Economic and Social Commission for Asia and the Pacific
Poverty and Development Division
United Nations Building, Rajadamnern Nok Avenue
Bangkok 10200, Thailand
Fax (66 2) 288-3007
E-mail escap-pdd@un.org
escap-publicationsoffice@un.org
Website http://www.unescap.org/

Microfinance for Poverty Reduction: Building Inclusive Financial Sectors in Asia and the Pacific

DEVELOPMENT PAPERS NO. 27

Microfinance for Poverty Reduction: Building Inclusive Financial Sectors in Asia and the Pacific

ECONOMIC AND SOCIAL COMMISSION FOR ASIA AND THE PACIFIC

ESCAP is the regional development arm of the United Nations and serves as the main economic and social development centre for the United Nations in Asia and the Pacific. Its mandate is to foster cooperation between its 53 members and 9 associate members. ESCAP provides the strategic link between global and country-level programmes and issues. It supports Governments of the region in consolidating regional positions and advocates regional apporaches to meeting the region's unique socio-economic challenges in a globalizing world. The ESCAP office is located in Bangkok, Thailand. Please visit our website at www.unescap.org for further information.

The shaded areas of the map indicates ESCAP members and associate members.

DEVELOPMENT PAPERS NO. 27

MICROFINANCE FOR POVERTY REDUCTION: BUILDING INCLUSIVE FINANCIAL SECTORS IN ASIA AND THE PACIFIC

United Nations
ESCAP
New York, 2006 ECONOMIC AND SOCIAL COMMISSION FOR ASIA AND THE PACIFIC

DEVELOPMENT PAPERS NO. 27

Microfinance for Poverty Reduction: Building Inclusive Financial Sectors in Asia and the Pacific

United Nations publication
Sales No. E.05.II.F.37
Copyright © United Nations 2006
All rights reserved
Manufactured in Thailand
ISBN: 92-1-120452-6
ISSN: 0255-9250
ST/ESCAP/2385

Development Papers is a series of studies issued by the Poverty and Development Division of the Economic and Social Commission for Asia and the Pacific (ESCAP). The Division is also responsible for the annual *Economic and Social Survey of Asia and the Pacific*, the annual *Key Economic Developments and Prospects in the Asia-Pacific Region*, and the biannual *Asia-Pacific Development Journal*.

The designations employed and the presentation of the material in this publication do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area or of its authorities, or concerning the delimitation of its frontiers or boundaries.

The opinions, figures and estimates set forth in this publication are the responsibility of the authors, and should not necessarily be considered as reflecting the views or carrying the endorsement of the United Nations.

This publication may be reproduced in whole or in part for educational or non-profit purposes without special permission from the copyright holder, provided that the source is acknowledged. The ESCAP Publications Office would appreciate receiving a copy of any publication that uses this publication as a source.

No use may be made of this publication for resale or any other commercial purpose whatsoever without prior permission. Applications for such permission, with a statement of the purpose and extent of reproduction, should be addressed to the Secretary of the Publications Board, United Nations, New York.

This publication has been issued without formal editing.

PREFACE

The present volume of the *Development Papers* series addresses the subject of the microfinance for poverty reduction: building inclusive financial sectors in Asia and the Pacific.

The General Assembly designated 2005 as the International Year of Microcredit to highlight and promote the recognition to the role of microfinance in the eradication of poverty, its contribution to social development. In particular, "building inclusive financial sectors" is a major theme of the Year.

The region holds two thirds of the world's poor. Varieties of microcredit schemes have been experimented within the past few decades with specific focus on poverty reduction. The region has also seen the development of microfinance institutions (MFIs) which offer a wide variety of financial services for the poor. While the contribution of microfinance to the improvement of the life of the poor has been widely reported, the overwhelming portion of the poor is still in need of access to microfinance. Funds available for subsidized microfinance schemes are also limited. Expansion of access to microfinance to a larger population of the poor relies to a large extent on further development and up-scaling of these microfinance programmes. Thus, the question arises as to how the microfinance institutions should develop to enhance their outreach and positive impact on the poor. One option is to link the microfinance sector with the formal financial sector.

In the spirit of commemorating the International Year of Microcredit, this volume attempts to discuss the issues associated with integrating microfinance programmes for poverty reduction into formal financial sector.

The present volume has been based on a paper prepared by Mr. C. Upendranadh, who has a long experience in microcredit programmes. He is currently working with Aide et Action in India.

Ravi Ratnayake
Director
Poverty and Development Division

CONTENTS

Page

Preface . . . . **iii**
Contents . . . . **iv**
Abbreviations . . . . **v**

I. INTRODUCTION 1
A. Microfinance and its potential for poverty reduction 2
B. Microfinance into the mainstream financial sector - the need for integration 4

II. DEVELOPMENT OF THE INCLUSIVE FINANCIAL SECTOR APPROACH 7
A. Shift of approach in microfinance 7
B. Comparison of different approaches 10
C. Issues confronting the microfinance sector in Asia and the Pacific. . . 15

III. BUILDING INCLUSIVE FINANCIAL SECTORS FOR POVERTY REDUCTION 18
A. Defining the contours of microfinance schemes in the inclusive financial sector approach 18
B. Advantages and disadvantages of building inclusive financial sectors 22
C. Impacts in the Asia-Pacific context 28

IV. APPROPRIATE MICROFINANCE APPROACH FOR POVERTY REDUCTION 31

V. CONCLUSIONS: THE WAY FORWARD 38

References 44

Tables

Table 1: Growth of microfinance in some Asian and Pacific Countries - some estimates (2002-2003) 4

ABBREVIATIONS

ASA	Association for Social Action
BASIX	New generation microfinance institution in India
BRI	Bank Rakayat Indonesia
BRAC	Bangladesh Rural Advancement committee (local NGO)
FDI	Foreign direct investment
ICICI Bank	Industrial Credit and Investment Corporation of India Bank
IFC	International Finance Corporation
IMEC	Impact monitoring
INGO	International Non-government Organization
MDG	Millennium Development Goals
MFB	Microfinance Bank
MFI	Microfinance Institution
NABARD	National Bank for Agriculture and Rural Development
NBFC	Non-Banking Financial Company
NGO	Non-governmental Organization
PKSF	Palli Karma Sahayak Foundation
PROSHIKA	A National NGO in Bangladesh, the name *'PROSHIKA'* is an acronym of three Bangla words, which stand for training, education, and action
RBI	Reserve Bank of India
RRB	Regional Rural Bank
SFMC	SIDBI Foundation for Microcredit
SHG	Self-help group
SHPI	Self-help Promoting Institution
SIDBI	Small Industries Development Bank of India
UNCDF	United Nations Capital Development Fund

MICROFINANCE FOR POVERTY REDUCTION: BUILDING INCLUSIVE FINANCIAL SECTORS IN ASIA AND THE PACIFIC*

I. INTRODUCTION

Microfinance[1] is the fastest growing segment of rural financial intermediation in the Asia-Pacific region. Spearheaded by non-governmental organizations (NGOs), microfinance is gaining a significant place in the national development plans of the region in the form of innovative field projects and programmes aimed at poverty reduction. For several decades, countries in Asia, which peopled approximately a third of the world's poor, were witness to targeted and subsidy-linked credit schemes as part of anti-poverty interventions. Such interventions have had a mixed impact on poverty. While some analysts argue that the government's anti-poverty schemes/projects have created conditions for poor people to participate in the local economy, others argue that these have adversely affected the credit discipline and created a dependency culture. A growing emphasis of microfinance practice is placed on the sustainability of its approach and the potential to integrate with the mainstream financial sector. In the discussion on microfinance development, 'inclusive financial sector development,' implies the identification of ways and means of enabling universal access to a complete range of financial services and the integration of the poorer segments of populations into the financial systems and markets. This aspect has been identified as one of the key challenges of accelerating poverty reduction. This sectoral approach is intrinsically linked to the possible future trajectories of the growth of microfinance in the Asia and the Pacific region and the way in which different national governments provide a fillip to the ongoing efforts to strengthen microfinance initiatives. This paper attempts to generate

---

* Based on a paper prepared by Mr. C. Upendranadh, Senior Head, Policy Advocacy, Education Resource Centre, Aide et Action, India.

[1] Microfinance is the supply of loans, savings, and other basic financial services to the poor. People living in poverty, like everyone else, need a diverse range of financial instruments to run their businesses, build assets, stabilise consumption, and shield themselves against risks. Financial services needed by the poor include working capital loans, consumer credit, savings, pensions, insurance, and money transfer services. (Source: CGAP website).

debate on this proposition and identify the *modus operandi* in the sectoral approach in the practice of microfinance in the Asia and the Pacific region that has been unfolding over the past few years.

The paper is divided into five major sections. The rest of this Section outlines the context and objectives of the paper and sets the stage by briefly describing the potential of microfinance in addressing poverty and development in the Asia and the Pacific region in terms of its growth. Section II describes the shifts in approaches by comparing these and highlights the pressing issues that confront the sector in the region. Section III attempts to define the contours of the sectoral approach and its possible impact on stakeholders. Section IV explores the trajectories that can be charted vis-à-vis the inclusive financial sector approach. And, finally, Section V identifies the way forward in terms of key findings and recommendations thereof.

A. MICROFINANCE AND ITS POTENTIAL FOR POVERTY REDUCTION

The potential and real impact of microfinance on poverty reduction has been well recognized.[2] Despite several methodological and computational limitations of research studies, it has been established *prima facie* that microfinance has the potential to address poverty through enhanced business/economic opportunities, enhanced income, smoothing of consumption and preparing the poor for shocks or addressing the vulnerability in the aftermath of shocks.[3] It has been observed widely across Asia that microfinance has addressed critical determinants related to poverty, vulnerability and coping with crisis. While observing various delivery mechanisms, many studies recognize the potential and real impact of microfinance on poverty reduction. Studies from Bangladesh indicate positive impacts on several economic and social indicators. One of the earliest studies by Hossain, M. (1988) indicates a positive change in terms of working capital needs, non-agriculture investments and labour force participation rate and income increase resulting from microcredit activities. Similarly, improvements in social and economic empowerment are reported in a study of IMEC, PK (1995). Rahman, R. (1996) indicates an increase in household consumption expenditure and human capital investment as a result of microcredit. Pitt and Khandker (1996) indicate an increase in household

---

[2] See Snodgrass, D Sebstad, J (2002) for discussion on this.

[3] See Weiss, J and Montgomery, H (2004) for a debate on impact.

expenditure, increased participation of girls in education and a positive change in women's non-land assets as the impact of microcredit programmes. Khadker, S. (2003) shows how ".... microcredit programmes operating in Bangladesh over a long period have produced a greater impact on extreme poverty than on moderate poverty". The results of this study strongly support the view that "... microcredit not only affects the welfare of participants and non-participants but also aggregate welfare at the village level". Similarly, several impact studies have also concluded the positive impact of microcredit in disaster situations and during post-disaster rehabilitation periods. Further, it was found that cash flows were smoothened by diversification of earnings, increased employment of family members and reliance on small businesses.[4] Similarly, studies in Indonesia found that microcredit borrowers increased their incomes by 12.9 per cent as compared with an increase of 3 per cent in the incomes of control groups. In another study, Bank Rakyat Indonesia (BRI) borrowers reported that on an average, clients' incomes had increased 112 per cent and that 90 per cent of the households moved out of poverty.[5]

Thus, the provision of small loans to the poor, especially women, has been one of the consistent strategies for poverty reduction in all these countries in the past two decades. These loans have been channelled either through government-led anti-poverty programmes, international non-governmental organizations (INGOs) and donor-led development projects, specialist microfinance institutions (MFIs)[6] or civil society-/community-based initiatives. The pioneering work of Grameen Bank in Bangladesh followed by similar others in South-Asia and East-Asia during the decades of 1980s-1990s were hallmarks of microfinance activities of the region.[7] In the 1990s, not-for-profit NGO MFIs, commerce-oriented MFIs and their operations grew rapidly in most of the Asia and the Pacific region, thereby presenting opportunities of meeting the credit needs of the poor through diverse modes of delivery. During the same period, India and other South Asian countries experimented self-help groups (SHGs), which, by the end of the decade, have come to stay as one of the dominant Indian variety of group-based,

---

[4] See UNCDF, Microfinance sector development approach 2004.

