the entire banking system. Banking will never be the same again,” Yunus said in a recent interview. And at a recent forum, he added, “The future of the world lies in the hands of market-based social entrepreneurs.”

Although Grameen grew to be self-financing – and the ADB notes that two other large NGOs, the Association for Social Advancement (ASA) and the Bangladesh Rural Advancement Committee (BRAC), are commercially viable – the history of microfinance

“Microfinance is the immediate follow-up assistance needed by those now receiving aid from relief organizations.”

in Bangladesh and elsewhere in South Asia shows it is heavily dependent on government and international donor support. And the competition from grants, subsidized funds and below-market loans can create a difficult climate for truly commercial efforts at microfinance. In the countries of South Asia, varying levels of government support for microfinance (and the government regulation that comes with the support) bring challenges to commercial development. Perhaps ironically, it is the commercial banks that will likely be at the forefront of commercial microfinance in the region

– but much depends on the funding and regulatory environment in different countries.

In Pakistan, for example, while the government of General Pervez Musharraf has in recent years expressed public support and issued licenses for new private-sector microfinance banks, the emphasis is on what he calls government's “legal, supervisory and regulatory arrangements to ensure orderly development of the financial sector.” The Pakistan Microfinance Network, largely funded by the Aga Khan Foundation and other donors, notes: “Compared to some other countries, the microfinance sector in Pakistan is in the initial stages of development. Estimates suggest that as many as 5.6 million households in Pakistan need microfinance services, but services reach only a tiny fraction of this population, probably less than one percent.”

And in Nepal, one of the poorest countries in the world, the Centre for Micro Finance (CMF) notes that while there is wide recognition that microfinance is one of the most significant ways to reduce poverty, there are still major issues for MFIs in Nepal. Among them it identifies the dominance of the government and its agencies in microcredit, the limited outreach in the most needy hill areas, and sustainability for current and emerging institutions.

Sri Lanka: Massive Rebuilding Needed

After the Dec. 26th tsunami, an official of the SANASA Development Bank in Sri Lanka sent an email to the bank's supporters to report that the work of the bank's branch in the town of Galle had temporarily switched from granting and administering loans to helping prepare 600 bodies for burial. Then the staff turned to other urgent needs – providing food, clean water, medicine and sanitation facilities to those who survived the wave.

Local MFIs will also play a key role over the longer-term, in both traditional and non-traditional ways. Many of those whose houses, shops and fishing boats were destroyed by the tsunami were already among the poor who are the client base for microfinance. Sri Lanka's National Development Bank, a former government institution that is now privatized, has provided initial funding and is seeking contributions for a Fisherman's Relief Trust Fund. The government estimates that 75-80 percent of the country's fishing boats were damaged or destroyed by the waves, and the trust fund aims to replace or repair as many as possible. It estimates that a standard 19-foot fishing boat with an engine costs \$2,260 in Sri Lanka – which may not sound like much in the developed world but is out of reach for a poor fisherman who lost his only way of making money when the tsunami hit.

More traditional MFI activities will continue long after the rush of international assistance is over. “More than any other measure, rejuvenating the local economy will

lead to recovery for the affected families,” Christopher Crane, the president of Opportunity International-US, which works on microenterprise development, wrote to supporters after the tsunami. “Microfinance is the immediate follow-up assistance needed by those now receiving aid from relief organizations.”

The natural disaster will make very evident the need for microfinance, and the gap between supply and demand. It also highlights the difference between direct

about 80 percent of the banking sector, and Sri Lanka, where two state-owned banks account for more than half the sector. The long experience and success of MFIs in Bangladesh however, have led them closer to self-sufficiency with more use of member savings and interest income than commercial outside funds. Still, according to a recent World Bank working paper, the government and donor-funded PKSF, and direct donor money, still play a very prominent role. (*see chart below*)

Table 1 Sources of funds for micro-credit lending in Bangladesh (%)

	1996	1997	1998	1999	2000	2001	2002
Member savings	26.5	17.1	22.6	27.4	27.6	26.2	29.6
PKSF	11.8	17.1	23.2	26.0	24.0	24.6	24.2
Donors	58.8	34.2	28.0	20.6	20.4	18.9	16.6
Interest income	0.0	15.4	13.4	13.5	17.2	17.7	18.9
Commercial bank	2.9	16.2	12.8	12.6	10.8	12.6	10.7

Source: Bangladesh Credit and Development Forum/World Bank

aid, which while important is also very fleeting, and microfinance, which has the potential to ensure that any rebuilding that happens in the wake of the tsunami has a permanent, structural effect on the region. It remains to be seen, however, what long-term impact the disaster will have on the prospects for commercial microfinance in the region. The ADB says subsidy-dependent cooperatives and government programs dominate the microfinance market in Sri Lanka, like that in Bangladesh. It notes that more than one-third of the microcredit is provided through government programs that are not commercially viable. There are some microcredit efforts by private commercial banks, but their combined loans were only 1.2 percent of the total in 2000. The cooperative sector and some NGOs have shown some progress toward commercialization, particularly in mobilizing deposits for onlending.