[5] See Littlefiend, E., Murduch, J. and Hashemi, S. (2003) for evidence on this.

[6] Institutional structure that aims at providing a range of financial services to low income clients. Registered under appropriate legal cover of the country of operations, MFIs typically look at their services as business propositions and would have sustainability as one of the key indicators of success.

[7] Grameen foundation has promoted several replications in many countries of Asia and Pacific region.

informal, institutional structures for the delivery of microfinance. Nevertheless, as the data in Table 1 shows, in many countries in the region, the outreach of MFIs is quite negligible in comparison with the potential demand, which is approximately 100 million poor families in Asia alone. Given a significantly large number of MFIs compared to other regions and the large pool of poor population in need of microfinance, the Asian and the Pacific region plays a critical role in accelerating outreach and ensuring sustainability of microfinance schemes.

Table 1. Growth of microfinance in some Asian and Pacific countries – some estimates (2002-2003)

Country	*No. of major MFIs/NGO In microfinance*	*No. of active borrowers (as per cent of population below poverty line)**	
Cambodia	8	330 198	(7.1)
Philippines	12	225 566	(0.84)
Indonesia	7	3 119 380	(8.12)
Viet Nam	1	42 132	(0.15)
China	1	3 115	(0.01)
Timor-Leste	1	2 961	
Samoa	1	1 740	(0.0)
Bangladesh	5	6 595 138	(10.2)
Pakistan	11	238 263	(0.54)
India	6	293 537	(0.11)
Nepal	1	32 678	(0.43)
Sri Lanka	1	234 143	(5.47)

Source: Mixmarket.org, for periods ranging years 2002-2003 and estimates of MFIs

Note: Apart from above, Grameen Bank of Bangladesh has an outreach of 3.2 millions. SHG-Bank Linkage in India reaches to approximately 16 million clients and several other NGO MFIs, cooperatives not reported here account for approximately 3 million clients. Taking all these will result in approximately coverage of 15 per cent poor in Bangladesh and approximately 8 per cent in the case of India.

* Population below national poverty line is based on ADB data for the most corresponding years. Population data is also for the relevant/nearest years.

B. MICROFINANCE INTO THE MAINSTREAM FINANCIAL SECTOR – THE NEED FOR INTEGRATION

During the 1990s, attempts to scale-up its client coverage, provision of diverse and innovative services and improvements in delivery technology

were cornerstones in the growth of microfinance in the region. These attempts, however, have not given a clear answer to MFIs on how to reach out to poorer and larger population on a sustainable basis, which is a critical issue for microfinance to make a dent to poverty situation. It partly reflects the limitations of MFIs which mostly depend on donor funds or soft loans for their operations. On the other hand, the entry of the formal banking sector into microfinance seen in some countries appeared to address outreach and sustainable issues, although experiences from such 'scaledown' are uneven and nascent. In fact, the very reason for the emergence of MFIs in many countries has been a response to address the failure of the state-led and mainstream formal financial system to reach this segment of the market. The poor were not seen as bankable clients by the formal sector due to information asymmetry and risk perceptions, although the successful experiences in microfinance may have contributed to change the perceptions to some extent. Thus, linking microfinance and the mainstream financial sector (creating inclusive financial sector) is considered to be an effective way to enhance outreach and sustainability of microfinance through such financial instruments as; mobilisation of funds by MFIs from capital markets; bulk borrowings' guarantees; and equity investments.[8] This process implies that the private and government sectors need to be able to create conditions for enhanced engagement of microfinance clients and institutions within the overall financial systems of the countries. Moreover, inclusive financial sectors imply the development of policies and institutions in financial systems that would be applicable to all sections of society, including the poor and the marginalized, without attracting system risks.

The issue of an inclusive financial sector would ideally be a part of the national development strategies since services provided to poor clients, such as microfinance, have to mediate through several economic, social and cultural barriers at client, intermediary and promoters' levels. The government's poverty reduction efforts critically hinge on reaching out to millions of rural people in need of financial services. Furthermore, ensuring outreach and sustainability is critical for any successful financial intermediation (project, programme or sector as a whole) from an institutional perspective. The presumption is that the goals of poverty reduction, as enshrined in individual development plans of the countries of the region and as reflected in the United Nations Millennium Development Goals (MDGs),

---

[8] UNCDF, Microfinance sector development approach 2004, provides a framework for inclusive financial sector approach to microfinance.

call for an inclusive approach in the provision of financial services that would reach millions of rural poor. While credit is one of the critical needs of the poor, savings is a grossly under-serviced segment of rural financial intermediation. So are services such as remittances, hire purchase and insurance. Many analysts, including United Nations Capital Development Fund (UNCDF), argue that such financial intermediation is possible only through a sectoral approach[9] and not through individual projects or schemes that identify the goals in a narrow perspective.

At the same time, there are several issues that come up on the supply side from diverse stakeholders on the possible impact and viability of such a sectoral approach, vis-à-vis, the provision of financial services to the poorer segments of the population. Some analysts argue for an approach that retains the specificities of services that are aimed at addressing the needs of poor clients without necessitating mission drift. Thus, inclusion can be seen from diverse perspectives and the aim of this paper is to bring these together.

The purpose of this paper would, thus, be to act as a springboard for ideas and perspectives on how to approach the development of inclusive financial sectors for microfinance in the Asian and Pacific region.

Objectives

The paper attempts to achieve the following objectives:

- Map the diverse models of delivery of microfinance available in the region
- Analyse issues related to outreach and sustainability
- Analyse the context of inclusive financial sector approaches for microfinance and issues thereof, and
- Provide recommendations towards the development of an inclusive financial sector approach to microfinance in the region.

This paper, while addressing issues that surround inclusive financial sector development, does not attempt to take sides on the need and/or relevance. Rather, it attempts to throw light on how various countries of the region are grappling with inclusive financial sector development and the positive as well as negative experiences so far in such an endeavour. The issue becomes important as universal access to financial services appears to be *sine qua non* among policymakers for addressing issues of poverty.

---

[9] See end note 6.

II. DEVELOPMENT OF THE INCLUSIVE FINANCIAL SECTOR APPROACH

A. SHIFT OF APPROACH IN MICROFINANCE

The genesis of microfinance in Asia and the Pacific is the creation of access to financial services that address poverty reduction in reaction to high dependence of the poor on exploitative informal credit sources. Microfinance, which now includes a wide range of financial services such as credits, savings and insurance, has been seen as one of the main poverty reduction strategies. In most of Asian and the Pacific countries, microfinance activities have been pioneered by NGOs with international donor support.

Countries in Asia, especially those in South-Asia, have pioneered in microfinance delivery technology and have some of the largest number of MFIs in the world in terms of outreach, poverty focus and size of loan. Over the past two decades, three different models (and their variants) have emerged in Asian countries.

1. Delivery technology at the client level

The joint liability group model, with Grameen Bank and its replicators having credit focus and joint liability as the principle binder, is one of the earliest delivery structures that are popular in many countries of the region. Most MFIs of the region either replicate Grameen or have developed its variants, adapting it to local conditions. Within Bangladesh, several other NGOs such as the Association for Social Advancement (ASA) have innovated upon the Grameen model in order to meet the requirement of large numbers of poverty-ridden clients.[10]

Self-help groups, a variant within group-based operations, with savings and credit as their focus and having principles of self help (and peer pressure) gluing the members together is another popular model that primarily has its origins in India and a vast coverage in the country. Within the SHG model, one can find two variants, one being NGOs (as promoter of SHGs)

[10] See Zaman, H., (2004).

undertaking financial intermediation and the other being promoters capacitating the SHGs and facilitating linkages with local commercial banks for financial transactions (mainly for credit).

Finally, in the individual-based operations where MFIs service clients at low operational cost and market rate transactions with focus on sustainability. While in some cases, MFIs are promoted by NGOs, banks and donors have set up MFIs with a focus on covering rural poor with financial services. This segment is growing slowly with the active support of formal financial institutions.

2. Approaches to microfinance

Three variants in the approach to the delivery of microfinance exist in the field.

Project approach

In many countries, historically, microfinance practices have evolved through the implementation of field projects especially those that address holistic development and poverty reduction. There are several such projects that are currently operational in many countries with the support of international agencies and the international donor community. For example, United Nations Development Programme has operationalized several pilot programmes in the region, especially in the Pacific island nations.[11]

With strong focus on poverty reduction, meeting specified targeted clients with identified services, normally savings and credit, characterise the project approach to microfinance. Soft loans, grants for operational costs and subsidised credit also feature as part of the project approach to microfinance. Major Bangladeshi NGOs, such as BRAC, PROSHIKA, ASA and several others, have started microfinance as one of the areas of intervention apart from community development interventions that address poverty and vulnerability. Donor support in the form of grants and soft loans for such projects became critical as they depended on them for operational costs and loan funds.

---

[11] UNDP has commissioned projects in Fiji, Solomon Islands, Vanuatu, Samoa and the Federated States of Micronesia. AusAid has supported projects in Papua New Guinea.

Institutional development approach

In this approach, focus is placed on microfinance institutional development. Many microfinance practices are institutionalized, and in that process the promoters have taken appropriate legal form relevant to their operations within the countries of their presence and the focus has been on institutional sustainability.

The needs for institutional strengthening have been recognized with increasing concern for expanding outreach and ensuring sustainability of microfinance to achieve poverty reduction at a larger scale. It reflected the limitation of microfinance through heavy reliance on subsidies and international donors. Thus, in some cases, NGOs hived off their microfinance portfolio into a separate identity or they became NGO MFIs. Grameen Bank and its replicators are examples of MFIs that have grown into formal institutions catering to the low income and poor clients, some of which use the social capital of the group as collateral. Various institutional forms such as not-for-profit NGO MFIs, development NGOs setting up separate MFI wings, commercial MFIs and community owned and controlled MFIs (as cooperatives) have started meeting the demand for financial services, especially of the low income and poor clients. For many of these MFIs, institutional sustainability became critical to ensure sustainable provision of microfinance services and to expand the outreach to the poor clients.

Sectoral approach

The third approach is the integration of formal financial sector and microfinance sector, such as growth and practice of microfinance within the formal financial sector wherein banks have downscaled their operations to reach out to the poor segments. BRI Indonesia is one such example. Credit cooperatives and agricultural co-operatives in several countries such as India, Pakistan, Sri Lanka, and Thailand have also provided small loans to resource-poor households. Welfare measures of the governments have also identified the role of microfinance for poverty reduction. Directed credit programmes, priority sector lending, subsidy-linked micro enterprise promotion supplied through the formal banking sector, identified the potential of microfinance market. The potential of such models of delivery to acquire leading and defining contours of microfinance sector development is yet to be tapped and this would be one of the trajectories of microfinance sector

development, especially in countries that have a large network of formal banking systems.[12]

3. Shift in approach

It can be seen that the growth of microfinance in the region has seen diverse models of credit delivery and most of the initial efforts have been through the project approach wherein donor funds and grants played a critical role. The results have been mixed in terms of their magnitude and the depth of their outreach to the poor. Institutional development acquired prominence, as setting up creative, private, sustainable institutions that specialize in delivering financial services to the poor became the goal in financing development. Promotion and sustainability of these institutions is often seen as a part of strengthening delivery mechanisms and financial infrastructure so that the distribution of economic opportunities takes place in a more equitable and accessible manner. Donor support to institutional strengthening has, in fact, been quite creative as several models of financial support, such as equity participation, commercial loans, start up grants, fee for capacity building and foreign direct investments have been used.[13] Finally, developing appropriate mechanisms for integration of microfinance into mainstream financial systems is seen as the next phase of graduation, (or sectoral approach), which would mean deepening financial systems into the poor populations without creating systemic risk. This would also mean sustainable MFIs seeking various forms of financial instruments to address issues of outreach, sustainability and risk.

B. COMPARISON OF DIFFERENT APPROACHES

At the outset, it needs to be underscored that while there is support from formal government financial and banking sectors in the development of microfinance in the region, most of the practice so far is either limited to the project approach or graduating to the institutional development approach. Sector-wise initiatives are far and few.

---

[12] In India, SHG-bank linkage, which is acquiring some kind of sectoral mechanism, is currently reaching to over 1 million SHGs. Still it is a scheme and has not acquired a cutting edge place in the formal financial systems. It also has acquired multiple goals like women's empowerment. See Srivastava, P., Basu, P.(2004).

[13] This is still an active agenda of many European donors who specialised in setting up specialised funds. Private sector funds are also available for such institutions. Microfinance information exchange Mix <www.themix.org> provides over 50 western apex agencies that provide funds for institutional development and over 450 MFIs that are operational in developing and least developed countries.

The UNCDF framework provides the basis for the analysis of developments in the sector so far. There are several institutions that provide microfinance services in countries, where in some are projects, some are institutions and government-led anti-poverty programmes (targeted) and poverty focused lending practices. In every approach, pros and cons exist.

There have been various anti-poverty projects in the region that are targeted at certain communities and have suffered from several bottlenecks of implementation such as poor targeting, leakages and high cost delivery of financial services to the poor population. The approach of such targeted programmes has been individual-oriented with a focus on self-employment, income enhancement and subsequent poverty reduction. Evaluations across the globe of such interventions appear to be mixed. While at the individual level, the project approach has demonstrated an increase in incomes of some of the beneficiaries, issues around targeting, outreach and sustainability have been seriously undermined. In fact, such programmes have led to a culture of subsidy-dependence among the poor and ruptured the repayment culture. Many NGOs too, through donor funds and grants, have implemented savings and credit schemes with targeted communities, through the project approach, with mixed results, especially in the context of outreach, sustainability and impact. These projects have demonstrated inherent limitations of the targeted approach vis-à-vis sustainable outreach as well as the impact of microfinance services. Further, there are limitations in project approach in terms of outreach and replication.

In contrast to the above, donor support to MFIs heralded the institutional approach to microfinance in which institutional sustainability is the overriding objective. MFIs are seen as efficient delivery channels for reaching out to the poor with financial services, especially credit. The underlying assumption is that financially sustainable MFI would be able to rapidly expand outreach as well. Several examples from Bangladesh testify that this is indeed the case.[14] However, critics of the approach argue that MFI sustainability depends on a conducive policy environment, which includes macroeconomic stability and policies on interest rates. Examples of MFIs of Bangladesh, India, Indonesia, Nepal and the Philippines suggest that even in the absence of a conducive policy environment, MFIs are able to demonstrate sustainability and enhance their outreach rapidly. An outstanding case is that of ASA of

[14] BRAC, ASA are two poverty focused lending MFIs and there are several others in Asian countries.

Bangladesh, which has been able to demonstrate thorough innovative product design and implementation, reach out to millions of poor rapidly, without any mission drift while maintaining the financial sustainability of its operation. This sends out optimistic signals that within the institutional approach, accelerated outreach is possible and that these two are not exclusive objectives. Rather, they are necessary conditions for viewing microfinance within the development paradigm. At the same time, experience demonstrates that most MFIs are able to reach to a limited number of clients due to lack of adequate capacities, infrastructure and capital.

When it comes to building an inclusive financial sector,[15] the trajectories that each country follows would be dictated by the local characteristics of financial markets, role of the central bank, governments and policy regimes. In many countries, microfinance interventions have started and continue to be in the form of donor-funded projects with a movement towards institutional strengthening focusing on outreach and sustainability. At the same time, a vast network of the formal banking sector in countries such as India, Pakistan and Viet Nam are being revitalized to address the financial needs of the poor, thereby attempting the integration of microfinance into the mainstream financial sector. Hence, the possibilities and options for reaching out to millions of poor are multiple and there is a need to study what works where and identify an appropriate path. For example, countries such as India, which have reached the threshold of microfinance clients, warrant an approach that enhances rapid scale-up, sustainability with concurrent regulation and supervision of growth, with the active intervention of the government and its financial infrastructure. The private sector alone would not be in a position to either meet the demand or achieve sustainability.

The integration of microfinance into formal financial systems is seen as a critical and necessary condition as it would rapidly increase the reach of financial systems to the poor. It is seen as integrating the poor into the market segment and allocating resources. International donors and experts thus argue that the integration of microfinance within the formal financial sector presupposes a conducive policy environment because most MFIs that have demonstrated effective management of risk need to provide value-added services in order to become relevant to the poor and recover costs

[15] While no concrete definition has emerged for this term, it connotes in the literature of processes that enable creation of universal access to financial services to all segments of population. The discussion on this aspect centres around supply side aspects of creating, strengthening of institutions and systems so that the poor are able to participate more effectively and benefit from financial systems.

of services at the same time. For example, while credit is necessary, the need for a safe savings avenue is an equally important service to which the poor seek access while the current policy scenario in most countries do not provide space for MFIs to accept deposits. Such value-added services not only help generate revenues but also the capital required for the MFI in order to expand its outreach. Such perspective and policy reforms are needed in order to enhance the microfinance market in examining the integration of microfinance into financial sector.

Thus, sectoral approach presupposes the need for developing microfinance portfolio as a commercial proposition (poor as viable market segment for financial transactions) within the formal financial sector. Access to various financial instruments to MFIs would be a critical element in the sectoral approach. In such contexts, sector performance needs to be looked at from the perspective of the extent of integration that microfinance has achieved within the overall financial sector. The depth of outreach, quality, and cost effectiveness become some indicators from the point of view of poverty reduction. Thus sectoral approach advocates would argue that such sector development would address critical gaps of demand and supply of access to finance for rooting out poverty.

In most of the countries in Asia and the Pacific region, this would mean providing a policy framework and enabling an environment for private sector participation and formulating strategies for expanding outreach through formal sector participation in microfinance. The framework for microfinance can be visualised as part of the formal financial sector interventions in rural areas. For NGO MFIs, access to financial instruments would mean simplification of procedures, lowering of limits and treating them separately but with similar prudential regulations and norms as of any formal financial intermediary. Such financial instruments would include debt swapping, bonds and stock market listing and participation, equity enhancement through private investments, foreign direct investments, and deposit collection from members or general public. The performance standards, initial start-up conditions also need to be arrived at on the basis of the client base and types of activities. Most importantly, the sectoral treatment of microfinance would enable more players to enter the field, implying more competition and a level-playing field. This is important for sustainable outreach and scale-up. It would also mean more flexibility in government's efforts towards poverty reduction as the government can rope in more cost-effective institutional structures for the delivery of financial

services. In some ways, the sectoral approach would provide more scope for the government to identify a suitable intermediary for financial intermediation instead of inefficient structures (formal banks, departments) that hitherto prevailed, which were not suitable for transaction with financially weak clients.

The financial sector approach to microfinance would also mean deliberate and conscious efforts of the central banks and governments in creating an enabling environment. Experiences demonstrate that several MFIs too have innovated on accessing different financial instruments that reflect possibilities towards integration with the mainstream financial sector. So far, efforts towards the sectoral approach are slow in many countries as formal financial sector played a cautious role in understanding clients and their behaviour. Most of the practices in many countries have evolved through action research and experimentation rather than the text book/blue print approach.[16]

The critical element to appreciate here is that while the project approach identified reaching the targeted clients as the goal, the institutional development approach has grappled with the issues of cost effectiveness linked with outreach and sustainability. The project approach addressed financial services mainly through grants while the institutional approach attempted through soft loans, commercial borrowings with near market rate interest regime and kept operational costs at a bare minimum. In these two approaches, donor funds, soft loans have played a critical role in the initial phase but quickly gave way to commercial borrowings. Given the nascent interest of the formal financial sector in microfinance in many countries, it has not acquired the characteristics of the sectoral approach, which according to many analysts would be the ultimate evolution of the sector to address poverty.

It would be pertinent to summarise the major issues that the microfinance sector is confronted with presently in order to establish the basis for a discussion on the inclusive financial sector.

---

[16] For example, in India, the central bank (RBI) and NABARD have acknowledged that sensitisation of bankers on poor, poverty and role of social banking is necessary as complimentary process of developing regulatory frameworks for MFIs as well as for rapid growth of microfinance portfolio of the banking sector. Similar approach has been taken by the State Bank of Pakistan, which has announced a comprehensive policy support for the growth of microfinance in the country.

C. ISSUES CONFRONTING THE MICROFINANCE SECTOR IN ASIA AND THE PACIFIC

Demand-Supply Gap

Lack of human and institutional capacities, shortage of expertise and weak co-ordination among various stakeholders are often identified as some of the factors that inhibit the growth of the microfinance sector in the region.[17] In countries where formal financial sector has wide coverage in terms of density of bank branches, one would expect that the supply would outstrip the demand. However, it has often been the case that banks are unable to reach to the poor clients due to the above-mentioned reasons.

This has also been the case as indicated by the central bank of Pakistan, which has taken up the promotion of microfinance through the sectoral approach. Muhammad Yunus of Grameen Bank, Bangladesh, too opines that lack of institutional capacities, lack of cost effective capital and legal and regulatory frameworks for promotion of microfinance act as constraints to outreach (Yunus, 2004). In addition, lack of capacities at the client level impinges on the loan appraisal process and affects the outreach. It is also to be noted that most MFIs, with exception of few, are unable to achieve sustainability of their own operation, which is critically linked to outreach.

The cost of funds for NGO MFIs and their access to different financial sources becomes critical in determining the rates of interests and their break-even business. This is critical as most NGO MFIs access funds at relatively high cost in comparison with the banking sector, whose function of collecting deposits can provide capital for its operation. Legal provisions very often do not provide such scope of access to cheap funds for MFIs in many countries as they are prohibited from deposit collection. This is a critical difference that cuts into sustainability as well as scope for rapid scale-up.

Institutional Sustainability

Sustainability can be defined as the ability of the organization to meet the cost of operations and build enough reserves for recapitalisation. This

[17] See Pascal, M., (2003). Five Years On: The Microcredit Summit Campaign and the Development of Microfinance in Asia and the Pacific, FDC, Australia.

implies whether or not the users will be in a position to pay full costs. The subsidy/grant culture that has set in through government-sponsored credit/ welfare programmes in many countries of the region[18] has ruined the repayment discipline. Even insurance schemes are so highly subsidised that the MFIs will be unable to compete on a sustainable basis. Even for a member owned and controlled MFI, which are in the nascent stages in India, full costs are required to be met in order to become sustainable.

Scaling-up of microfinance operations beyond a certain level would be difficult for MFIs due to regulatory and legal frameworks that restrict operations. In many countries of the region, NGO MFIs does not have appropriate financial form or legal structure to operate beyond certain levels of turnover. Given such a situation, competing with the public sector banks would be an uphill task for MFIs. Interest rates (to be precise caps on interest rates) is another issue that merits discussion in the context of outreach and sustainability in many countries where interest rates are artificially pegged down on loans to poor clients.