The role of commercial lenders

When he describes the roots of Grameen Bank, its founder Muhammad Yunus frequently tells of the struggles he went through trying to convince banks to lend to the poor, or loan him money that he could then on-lend. It was a problem that ultimately led him to form his own for-profit bank. Three decades later, commercial banks in South Asia and some international banks and investment funds are beginning to see the point of microfinance.

But there are clear differences between the countries in the region in terms of interest by commercial banks. Truly commercial microfinance prospects appear poorer in Bangladesh, where nationalized banks account for

India: An Untapped Gold Mine?

In India, on the other hand, private banks are leading the way in the commercialization of microfinance. Some are looking to expand directly into microlending and other financial services to the poor and to near-poverty-level entrepreneurs, while others are seeking to invest in existing MFIs. This trend may be in part because bankers see a market – the Asian Development Bank reports the potential for microfinance lending in India alone is estimated to be between \$6 billion and \$8 billion. That is far beyond what anyone expects to see coming from governments or other donors. However, when banks or commercial microfinance funds look at investing in MFIs, the next statistic in the ADB report will also catch their eye: of 51 Indian MFIs rated by Micro-Credit Ratings International in 2000, only nine were classified as highly credit-worthy.

The 2004 ADB report also explains why Asian MFIs lag behind those in other regions – particularly Latin America – in seeking commercial sources of funding. “Relatively easy access to concessional finance, lack of industry standards and inadequate transparency of MFI operations may explain these regional differences,” the report says. It argues that continued subsidies for microcredit undermine commercialization, and notes that in Bangladesh there are 18 separate government microcredit programs, and in Sri Lanka government and donor programs offer subsidized funds through state banks and other financial institutions.

“With subsidized interest rates and poor loan collection, these interventions undermine commercial microfinance by existing MFIs (by introducing market distortion)

and new entry by commercial banks,” the report said. The ADB recommends that governments shift resources from subsidizing microcredit to “capacity building” that will allow more outreach and better chances that an MFI will be able to get commercial funds and operate at a sustainable level.

Nonetheless, India’s potential is so huge that these obstacles are worth the risk for many micro lenders. India is the world’s second-most populous country, with 1.07 billion people. And despite continuing high levels of poverty, it has enjoyed one of the strongest growth rates in the developing world. The economy has grown an average 6% a year over the past decade, and 8.2% last year, to an estimated GDP of \$648 billion.

A large chunk of India’s growth rate has been fueled by its offshore services industry, which has generated millions of jobs in information technology and business process outsourcing, as well as created a need for millions more related jobs in building infrastructure, facilities maintenance, etc. The boom in offshore outsourcing has also attracted capital to microfinance, as international venture capital firms, banks and others involved in financing offshore service firms extend their reach down the economy – both for philanthropic reasons and for practical purposes of building a base of future entrepreneurs to service the industry. Infrastructure improvements have also made it easier for micro lenders to reach disperse parts of the population.

The managers of South Asian MFIs and commercial banks seem to recognize the need to expand microfinance in the region from donor and government funding to reach commercial sources of capital.

“Commercial funding will increase the pace of outreach to poor households in a manner that is more sustainable than grant funds,” says Nachiket Mor, executive director of ICICI Bank in India, which recently began securitizing loans made by a microfinance institution and has more than doubled its microfinance portfolio in the last year.

For Indian commercial banks, there is another incentive to expand into microfinance – it helps them meet so-called priority sector lending targets.

International banks are also showing interest in microfinance in the region, with ABN Amro launching microfinance services in India in September 2003. The bank has set a goal of reaching a million poor rural women in five years with loans and advisory services to self-help groups. So far, ABN Amro reports it has set up credit facilities totaling 3 million euros for five local MFIs. In addition to providing capital, the bank is also offering financial “mentoring programs” for MFI management.

Commercial microfinance investment funds are also looking at South Asia. The Europe-based Dexia Micro-Credit Fund managed by BlueOrchard Finance has at least two Indian MFIs in its portfolio and has been in talks with others.

However, growth in international commercial funding of MFIs will be constrained, according to Samir Bhatia of HDFC Bank, “by the lack of professionally managed MFIs to lend to.” Vijay Mahajan, who heads the Hyderabad-based MFI BASIX, says in order to meet the demand for capital, MFIs “need to change their orientation from that of a welfare organization to that of a financial business.”