Provision of Diverse services and Reaching out

Another important feature that has been enunciated is the requirement of a basket of services for the poor and very poor, and most MFIs are not in a position to address all of these due to the orthodoxies of the models that they follow as well as lack of appropriate legal framework. NGO MFIs are unable to undertake services such as flexible savings, credit, micro insurance, remittances and hire purchase, as all of them require an undisturbed environment to operate and arrive at sustainability. Another element related to outreach is the geographical spread and depth of outreach. This depends on country contexts, development of financial markets etc. Island nations of the Pacific region especially require a framework of microfinance operations which takes into consideration the geographical specificity.[19]

---

[18] This is especially so in countries like India, Sri Lanka and other South Asian countries.

[19] These countries have limitations of low density and high transaction costs due to geographical dispersal of populations; 7 million people are spread over 14 million square kilometers. See presentation of Pascal, M. (2003).

Reaching the poorest of the poor is another issue. In this case, most MFIs find it difficult to meet this criterion while achieving outreach and sustainability. Some argue that microfinance alone is not a sufficient strategy for poverty reduction but needs to be complimented with several other anti-poverty activities, especially with wage employment creation as the focus. It has to be critically analysed that, for the poor and poorest of the poor, to what extent microfinance services enable them or disable them to move out of poverty.[20]

Legal and regulatory frameworks

This is one of the prime issues of discussion in the context of inclusive microfinance in the region with the exception of Pakistan, Philippines and, to some extent, Indonesia. The role of government and central banks come into close scrutiny in this, especially in providing a level-playing field and developing a competitive market for microfinance. In Bangladesh, NGO MFIs are not regulated, supervised or monitored by any one authority. In the other countries of the region, legal and regulatory aspects are in the nascent stages of development.[21]

In the subsequent section, we will develop further understanding on inclusive financial sector development in the region and how some of the constraints and issues are to be addressed through such an approach.

---

[20] See Mahajan, (2004) for a discussion on this issue.

[21] It is to be noted that in India formal banking sector, cooperatives, NBFC (those who take deposits) are covered under prudential norms and are supervised by the Reserve Bank of India (the central bank). The rest of the microfinance sector is covered with very minimal regulations. SHGs, which are informal groups, are not registered but have recognition from the central bank for the purpose of financial transactions with formal banks.

III. BUILDING INCLUSIVE FINANCIAL SECTORS FOR POVERTY REDUCTION

A. DEFINING THE CONTOURS OF MICROFINANCE SCHEMES IN THE INCLUSIVE FINANCIAL SECTOR APPROACH

Operationally, the inclusive financial sector is the one that meets the effective demand of all clients, including the poor as economic agents as both borrowers and as depositors and as recipients of various other forms of financial services. While this is from the demand side, on the supply side, inclusive financial sector would mean as discussed earlier, 'a combination of policies and institutions that addresses the needs of all stakeholders and creates an enabling environment for knowledgeable participation by all sections of the society, avoiding the risks of one or other stakeholders upsetting the equations between stakeholders by deciding the normative conditions for participation by others'. This calls for an environment that provides free access as well as unbiased information.

In the context of the inclusive financial sector approach, microfinance schemes would imply creating greater access to sustainable financial services to the poor through diverse kinds of delivery channels.

Inclusive microfinance can be approached through two means:

- If MFIs function as formal financial institutions
- If formal financial institutions are directly or indirectly involved in microfinance activities

Financial sector development of the countries determines the extent of participation of the governments and bankers in microfinance. Currently, most of the delivery mechanisms in the region address institutional aspects and do not have a clear sectoral scope. In contrast, although the outreach is limited, Pakistan has developed a framework for integrating microfinance into the formal financial sector. The participation of MFIs, both NGO-inspired and private, is encouraging in a way that necessitated the development of tools for onsite inspection, assessment criteria and the creation of apex-level funds for microfinance. In Bangladesh, close links between the formal government sector and Grameen Bank have led to the establishment of

institutional mechanisms for microfinance delivery through apex-level funds. Nevertheless, microfinance is not an integrated part of the formal financial sector (even after having a coverage of over 65 per cent of poor through microfinance services). In contrast, Indonesia has a strong governmental presence in microfinance delivery and microfinance figures in the formal financial sector, especially through BRI Unit Desa. Subsequent developments in microfinance sector have led to reforms in the financial sector in Indonesia with regulatory frameworks in place to ensure microfinance development. In the Philippines, regulatory frameworks have been established with the active support of the national central bank and microfinance is an integral part of the national financial sector.

The shift of approach in microfinance from project to institutional development to microfinance sector development reflects the perceived need of MFIs to scale up and to link themselves with the local financial sector/market. Different stages of financial integration can be visualised, starting from donor/concessionary funds to bank lines of credit, to savings mobilisation, capital markets debt financing and equity markets. Integration can also take place with MFIs scaling up as well as the financial sector downscaling to reach to the needs of MFIs. It is important that this trajectory be backed by legal and regulatory frameworks in the countries, and a lot depends on the maturity of financial markets in the countries.[22]

Although started as an 'alternative' or 'parallel' stream of provision of services for the poor, microfinance has been able to establish linkages with the mainstream financial sector, especially through the participation of the formal banking system in a few countries. It is time now to see such integration on a scale, which means that there is a need for concerted efforts from donors, government, United Nations agencies and all stakeholders to learn and share from each other. This section outlines several issues that constrain rapid outreach and sustainability of MFIs while providing services to the poor clients. How does one visualise such integration while engaging in addressing the issues? Are they forming a part of the solutions for integration? Or are they going to contribute to integration? The issues can be recapitulated as follows:

- That several MFIs find limitations in outreach due to a host of factors that primarily point towards their inability to access instruments of formal financial sector to leverage low-cost funds and guarantees and this is mainly due to lack of policy environment

---

[22] Innovations are possible in this aspect as documented from this region too. See CGAP (2004) document: Building financial systems for the Poor.

- MFI dependency on high-cost funds and donor grants lead to sub-optimal performance with respect to sustainability
- In countries such as India, while the SHG-Bank linkage model appears to be moving towards greater outreach, the model has its own constraints, in terms of non-availability of quality groups, capacity constraints of promoters and graduation of clients to higher loan brackets, thereby demanding value-added services
- An institutional approach to microfinance has limitations in terms of 'mission drift' as more and more MFIs are looking for sustainability and thereby diluting the poverty focus
- Integrating microfinance into formal governmental anti-poverty programmes is one of the strategies but it is mired with political dynamics and carries the baggage of subsidy-driven credit programmes, which would lead to adverse selection and failure in terms of targeting and sustainability
- From the government's and regulators' side, efforts seem to have been made, but a lot more is needed in order to identify the constraints for growth and create conducive environment in most countries, with possible exceptions of Pakistan and the Philippines
- Donor funds and government funds continue to be important sources that meet the subsidy components
- The sectoral approach to microfinance is gaining ground in most countries, but the experience and expertise is limited in addressing the reforms needed in the financial sector, especially supervisory capacities of central banks, understanding of the needs of the MFIs and their clients is limited
- Central banks are cautious in their approach to develop frameworks and regulations

It is to be noted that all these points are in some way interrelated and they reflect the fact that microfinance schemes, as they are practised currently, need complimentary support especially from the point of policy and regulation from the government, the formal banking sector, donors and the private sector in order to scale up and reach out to millions of poor. This forms the basis for the microfinance sector development approach.

Some innovations in relation to scaling up of microfinance from the ground level and downscaling mainstream financial institutions are warranted here in order to appreciate the efforts so far in integrating microfinance with

mainstream financial sector. The experience of Indonesia illustrates how the formal sector downscaled its operations to meet the needs of clients. BRI Unit Desa successfully restructured the formal financial system to meet the needs of the very poor and vulnerable clients. It is to be noted that even during the East Asian financial crisis of early 2000, BRI has demonstrated high levels of repayments from poor clients. Similarly, experiences from some of the MFIs demonstrate that they are capable of accessing instruments of formal financial sector, such as foreign investments, securitisation of loans and tapping the bonds and capital markets.

China's experience of microfinance demonstrates a conscious effort of forging a partnership between NGOs, donors and government. The initial experiences of Funding the Poor Co-operative (FPC), microlending by formal rural credit co-operatives (RCCs) and similar projects supported by UNDP, Ford Foundation and other donors posed diverse challenges. There are attempts at transitions from pilot projects to institutions; turning formal RCCs into a main force in microfinance, preparing MFIs to enter into markets and identifying organizations and structures that would undertake regulation and supervision.[23]

In the case of Bangladesh, one of the innovations that enabled MFIs to reach sustainability is PKSF, which is a wholesale provider of microfinance funds to MFIs. PKSF, which was set up in 1999, has been able to disburse over $200 million to over 200 MFIs. This has been set up as an autonomous fund by the government and international donors to enable quicker and cheaper access to microcredit funds. In fact, in Bangladesh, the donor dependency on microfinance funds has come down substantially over the past few years as the data informs us that from over 60 per cent of donor funds in 1996, it has come down to 19 per cent in 2002. PKSF provides over 24 per cent of funds to microfinance sector, apart from interest incomes, which accounts to over 18 per cent of total credit funds (Zaman, 2004).

Pakistan too has created apex level funds for providing line of credit to MFIs.[24] Facilitated by the government, PPAF – a wholesale microfinance fund with $100 million grant from the World Bank – has been established to disburse funds to MFIs. Similar apex-level microfinance fund has been created in India by SIDBI, an apex bank that promotes small enterprises. Donors had set up SIDBI Fund for Microcredit (SFMC), and it acts as a wholesale microfinance fund to on-lend to MFIs and NGO MFIs. It also

---

[23] See Sun, R., (2003). The Development of Microfinance in China (final draft).

[24] See Rashid, B., (2002).

provides promotional and capacity building costs to MFIs in order to strengthen the institutions.[25]

In Pakistan, microfinance sector approach has been followed with active support from the State Bank of Pakistan, which has provided elaborate guidelines for promotion, and supervision of MFIs. In Bangladesh, though government has supported, there is no exclusive regulatory framework for microfinance, which is still an impediment. In the Philippines, exclusive microfinance legislation governs the growth of the sector. In Thailand and other countries, local banking regulations are appropriately adjusted to meet the needs of the sector.

Private investments in microfinance are another innovation that is in its nascent stage in many countries. Citigroup and other international banks have come in to play a role in microfinance. Securitization of loans, guarantees, line of credit and other instruments are used to promote private capital in microfinance. In India, ICICI Bank has securitized loans of BASIX and SHARE, thereby releasing the equity funds for the organizations to on-lend to clients.

Thus, in the inclusive financial sector approach, two concurrent processes are in the offing. While in some countries, the formal banking sector is responding by downscaling their operations to meet the needs of poor clients (and the intermediary MFIs), several private MFIs are in the process of scaling up to meet the demand.

B. ADVANTAGES AND DISADVANTAGES OF BUILDING INCLUSIVE FINANCIAL SECTORS

Building the inclusive financial sector for microfinance would have several implications for stakeholders involved in financial systems. There would be several advantages as well as disadvantages, which need to be weighed against the overall goal of reaching finance to the poor. It is to be

---

[25] See presentation of SIDBI in the Report on Asia/Pacific Microcredit Summit Meeting of Councils, 2004. In India NABARD and SIDBI have played tremendous facilitative role in downscaling especially persuading commercial sector to engage in microfinance. Similarly government efforts in India have been focused on providing fillip to revive rural credit delivery through cooperatives and RRBs. Revival package with thrust in agriculture and rural development will also provide motivation to enter into Microfinance. RBI has made some beginning in addressing the needs of the sector, though at a slower pace than anticipated. Removal of service area restriction, directing private banks to earmark priority sector lending, treating deposit-collecting (from members) NBFCs differently from those of regular NBFCs and such actions would help development of the sector.

noted that the advantages and disadvantages have to be weighed against institutional and project approaches, which are essentially restrictive in nature as they intend to address microfinance in a limited way.

The following stakeholders can be identified while discussing inclusive microfinance:

- Poor and their collectives
- MFIs, NGO MFIs and NGOs
- Donors
- Governments and formal financial institutions

In the following sub-section, we present possible (and real) advantages and disadvantages vis-à-vis stakeholders:

The poor and their collectives

From the point of view of the poor, the inclusive microfinance sector approaches implies arriving at choices and expanding options in terms of securing financial services on terms and conditions that are comfortable for them. There can be situations in which the poor are presented with choices in terms of delivery channels, products, terms and conditions of loans and criteria of participation. There can be more than one supplier through competition and would help enhance efficiency and ultimately benefit the poor.

It can also mean more options for poor communities to participate in the financial systems. For example, in India, SHG federations would like to access more loans and conduct business with innovative products and services. This requires an enabling framework, which would be available through a sectoral intervention, especially through wholesale funds, commercial banks or co-operatives or apex level exclusive funds. They also would like to secure credit at competitive interest rates and possibly at a low transaction cost as current access and terms of credit appear to be of high cost. The critical element is the continuous flow of credit and other value-added services from a single source. For example, currently, most SHGs in India face resistance from bankers as there are a lot of subjective elements in terms of loan appraisal, interest rates and terms of credit. Mainstreaming would introduce a lot more flexibility and multiple sources can be accessed. More MFIs can come into play, leading to competition. The SHG-Bank linkage model will, in fact, become more

competitive so that it would benefit the clients. Other models would also provide an array of services to the poor.

The poor would also benefit from the policy environment that would accompany the inclusive financial sector. Deregulation of interest rates, though in the short-run may affect the poor negatively, would ultimately help the poor to gain access to credit at rates that are competitive in the financial markets and over a period of time. One would expect cheap capital entering the microfinance sector, which would lead to a downward movement of interest rates.

MFIs, NGO MFIs and NGOs

For MFIs, financial integration will have motives of accessing capital at competitive prices to fund its growth, risk management and lowering financial costs. There can also be several dimensions to it, like accessing debt, mobilising savings (from members and public) and utilising capital market instruments. Accessing foreign investments would also be an option that many MFIs are conscious of. In fact, in India, FDI in the microfinance sector has been allowed but at very high entry levels, which may not be feasible for many foreign investors to venture into. There are several other countries, which provide scope for FDI in the microfinance sector through donor funds and corporate funds and by creating specialized autonomous wholesale funds.

From the point of view of MFIs, they will be able to scale up and deliver services with more efficiency if a conducive sectoral approach is taken in terms of policy and regulation. Examples of Bangladesh, Indonesia and the Philippines would testify to the fact that MFIs can scale up their activities more efficiently once the sectoral approach is adopted for microfinance. They can develop business plans based on multiple sources of funds. MFIs can tap capital markets, FDI and other innovative ways of enhancing equity. For example in India, some MFIs have securitized their loan portfolio with local private commercial bank. MFIs can also provide savings services, if there are relevant changes in the regulatory frameworks of the countries of operation. At the same time, the services can be more reliable, transparent and cost-effective.

Most importantly, the sectoral approach would also mean NGO MFIs would be able to provide multiple services that would enable rapid outreach and sustainability. For example, in most countries, NGO MFIs can neither provide savings services to their member clients nor enhance their equity

through public deposits. If this lacuna is removed through a comprehensive sectoral approach with appropriate prudential norms and mechanisms, many NGO MFIs can expand their outreach more rapidly. This has been one of the recommendations of several expert committees in countries such as India and Bangladesh. For NGOs, who do not deal in financial transactions, the inclusive financial sector approach to microfinance may imply the provision of necessary capacities and skills to the communities to access financial services. Their role in promotional activities becomes critical in the efforts towards access and outreach. Information and communication systems need to be developed in this regard.

Formal financial sector

The process of inclusive financial sector development for microfinance implies greater space and role for the formal financial sector. Public and private sector financial institutions under a policy framework would be able to engage with the rural communities in financial transactions through various intermediary institutions and structures. While in some countries where the breadth of the formal sector is wide, they can reach to the poor, directly creating specialized branches, in countries where the outreach of the formal sector is limited, they would identify creative ways of reaching through intermediaries. There are several possibilities, and in several countries, formal banks have created apex level funds for microfinance for on-lending. Under this, NGO MFIs would act as banking correspondents or agents for formal banks and draw upon the apex funds. PKSF in Bangladesh and Sonali Bank of Pakistan are examples of such intermediation. Formal financial institutions can also devise products and services that are compatible for the needs of the poor and intermediary agencies. In some countries, formal financial agencies would be able to fulfil their social obligations of priority sector lending once the inclusive financial sector is developed.

Governments and donors

The anti-poverty programmes of the government in the context of market-oriented reforms require clear targets and operational efficiency. There is a need to see microfinance services from the perspective that several players in the field would create competition and ensure efficiency in delivery of financial services. Market interest rates would create conducive environment without resorting to a subsidy in government programmes and

this would be possible through a sectoral approach to microfinance. As a matter of fact, the government needs to create a level-playing field for all the players to undertake microfinance activities. This implies that an approach towards 'populist' schemes and projects that ostensibly address poverty reduction needs to be re-looked into. The government's role, thus, becomes critical in investing in human resource development, market information and intelligence, training and capacity building, leaving the delivery of financial services to the market players.

Once microfinance is integrated with the mainstream financial sector, donors and other promoters (especially multilateral financial institutions and United Nations agencies) may in fact be in a comfortable position to work with the governments and MFIs towards developing sustainable models of microfinance delivery. This will help in addressing overall poverty reduction goals of national governments and also in meeting the millennium development goals.

Thus, *prima facie*, a sectoral approach would benefit the poor. It would also help MFIs in creating greater flexibility and operational viability. From the governments' and donors' point of view, the sectoral approach would create greater space to address poverty reduction through financial services. While benefits exist, regulatory mechanisms need to be created so as to avoid mission drift in the event of mainstream players entering the microfinance sector.

Possible Limitations (or disadvantages)

For the poor

A critical issue from the point of view of the poor is whether or not accessibility to microfinance remains the same. Will the focus on social banking remain? Will the poor and poorest receive on terms that are comfortable to them and address their poverty issues? Are the current approaches of peer pressure, group lending (dominant models) be viable options? If alternatives were needed, how would they fare in the case of unintended consequences of group lending, such as empowerment and gender equity? Will the poor be able to absorb the full cost pricing of credit and other value-added services, which were hitherto delivered through MFIs/ NGO MFIs at subsidised rates? These questions become critical, as the historical evolution of microfinance schemes have their bearing on concerns related to marginalisation, exclusion, lack of access, and empowerment of the poor. The purpose of specialized alternative financial channels is to

address these concerns, and any drift in such goals would become an unintended negative consequence of inclusive financial sector development. And it may, in fact, lead to the appropriation of surpluses of the poor away from their own local economy if there were no mechanisms of creating production capacities and management capacities among women in rural areas through systematic credit plus services.

MFIs

From the MFI point of view, the sectoral approach may imply more regulation and restrictions on operations, which may in fact hinder the informal nature of transactions. Such restrictions may create entry barriers for nascent MFIs and small organizations working locally and may create monopsonic market conditions vis-à-vis microfinance. It may also lead to more governmental control over their small-scale operations, which may in fact lead to the dilution of vision, commitment and impact as a result of inefficiencies inherent in government systems.

Governments

Government capacities and resources for establishing regulation and monitoring mechanisms would come under tremendous strain in the event of integration of microfinance into financial sector. In many developing countries, this is one of the serious considerations, which propels national governments to move cautiously on developing legal and regulatory frameworks. Even in countries such as Pakistan, which has fairly well-developed regulatory mechanisms for the microfinance sector, on-site supervision mechanisms need to be further developed to suit the microfinance sector. Most of the traditional supervisory and monitoring mechanisms need to be revisited and adapted to the needs of the microfinance sector. For many governments, this would mean acquiring sufficient knowledge, resources and technical know-how. The role of donors in this respect would be very important, as they would be in a position to help national governments enhance their capacities.

Another possible fallout, which is endemic to many governments of the region, is that microfinance may become another populist scheme, subservient to the political system. Such dangers need to be taken into consideration while developing frameworks for integration. Donors can play a critical role in this respect, supporting governments in developing sound frameworks for financial integration.

Donors

Donors, while providing support to national governments and local NGOs, may unwittingly contribute to a shift in their priorities away from client-level impact to institutional and sectoral impact, which would imply a shifting of resources away from activities that would strengthen the household and community. While, in the long run, this may help national governments to strengthen their systems of delivery and efficiency in services, this would mean in the short-run non-availability of cheap capital for microfinance for fledging MFIs and NGO MFIs who depend on donor soft loans and grants. Donor focus in a scenario of development of inclusive financial sectors for microfinance would also mean promotion of commercial microfinance, which is often seen as mission drift, away from the goals of social and economic development of the poor and marginalised.

On balance, while there are several advantages in integrating microfinance with mainstream financial systems, there are also potential drawbacks in such an integration, especially if one were to view from the point of view of government, MFIs, donors and the poor. At the same time, there is scope for addressing these drawbacks through a systematic approach to the development of sectoral policy frameworks and reform the existing systems. The greatest litmus test would be to see whether or not the inclusive approach would address the goals of reaching millions of poor people with financial services. This would outweigh all possible drawbacks, as the countries need to gear up to meet the global development challenges (the MDGs).

C. IMPACTS IN THE ASIA-PACIFIC CONTEXT

The positive impacts of inclusive financial sector development for microfinance can be visualised in the region in terms of:

- Rapid outreach to meet the goals of MDG and Microcredit summit
- Increasing investments in microfinance sector by governments and private sectors
- Increasing FDI into microfinance sector
- NGO MFIs and other institutional forms of suppliers benefit from diverse sources of funds, within their countries and from the region through collaboration and tie ups

- Regional cooperation in terms of technology transfer and other cross learning opportunities
- At the client level – it can mean rapid coverage and value-added services and greater impact at the household level

Microcredit summit goals of reaching 100 million poor families throughout the world by 2007 in the Asian context would mean addressing over three-quarters of the poor. Given the current pace of outreach, one assumes that the countries are somewhere half way in achieving the goals. In countries such as India and China, the current outreach needs to be rapidly accelerated. With the inclusive microfinance approach, one would expect accelerated progress, which would enable reaching the targets of the MDGs, much earlier than anticipated. However, given the limitations of microfinance in addressing poverty, especially of the poorest of the poor, moving the poor out of poverty is a long haul that needs repeated services and innovative services. This is the challenge that inclusive financial services approach to microfinance would need to address.

In many countries, the sectoral approach would mean providing adequate promotional activities for MFIs to grow. It is visible in Bangladesh, Pakistan and other countries of East Asia. However, the Government's role should be more apparent in policy regime in other countries. These will positively help in terms of greater access, less cost, and enable empowerment and the realisation of other goals. The formal sector will provide wider scope for implementers and new players. It can also mean reforming the public sector to be more competitive. For example, in India, the goals of social banking will continue, as there would be definite regulation from the government and other central banking authorities. The current models will continue, as the policy reform essentially would mean hands-off supervision at the field level. More security for savings of the poor people will be available.

On Welfare of the Poor

When it comes to the sectoral approach, one would expect a greater impact on the welfare of the poor as competition in the market provides choices for the borrowers and many services can be accessed through MFIs and other service providers. In fact, research has established that the poor require a package of financial services, which would be possible by applying the sectoral approach, wherein the financial sector responds to the needs of the poor through MFIs (who have menu of activities, instead of current narrowly focused credit delivery).