Some international non-profits are trying to help by playing an intermediary role. While not entirely commercial, organizations like Unitus act like venture capitalists for MFIs by making a combination of equity, grant and debt investments that will allow the institutions to grow and be able to borrow truly commercial capital for onlending in a sustainable microfinance business. In 2003, Unitus committed nearly \$4.7 million to SKS, an MFI in Andhra Pradesh, India. The Unitus capacity building program has helped SKS increase its client numbers from about 10,000 to more than 60,000. The \$4 million credit line offered by Unitus and the equity stake taken by the U.S.-based non-profit have a significant multiplier effect on the money SKS is able to borrow in India for onlending.

The role of Apex organizations

Each country in South Asia funds at least some microfinance activities through one or more “Apex organizations” – sometimes known as microcapital funding organizations. Generally, these are government created or backed agencies that use both public and private international development money to fund MFIs and provide training and other “capacity building” activities.

In Bangladesh, the national apex organization is the Palli Karma Sahayak Foundation, or PKSF. The Islamabad government recently set up the Pakistan Poverty Alleviation Foundation, which is funding at least a dozen MFIs. Other examples include Nepal’s Rural Microfinance Development Centre, the National Credit Fund for Women in India, and NDTF in Sri Lanka. The World Bank and other international financial institutions frequently work through national Apex organizations, and large private international donors sometimes participate or fill a similar role as “wholesalers” of capital for MFIs. Some local NGOs in South Asia also function as mini-Apex organizations, providing smaller MFIs with funds for onlending.

Just as Grameen is seen as a demonstration model by MFIs around the world, the Bangladesh government’s Palli Karma Sahayak Foundation (PKSF) is held up as a good example of a domestic Apex organization. It is interesting to note that while the amount of funds provided by PKSF has grown considerably over the years, the number of new partner MFIs that PKSF adds each year has declined (*see chart*), meaning Apex funding goes mostly to the same established group of MFIs that is has gone to for more than a decade.

Table 2 PKSF Microfinance Funding in Bangladesh

Year	Number of Partner Organisations	Cumulative Number of Partner Organisations	Funds Outstanding (US \$)
1990-1991	23	23	55,710 (Tk 3.0 mill)
1991-1992	27	50	531,102 (Tk 28.6 mill)
1992-1993	31	81	2,436,384 (Tk 131.2 mill)
1993-1994	18	99	4,969,332 (Tk 267.6 mill)
1994-1995	17	116	8,519,916 (Tk 458.8 mill)
1995-1996	12	128	13,596,954 (Tk 732.2 mill)
1996-1997	22	150	22,724,109 (Tk 1223.7 mill)
1997-1998	20	170	48,486,270 (Tk 2611.0 mill)
1998-1999	12	182	76,840,803 (Tk 4137.9 mill)
1999-2000	07	189	108,599,210 (Tk 5848.1 mill)

Source: PKSF

In each of the countries of South Asia, Apex organizations often fund and assist the most stable and most sustainable of the MFIs – the same market that a commercial funder would be likely to first approach. While both Apex organizations and commercial sources of funds have the same professed goal of financial self-sustainability for MFIs, the problem of Apex organizations “competing” for the same top-tier “market” with subsidized funds has yet to be substantially addressed.

In a report for a 2004 regional conference on microfinance in Dhaka, Bangladesh, the managing director of PKSF, Dr. Salehuddin Ahmed, said he hopes national apex funds at more advanced stages of operation can “provide a bridge between the capital market and domestic MFIs by rating the credit-worthiness and securitizing portfolios.” Supporters of Apex organizations also point out that they perform an important wholesaling function in many markets, by consolidating government and international financial organization funds and then efficiently doling out smaller amounts to MFIs after careful evaluation that might not be possible for the international organizations. Critics say they are unfair competition for truly commercial funds, and can be yet another intermediary to get between international funds and the poor people they are intended to help.

Conclusion

While commercial interest in microfinance is growing, the full benefits of a commercial approach are further from reality in South Asia than in other regions. As the ADB points out, that is due in part to the large subsidized microcredit programs promoted by the region’s governments and some donors. And, as Unitus president Geoff Davis noted in an interview with Dow Jones news service, “There is a tension, at least philosophically, between those that believe being profitable and serving

the poor more efficiently are at odds.” But part of the blame also rests with the inability of commercial microfinance funds and MFIs to tap the huge potential for micro lending in India. Going forward, the Unitus partnership with SKS in India - and other private sector efforts – will serve as demonstration projects. And South Asian governments and MFIs can also now look to the successes of commercial microfinance in places like Latin America – or Indonesia and the Philippines closer to home – for evidence that commercial funding and helping the poor can go together quite well.

India clearly has the greatest potential for commercial microfinance in the region – and ultimately perhaps in the world. A 2002 study estimated there are 75 million households in India that could use microcredit, with less than 4 percent of them currently served. That is a huge demand, and only commercial microfinance is likely to find the capital and make the outreach needed to meet it.

About the MicroCapital Institute

The MicroCapital Institute is a non-profit organization supported entirely through private donations. Our mission is to educate financial professionals on the emerging asset class of microfinance.

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