Some negative consequences

There could also be unintended negative consequences:

- More formalisation of 'informal' operations of women's collectives can mean more cost and require management capacities beyond the reach of some of the women. This could also mean the possible dilution of social and empowerment goals of group-based lending.
- More integration into the formal financial sector could also mean NGOs having better options of investing their surpluses and leaving out credit rationing and mission drift. Integration into the formal sector may also mean NGOs, especially NGO MFIs being subjected to more rigorous appraisal processes for accessing market-based financial instruments.
- The sectoral approach may also lead to use of diverse technologies, which on one side reduces costs, may also lead to the dilution of group approach and joint liability approach as MFIs tend to move away from group-based lending (especially in contexts, where they have reached substantial outreach) to individual lending. The externalities associated with group-based lending may thus, be compromised.
- Also, crowding-in of MFIs in lucrative markets may take place while difficult areas are left out because most MFIs have to compete to achieve outreach and sustainability.
- Competition may lead to the drying-up of credit for those who are in actual need, which was what happened during the subsidy-driven programmes.
- Capacity building of groups on social issues may become another casualty as most MFI-NGOs focus on finance-related operations during group meetings. It can also mean shifting the focus from poverty to a more bureaucratic approach.

IV. APPROPRIATE MICROFINANCE APPROACH FOR POVERTY REDUCTION

The appropriate path for development of microfinance would include identifying gaps in the existing practices and taking recourse to corrective mechanisms that would create conditions for microfinance that is more inclusive. This would mean the transition of the formal banking sector to meet the needs of the poor as well as the upscaling of operations of MFIs and other microfinance promoters (NGO MFIs) to accelerate outreach. The role of donors, the private corporate sector and FDIs would also become critical.

The appropriate path would vary, depending on country conditions in terms of growth of the sector, role of government and policy framework. For example, in India, SHGs may remain the main suppliers through which inclusive microfinance can be visualised. Other countries, NGO MFIs or commercially conscious MFIs set up by NGOs or private sector, would become dominant. In most countries, apex-level funds for microfinance would become a critical step in ensuring the integration with the formal financial sector. PKSF in Bangladesh, apex fund in Pakistan, NABARD as a refinancing agency and SIDBI foundation as the wholesaler in India are a few examples where such apex funds would support MFIs. There are similar apex funds created by donor agencies in the north (developed countries) who would be able to provide bulk lending to MFIs once the host country policies allow such infusion of foreign investment. Central banks play a critical role in terms of policy formulation and guidelines for FDI into this sector. This will help international bodies such as IFC and private banks such as Citigroup to enter microfinance wholesaling more comfortably.

In a review of experiences of NGO transition into formal financial institution Fernando, N. (2004) provides interesting insights into this aspect. Most NGOs in the microfinance sector that have transformed into formal financial institutions have been able to broadbase the ownership structure with more members becoming part of shareholders so that the balancing act of social mission and profitability/sustainability is maintained. Such transformed institutions have also been able to access more commercial capital and provide a broader range of services to their clients. And, finally, most of the transformed institutions were able to broaden the outreach and

the depth of their outreach has also increased reflecting the fact that they were not the victims of mission drift. One of the features that is appreciative of the transformed institutions is that they were able to replace donor grants with equity and debt financing, which by itself is a remarkable turnaround in microfinance sector although it was observed that so far, there was no private risk capital in the microfinance sector.

Fernando, N. (2004) also points out that while these positive features are appreciable, this does not mean that transforming into regulated financial institutions is the only route for NGOs as the cases of ASA and BRAC who even by remaining, as NGOs were able to demonstrate sustainability, by adopting a business-like approach to microfinance.

Experiences reveal that several possibilities exist for enhancing the outreach of microfinance and the sectoral approach needs to accommodate diverse operations and modalities of delivery with an emphasis on sustainability. At the same time, the transition to the sectoral approach is a long haul, wherein several promotional, legal and regulatory frameworks are to be in place. The pace of reform is slow in some countries while in many others, it is quite proactive. It critically depends on the current outreach and the approach that the governments take towards microfinance. So far there is an optimistic view on the role of microfinance in poverty reduction in most developing countries of Asia and Pacific. In most countries, MFIs remain the main suppliers of microfinance with the possible exception of India, which would see a combination of SHG-Bank linkage model and host of other suppliers. In India, the SHG-Bank linkage would remain a steadfast model with overwhelming coverage through the formal banking sector and there will be the presence of MFIs who would adopt predominantly SHG methodologies and a mix of other approaches. However, what would be of interest is to see how the formal sector would be able to revitalize its rural branch networks, especially regional rural banks (RRBs) and spearhead microfinance through them. Reform in this direction is an urgent need in the case of India. Correspondingly, in India, MFIs that serve the poor through cost-effective measures would also expand their base and outreach once an appropriate policy regime is in place.[26]

The expansion of microfinance in areas that have rough geographical terrain would be a challenge for all the countries of the region, especially the Island nations in the Pacific. The same is the case with countries such

[26] For India especially the focus would be in difficult areas of northern India and the challenges of reaching into interior and remote areas of north east, central India and desert areas.

as Pakistan, Nepal and several East Asian countries that have a large poor population. Countries with higher microfinance penetration such as Bangladesh would witness intense competition, and subsequently a range of services that would enhance value for clients who would enter the markets. New products such as life insurance and health insurance would be options for consideration for MFIs as value-added services to their clients. In the formal sector, regional banks, cooperatives and other formal structures will enhance their presence and compete with the private sector, which one hopes would give rise to a healthy microfinance sector in most of the countries, including China which has a large number of rural credit cooperatives (RCCs).

It is the role of governments to create a legal and regulatory environment for microfinance, which in turn helps create investor confidence, client confidence as well as level-playing field for all the players to enter into the microfinance sector. The space for all types of microfinance players to offer services to the poor is necessary for healthy growth of microfinance sector. Introduction of prudential norms that are necessary for protection of deposits. Similarly, licensing processes, regulation and supervision processes need to be established. Some organizations have warned about the rush to regulate because premature and inappropriate regulation can have a significant adverse impact on the growth of the industry.[27] Rhyne, E. (2002) notes that 'banking authorities in many countries seek to define regulations for microfinance institutions in advance of their development, thus risking choking off potentially crucial innovations and adaptations.' In countries where the industry has reached a reasonable level of maturity and formal institutions have a significant presence, governments need to consider how they can be brought under effective prudential regulation. In other countries, the governments may serve the industry better by focusing on measures that increase the information available to both potential clients and service providers, non-prudential regulation and improving transparency and governance of semi-formal microfinance institutions. In transitional economies where there are restrictions on mobilising deposits by financial cooperatives from even their members and operations of NGOs in microfinance, governments need to focus on easing those constraints rather than regulating the industry.[28]

---

[27] See Christen, R.P. and Rosenberg, R. (2000) for a debate on this.

[28] See Fernando, N., (2004) for a discussion on governments' role.

Pakistan has developed an exhaustive policy framework for microfinance in the year 2001, which is seen as a path to develop the microfinance sector. It has adopted a holistic, inclusive strategy for promotion and spread of microfinance. One important element is strong political commitment from the establishment on promoting microfinance, which appears to be the case with respect to Pakistan. Space is provided for multiple actors – community-based organizations, NGOs, public sector, private sector, rural support programmes (poverty focused projects) have been in the field of microfinance delivery, which helps in developing competition. The policy framework enabled setting up formal microfinance banks (MFBs) and also NGO MFIs to conduct microfinance services. Unregulated NGOs, however, are not allowed to receive deposits from the public for their operations. The central bank of the country (State Bank of Pakistan) undertakes the supervisory and regulatory role and a separate regulatory framework for MFBs has been established in terms of capital adequacy requirements, loan size, classification of credit portfolio and provisioning and reporting requirements and governance standards. Several on-site and off-site surveillance and examination tools have been developed in order to supervise MFBs and other microfinance institutions that are licensed by the State Bank. Currently, it is in the process of developing an on-site examination manual, which is suitable for MFBs so as to equip the bank functionaries with necessary skills.

The paths that the countries may opt include developing separate laws for the microfinance sector or providing space within the existing legal frameworks to enable MFIs to engage in delivery of financial services. Muhammad Yunus of Grameen advocates for a separate law for governing microfinance activities in Bangladesh. He suggests for a legislative policy that enables NGOs to convert themselves into banks.[29] Others believe that NGO MFIs do not have a legal charter to provide certain types of financial services, such as voluntary deposit-taking. Given the industry structure, the government can play an important role by introducing an environment – both policy and legal – to transform matured NGO MFIs into formal financial institutions. This could be done by creating 'a distinct legal tier for non bank MFIs', with regulation and supervision either by a distinct unit within the central bank or by a third party having delegated supervisory authority'.[30] Simultaneously, Professor Yunus advocates for the creation of a regulatory

[29] See presentation of Professor Yunus at the Asia/Pacific Region Microcredit Summit Meeting of Councils, 2004.

[30] See Rahman, S. and Charitonenko, S., (2002), p.42 for a discussion on regulatory issues.

body to oversee the operations of microfinance banks and facilitating their growth. According to him, the process of creating and transforming NGOs into microfinance banks would strengthen self-reliance as well as the financial system of the country by filling the vacuum created by the formal financial sector. He also advocates for the setting up of wholesale funds on the lines of PKSF in order to create easy access of funds to MFIs, which can be formed through the government and donor participation.[31]

India may opt for a twin track of developing frameworks for regulation of MFIs as well as restructuring public sector banking infrastructure to deliver microfinance. This possibly would be the route even for countries such as China.

Given the banking infrastructure of India, the formal banking sector would take the lead in defining the sector growth. However, there are constraints for nascent MFIs in their growth and integration into the formal financial sector, which are highlighted by Sadhan a network of community development finance institutions[32] in a recent submission to the Government of India. In summary, some of the constraints are;

- Savings services are limited in rural areas due to legal restrictions
- NBFC registration difficult due to high capital requirements
- Microfinance NBFCs cannot raise deposits
- Most MFIs are registered as trusts/societies due to lack of appropriate legal form and are not seen credible for borrowing from banks
- External funds are not easily accessible for MFIs (due to external commercial borrowing (ECB) restrictions)
- Taxation policies of the government do not enable MFIs to build reserve funds for engaging in further microfinance activities

It is to be noted that given the nascent growth of MFIs in India, as most of the outreach is through government programmes (SHGs promoted by government or NGOs), one has to qualify that these limitations identified are applicable to those who would like to enhance their outreach through an MFI route. The situation is similar in many developing countries of the region with regard to the promotional aspects of MFIs.

---

[31] See endnote 17.

[32] See Sadhan (2004) presentation to finance minister.

Some of the measures in this regard could be the following:[33]

- To have a separate scope for setting up a microfinance company under the existing Companies Act with all necessary prudential norms and regulations to be applicable.
- Development of a national equity fund for microfinance
- Exemption of MFIs from external commercial borrowing ban and reducing the entry of foreign equity to $50,000
- To set up a microfinance development and regulatory authority

The above discussion reflects the need for integrating microfinance into the mainstream financial system so as to benefit from the provisions of the formal financial sector as well as protecting the interests of clients and other stakeholders. In the long-run, restructuring the formal banking sector, including the revival and restructuring of RRBs and cooperatives would create tremendous potential for reaching out to millions of poor. Removing the ceilings on interest rates, redefining priority sector lending, promotion of private banking sector in microfinance requires systematic government intervention.

It is to be noted that several analysts identified somewhat similar constraints in other countries as well, which reflects the need to take a regional perspective in developing regulatory and policy environment for microfinance. There is scope for learning from experiences of other countries and make necessary adaptations.[34]

While several sector-related regulations are warranted in many countries, there is also the critical role of the government in creating macroeconomic stability, especially price stability. Macroeconomic management is critical for the success of microfinance in developing countries. Many analysts argue that growth in Bangladesh is attributed to the macro economic stability of the country, in terms of low inflation, high investor confidence and growth. Apart from that, Fernando (2004) recommends that governments should;

---

[33] The network of community-based development finance institutions (Sa-dhan) has proposed several measures, of them the critical ones are presented which are perhaps common to many countries of the region.

[34] In fact the Microcredit summit campaign identifies such a need as many countries have similar ground conditions. See State of the Microcredit summit campaign Report 2004, written by Sam Daley Harris 2004.

- Curtail the emerging trend for the re-introduction of directed credit programmes
- Support ICT development in rural areas (to reduce transaction cost and enhance efficiency in microfinance)
- Allow more room for foreign equity participation
- Reform state-owned rural financial institutions

Discussing on the same subject, Nancy Barry, president of Women's World Banking advocates for policies which reflect the needs of the poor, which include, speed and convenient loan delivery, access to larger and flexible loans including housing loans, low interest rates, health and life insurance, short-, medium- and long-term savings products and, above all, respect and recognition. She also identified the need for creating domestic market for microfinance in countries and that governments should not be providing retail microfinancing in order to promote several players in the market who can deliver in a cost-effective way.[35]

In countries where community-based microfinance is practised, there is a need to invest in capacity building at all levels, which needs to be facilitated by the governments. For example, in India, NABARD has set up a separate fund ($20 million) for microfinance capacity building for clients, their federations, self-help promoting institutions and bankers. Similar funds need to be created in other countries by the donors in order to enhance capacities across the stakeholders of the sector. There is a need for considering separate apex regional level agency to provide technical and financial support to the MFIs of the Pacific subregion.[36]

---

[35] See presentation on this topic at Report on the Asia/Pacific Region Microcredit Summit Meeting of Councils, 2004.

[36] See Pascal, M. (2003), who advocates for such a regional apex institution, given the specificities of the Pacific island nations.

V. CONCLUSIONS: THE WAY FORWARD

This paper has attempted to provide an overview on the current status of microfinance practice in the Asia and the Pacific region with the objective to explore the scope for inclusive financial sector development. As the purpose of the paper is to highlight the pros and cons of the inclusive financial sector approach to microfinance, the experiences faced so far indicate that one of the critical complimentarity, apart from institutional sustainability, is the response of the financial system to the needs of financially weak clients. This outweighs all the possible disadvantages or apprehensions on the integration of microfinance with the formal financial sector. Evidence suggest that the integration of microfinance into the formal financial sector is one of the critical and logical corollaries for an inclusive development strategy.

Evidences also point towards the conclusion that in countries where formal financial infrastructure exist, a robust downscaling of the formal sector to reach out to meet the needs of the poor would be a compelling strategy in the context of globalization and competition for the survival of the formal banking infrastructure. Efforts towards restructuring RRBs and cooperatives in India are worthwhile examples. While current MFI growth is somewhat slow, it is expected that leveraging resources from the formal sector would be one of the paths of growth for MFIs in India.

In other countries, government's efforts to create a conducive policy environment for MFIs and the creation of apex-level funds are some initiatives that enable MFIs to expand their outreach rapidly.

This paper has also examined the pros and cons of the sectoral approach vis-à-vis its impact on the poor. A conclusion that emerges from all available evidences is that the poor would certainly benefit from the choices that would be available in terms of access as well as the quality and diversity of services once the sectoral approach is adopted. At the same time, there are apprehensions of mission drift and a possible concentration of MFIs in lucrative markets, thereby ignoring the needy. This brings to focus the role of government and central banks in developing appropriate mechanisms of regulation and policy direction. The capacities of governments and MFIs in

addressing issues of regulation will come to fore once the sectoral approach is adopted. There is a need to invest adequately in these aspects.

Thus, the microfinance sector in most of the Asia and the Pacific countries has reached a critical mass and is moving towards the sectoral approach. In all the countries, especially in South Asia, the presence of the public sector – formal banking structures – provides an opportunity for the integration of microfinance to scale up. At the same time, it is a challenge as most of the public sector formal sector needs a revitalizing and refocusing on the sustainable microfinance as a portfolio for poverty reduction. Nancy Barry, president of Women's World Banking, identified the challenges as extending the outreach to millions of people by increasing MFI capacity, involving mainstream banks and mobilising the domestic capital market, building assets on the borrowers' part and building a culture among MFIs, bankers, policymakers and funders of microfinance based on trust transparency, shared standard, generosity and mutual accountability for results.[37]

The rapid growth of MFIs in Bangladesh and to a lesser extent in other countries reflects the demand for microfinance services, and it is estimated that the supply lags behind demand by manifolds. Several factors contribute to this situation, one critical aspect being the lack of capacities in the microfinance sector. In addition, moving from the institutional approach to the sectoral approach requires active government and donor intervention.

A review of experiences of countries reveals that in most countries, NGO MFIs, MFIs and other institutional forms are primary suppliers, albeit with formal financial institutions providing promotional support, and in some cases have created apex-level wholesale funds. In none of the countries, with the exception of Pakistan, the Philippines and Indonesia, is comprehensive microfinance sector development available. Microfinance banks, licensing of NGO MFIs, developing rating and prudential norms and developing appropriate supervisory mechanisms are some important elements of currently available sectoral policies in some of the countries but not in all the countries.

What is critical for the microfinance sector development is political commitment as it determines the pace of movement towards sectoral approach to microfinance. Most countries, except a few, need to set up

---

[37] See Report on the Asia/Pacific Region Microcredit Summit Meeting of Councils, 16-19 February 2004, Dhaka, Bangladesh.

legal and regulatory frameworks to integrate microfinance into mainstream financial systems. This warrants learning from experiences of others. For example, Pakistan has developed regulatory frameworks and a microfinance policy, which may need to be studied and adapted in other countries. Similarly, the experience of Bangladesh on apex microfinance funds is worth emulating in other countries of the region.

Microfinance policy regimes in countries should aim at the promotion of diverse models so as to accelerate growth and sustainability. This is particularly important as the demand-supply gap needs to be filled through all available means and methods.

The development of national apex microfinance funds, regional funds (at SAARC, ASEAN level and separately for Pacific Island nations), would enable the flow of capital (in different forms) into the microfinance sector. This needs further deliberations at different levels, as indicated during the Microcredit summit council meeting in Dhaka held in February 2004. The promotion of private apex-level funds would be another strategy that many international donors may consider adopting. For example, Grameen Foundation, with the support of international donor community, has excellently promoted the Grameen model in over 40 countries of the developing world. Such apex-level funds by private donors would help enhance investments in the microfinance sector. Similarly, at the Pacific level, with the support of FDC, Australia, the apex-level network has been formed, which needs to consolidate its base and begin providing support to member countries.

What is important in the move towards the sectoral approach is building a constituency for microfinance in respective countries. Networking and advocacy plays critical role in sharing knowledge and experiences. Industry leaders need to network for information exchange, best practice sharing and advocating policy changes. While such efforts are available in several countries, there is a need to build alliances across the countries. There is specific role for apex-level MFIs, apex banks and regulatory authorities in this direction.[38]

---

[38] This was attempted at the Asia/Pacific Region Microcredit Summit Meeting of Councils, 16-19 February 2004.

Specific Policy Recommendations

The countries of the Asia and the Pacific region are on the threshold of unleashing the potential of microfinance in poverty reduction efforts. The experiences so far indicate that inclusive financial sector approach would provide an effective option for poverty reduction and there is significant support for developing a sectoral approach to microfinance that not only enhances outreach but also addresses issues of sustainability. It is important that with the support of international donors and United Nations agencies, countries of the region take steps that enable the integration of the microfinance sector with the mainstream financial sector in a smooth and trouble-free process. The following specific recommendations would help achieve this:

1. In several countries, current legal and legislative frameworks need an overhaul and reform so as to enable NGO MFIs and other forms of microfinance suppliers to engage in rapid outreach and attain sustainability. While there are some studies that look at legal and regulatory practices, a comprehensive comparative study and road-map based on country requirements need to be facilitated. The output of such a study would help advocate at the regional level among microfinance practitioners and regulatory authorities. Wherever required, based on country specifications, there is a need to study the implications of upscaling of MFIs as well as downscaling of the formal sector. A special microfinance sector policy can be developed or modifications for existing financial policies may be undertaken in each of the countries. Such an overarching mandate may be developed by United Nations agencies.

2. The dynamic relationship between private sector involvement in microfinance and that of the government sector dictates the trajectory of the inclusive approach. This needs to be studied, and has to be contextualised while advocating for inclusive approach. In countries where the formal sector is widespread, the response to an inclusive microfinance approach would be different from countries where the banking sector is not all-pervasive. Also, the power that central banks wield vis-à-vis the finance ministries also determines the pace and scope of downscaling. This aspect needs to be accounted for, especially while undertaking advocacy with policymakers.

3. Specifically, central banks and the ministries of finance of the countries of the region need to identify specific needs of the microfinance sector and arrive at a realistic and operationally viable set of policy directions with regard to the licensing of NGO MFIs, enhancing a range of products that they offer, prudential norms and practices and setting the environment for rapid growth of microfinance sector. Appropriate supervisory and monitoring mechanisms need to be established.

4. Flow of private commercial capital, venture capital, foreign capital and access to various forms of financial instruments for NGO MFIs and MFIs is the need of the hour for enhancing the outreach. National governments need to undertake steps in this direction through financial sector reforms. Similarly, franchising of successful models (and MFIs) in other countries may also be permitted for rapid outreach, as the experiences of Grameen and CASHPOR in several other countries testify.

5. Apex loan/equity funds for microfinance at the national level are identified as one of the critical factor that attracts more players into the microfinance sector. This should be seen in the context of national development goals for creating access to financial services to low-income clients. Experiences with such apex-level microfinance loan/ equity funds has been so far positive in many countries such as Bangladesh, Pakistan, Indonesia and the Philippines. Other countries may emulate the same.

6. Similar apex-level funds for capacity building need to be created in order to meet the challenges of capacity building.

7. Donors, who can coordinate their investments into microfinance may create regional funds for microfinance. Donor support for the development of sectoral approach to microfinance may be identified as one of the criteria for disbursement of regional funds. This would help develop competition among the countries of the region and also help exchange of ideas and technology. SAARC fund for poverty reduction, which has been endorsed by heads of nations meeting at Islamabad in 2003 and is currently at a stage of feasibility, has already identified microfinance as one of the critical interventions for poverty reduction, and such a fund may help in developing sectoral approach. Similarly, a separate fund for the Pacific region may be considered.

8. National Governments and United Nations bodies may develop regional, technical and resource agencies that can pool the existing talent and develop mechanisms to enhance the capacities of national governments, NGOs, MFIs, the private sector, the banking sector and others to engage in microfinance sector development. Substantial investments in research and innovation are required as most of the experiences of financial specialists and analysts have so far remained within the realm of the formal financial sector and their exposure to microfinance is somewhat limited.

9. National and regional networks for technical collaboration and exchange may be promoted under the aegis of United Nations agencies. Networks like CGAP may downscale their operations at the regional level in order to provide technical assistance. This helps spreading the technology across the nations and also helps in scaling up innovations.

10. The development of regional-level credit bureaus and national-level credit bureaus would be appropriate as part of the development of the microfinance sector. This helps in sharing information at different levels and appropriate infrastructure for such bureaus may be supported by United Nations agencies like UNCDF.

11. The year 2005 being the International Year of Microcredit, the United Nations and its operative wings should take the lead in identifying targets for sector development in each country and work with national governments, MFIs, NGOs and private sector in achieving these targets. Financial integration pre-supposes a policy regime that is conducive, and hence, commitments from governments and central banks for concrete policy changes need to be secured through advocacy at different levels.

12. Engagements with national governments in the context of the International Year of Microcredit should be aimed at the development of the sectoral approach to microfinance.

13. Promotion of microfinance requires appreciation of diverse models of delivery. Governments and international agencies, such as the United Nations, should strive for flexible approaches for sector development instead of backing monolithic and rigid models. This will help create conditions for multiple players to come into the picture, which would ultimately help the poor.

REFERENCES

Basix – Annual Report, 2003, (India).

CARE India (2004). Microfinance in India 2008 – Event Report.

CGAP (2004). The role of the governments in Microfinance, donor brief No. 19, June 2004.

Christen, R.P. & R. Rosenberg, (2000). The Rush to Regulate: Legal Frameworks for Microfinance (Occassional Paper No. 04) CGAP – Consultative Group to Assist the Poor.

Donaghue, K., (2004). Microfinance in the Asia Pacific, Asian-Pacific Economic Literature, 2004, Vol. 18 (1) PP.41-61.

Fernando, N. (2004). Micro Success Story? Transformation of Non-Government Organizations into Regulated Financial Institutions, June 2004, (Manila, Asian Development Bank).

Grameen Bank at a Glance – from Grameen website < http://www.grameen-info.org/bank/index.html>

GTZ (2004). Emerging Scenarios for Microfinance Regulation in India: Some Obeservations from the Field, Division 41, Financial Systems Development, GTZ GmbH.

Hossain, M., (1988). Credit for the Alleviation of Rural Poverty: The Grameen Bank in Dhaka, Bangladesh, (Bangladesh Institute of Development Studies (BIDS)).

Impact Monitoring and Evaluation Cell, Proshika (IMEC, PK), (1995). *Impact Assessment Survey Report*, Proshika Manobika Unnayan Kendra.

Khandker, S.R. (2003). Micro-finance and Poverty: Evidence Using Panel Data from Bangladesh, World Bank Policy Research Working Paper Series No. 2945, (Washington D.C., World Bank).

Lirio, R. P. (2004). Regional cooperation in microfinance: the banking with the Poor network in Asia, paper presented at Asia Pacific Microcredit summit meeting of councils, Dhaka, Bangladesh February 2004.

Littlefield, E, J. Murduch, and S. Hashemi, (2003). Is Microfinance an Effective Strategy to Reach the Millennium Development Goals? CGAP Occasional Paper 24, January 2003.

Mahajan, V., (2004). From Microcredit and Livelihood Finance, James Mascarenhas Memorial lecture, (mimeo)

Mahajan, V. and R. B. Gupta (2003). Microfinance in India – Banyan Tree and Bonsai, A review paper for the World Bank

Mathie, A., (2001). Including the Excluded: Lessons Learned From The Poverty Targeting Strategies Used By Micro-Finance Providers The Coady International Institute, (Nova Scotia, St. Francis Xavier University).

Micro-credit Ratings International Limited (M-CRIL), Microfinance Review 2003, <http://www.m-cril.com> (India).

National Bank for Agriculture and Rural Development (NABARD), (1999). Report of the Task force on Supportive Policy and Regulatory Framework for Microfinance in India – Summary and Recommendations, (India, NABARD).

Pascal, M., (2003). Five Years On: The Microcredit summit Campaign and the Development of Microfinance in Asia and the Pacific (Australia, Foundation for Development Cooperation).

Pitt, M. and S. Khandker (1996). Household and Intrahousehold Impact of the Grameen Bank and Similar Targeted Credit Programmes in Bangladesh, World Bank Discussion Paper No. 320, (Washington D.C., World Bank).

Rahman, R., (1996). Impact Of Credit For Rural Poor: An Evaluation of Palli Karma – Sahayak Foundation's Credits Programme Dhaka, Bangladesh, (Bangladesh, Institute of Development Studies (BIDS)).

Rahman, S. and S. Charitonenko (2002). Commercialization of Microfinance – Bangladesh, (Manila, Asian Development Bank).

Rashid, B., (2002). 'Rural credit methodologies and the role of the rural support programmes in delivery of Microcredit in Pakistan, Committee on Rural finance

Report on the Asia/Pacific Region Microcredit Summit Meeting of Councils February 16-19, 2004, <http://www.microcreditsummit.org/aprms/2004/>

Rhyne, E. (2002). The Experience of Microfinance Institutions with Regulation and Supervision, presentation at the 5th International Forum on Microenterprise (Inter-American Development Bank September 10, 2002).

Sadhan, (2004). Presentation to the Honourable Finance Minister of India, November 12-26, 2004.

Sinha, S., (2000). India Country Study in Role of Central Banks in Microfinance in Asia and The Pacific, Country Studies Vol. 2. (Manila, Asian Development Bank).

Srivastava, P., and B. Priya (2004). Scaling-up access to finance for India's Rural Poor, A case study from "Reducing poverty sustaining growth – what works, what does not and why, a global exchange for scaling up success, Scaling up poverty Reduction: a global learning process and conference, Shanghai, China, May 12-26 2004.

Snodgrass, D. and J. Sebstad, (2002). Clients in Context: The Impacts of Microfinance in Three Countries – Synthesis Report, (Washington D.C., Assessing the Impact of Micro Enterprises, Management Systems International (AIMS) Project).

Sun, R., (2003). The development of Microfinance in China (final draft), by Hongkong: China Rural Development Institute, Chinese Academy of Social Sciences.

United Nations (2004). International Year of Microcredit 2005 Concept Paper: Building Inclusive Financial Sectors to Achieve the Millennium Development Goals, (New York).

UNCDF (2004). Building Inclusive financial sectors that serve the poor and low income people, UNCDF Microfinance sector Development approach paper 2004.

Women's World Banking (WWB), (2004). "Foreign exchange risk management in Microfinance' financial products and services occasional paper Vol. 1 (2), (New York, WWB).

Women's World Banking (WWB), (2004). Remittances: ICICI Builds Technology Based financial literacy services and remittance products for rural markets' The WWB Global network for banking innovation in microfinance, Innovation Brief, (New York, WWB).

Women's World Banking (WWB), (2004). 'Strategies for Financial Integration: Access to Commercial Debt', Financial services and products occasional paper, July 2004, (New York, WWB).

Weiss, J. and H. Montgomery (2004). 'Great Expectations: Microfinance and Poverty Reduction in Asia and Latin America', ADBI Discussion paper 15, (Tokyo, ADBI).

Yunus, M., (2004). 'Expanding Microcredit outreach to reach the millennium development goal – some issues for attention' presentation at Asia Pacific Microcredit summit meeting of councils in Dhaka, Bangladesh, February 2004.

Zaman, H. (2004). The Scaling-up of Microfinance in Bangladesh: Determinants, Impact, and Lessons World Bank Policy Research working paper 3398, September 2004, (Washington D.C., World Bank).

READERSHIP SURVEY

The Poverty and Development Divisionof ESCAP is undertaking an evaluation of the publication: ***Microfinance for Poverty Reduction: Building Inclusive Financial Sectors in Asia and the Pacific***, with a view to improving the usefulness of future publications to our readers. We would apprciate it if you could complete this questionnaire and return it, at your earliest convenience, to:

Chief
Poverty and Development Division
ESCAP, United Nations Building
Rajadamnern Nok Avenue
Bangkok 10200, THAILAND

QUESTIONNAIRE

		Excellent	*Very good*	*Average*	*Poor*
1.	Please indicate your assessment of the *quality* of the publication in terms of:				
	• Presentation/format	4	3	2	1
	• Readability	4	3	2	1
	• Timeliness of information	4	3	2	1
	• Coverage of subject matter	4	3	2	1
	• Analytical rigour	4	3	2	1
	• Overall quality	4	3	2	1
2.	How *useful* is the publication to your work?				
	• Provision of information	4	3	2	1
	• Clarification of issues	4	3	2	1
	• Its findings	4	3	2	1
	• Policy suggestions	4	3	2	1
	• Overall usefulness	4	3	2	1

3. Please give examples of how this publication has contributed to your work:

....
....
....

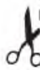
4. Suggestions for improvement of similar publications:

....
....
....

5. Your background information, please:

Name: ....
Title/position: ....
Institution: ....
Office address: ....

Please use additional sheets of paper, if required, to answer the questions.
Thank you for your kind cooperation in completing this questionnaire.



This publication may be obtained from bookstores and distributors throughout the world. Please consult your bookstore or write to any of the following:

1. Sales Section
   Room DC2-0853
   United Nations Secretariat
   New York, NY 10017
   USA
   Tel.: (212) 963-8302
   Fax: (212) 963-4116
   Telex: 422311 UN UI

2. Sales Section
   United Nations Office at Geneva
   Palais des Nations
   CH-1211 Geneva 10
   Switzerland
   Tel.: (41) (22) 917-1234
   Fax: (41) (22) 917-0123
   Telex: 23711 ONU CH

3. Chief
   Conference Services Section
   Administrative Services Division
   Economic and Social Commission for Asia and the Pacific (ESCAP)
   United Nations Building
   Rajadamnern Nok Avenue
   Bangkok 10200, Thailand
   Tel.: (662) 288-1234
   Fax: (662) 288-1000
   Telex: 82392 ESCAP TH

For further information on publications in this series, please address your enquiries to:

Chief
Poverty and Development Division
Economic and Social Commission for Asia and the Pacific (ESCAP)
United Nations Building
Rajadamnern Nok Avenue
Bangkok 10200, Thailand
Fax: (662) 288-1000, 288-3007
Telex: 82392 ESCAP TH, 82315 ESCAP TH
email: escap_pdd@un.org
Cable: ESCAP BANGKOK

كيفية الحصول على منشورات الامم المتحدة

يمكن الحصول على منشورات الامم المتحدة من المكتبات ودور التوزيع في جميع انحاء العالم · استعلم عنها من المكتبة التي تتعامل معها أو اكتب الى : الامم المتحدة ،قسم البيع في نيويورك او في جنيف ·

如何购取联合国出版物

联合国出版物在全世界各地的书店和经售处均有发售。请向书店询问或写信到纽约或日内瓦的联合国销售组。

HOW TO OBTAIN UNITED NATIONS PUBLICATIONS

United Nations publications may be obtained from bookstores and distributors throughout the world. Consult your bookstore or write to: United Nations, Sales Section, New York or Geneva.

COMMENT SE PROCURER LES PUBLICATIONS DES NATIONS UNIES

Les publications des Nations Unies sont en vente dans les librairies et les agences dépositaires du monde entier. Informez-vous auprès de votre libraire ou adressez-vous à : Nations Unies, Section des ventes, New York ou Genève.

КАК ПОЛУЧИТЬ ИЗДАНИЯ ОРГАНИЗАЦИИ ОБЪЕДИНЕННЫХ НАЦИЙ

Издания Организации Объединенных Наций можно купить в книжных магазинах и агентствах во всех районах мира. Наводите справки об изданиях в вашем книжном магазине или пишите по адресу: Организация Объединенных Наций, Секция по продаже изданий, Нью-Йорк или Женева.

CÓMO CONSEGUIR PUBLICACIONES DE LAS NACIONES UNIDAS

Las publicaciones de las Naciones Unidas están en venta en librerías y casas distribuidoras en todas partes del mundo. Consulte a su librero o diríjase a: Naciones Unidas, Sección de Ventas, Nueva York o Ginebra.

United Nations publication
Sales No. E.05.II.F.37
Copyright © United Nations 2006
ISBN: 92-1-120452-6
ISSN: 0255-9250
ST/ESCAP/2385

Printed in Bangkok
March 2006 - 800