



Microfinance Industry: Some Changes and Continuities*

Nimal A. Fernando
Principal Finance Specialist (Microfinance)

Asian Development Bank
East Asia Department
May 2007

* Handout paper prepared for the Japan Microfinance Symposium, organized by PlaNet Finance held at the Asian Development Bank Institute in Tokyo on 10 May 2007.

Microfinance Industry: Some Changes and Continuities¹

Nimal A. Fernando
Asian Development Bank

I. Introduction

The modern microfinance industry which began with experimental efforts in the 1970s to provide collateral-free loans to poor people has grown significantly over the last 2 decades. According to the data collected by the Microcredit Summit Campaign, by the end of December 2005, globally 3,133 microcredit institutions had 113.26 million clients with a current loan. And 1,652 of these institutions were in the Asia and Pacific region. The region's institutions reached about 97 million clients with a current loan and some 64 million of these clients were poorest women. These data refer only to microcredit clients. Data available from other sources indicate that many poor people have also been able to use deposit facilities that microfinance institutions (MFIs) and a variety of other financial institutions offer. For example, savings banks, post offices, cooperatives, and commercial banks in many developing countries have opened their deposit facilities to an increasing number of poor people during the last 2 decades. In some countries, even nongovernment organizations (NGOs) are offering deposit services.

The dramatic growth reported by a number of flagship MFIs in the region and elsewhere also provides further evidence of the dynamism in the microfinance industry. The Association for Social Advancement in Bangladesh, better known in its acronym ASA, had over 4.65 million active borrowers at the end of June 2006, as against 1.1 million at the end of 1999. BRAC, also in Bangladesh, had 4.55 million active borrowers at the end of 2006 as against 2.6 million it had at the end of 1999. In India, because of their rapid growth during the last decade, self-help groups now provide credit to over 10 million poor women. In Indonesia, unit desas of the Bank Rakyat Indonesia (BRI) now reach more than 15 million poor and low-income households with deposit services. BRI-units had 30.9 million savings accounts at the end of 2006. The units also provide credit facilities to over 2.5 million poor and low-income households. In the Latin American region, for example, Compartamos in Mexico increased its number of active borrowers from about 93,000 at the end of 2001 to about 617,000 at the end of 2006. A number of other institutions, such as Mibanco in Peru, have also reported rapid growth.

II. Changes and Continuities

With the rapid growth, many aspects of the industry seem to have changed significantly while many other aspects seem to continue. What has changed and what appears to continue? In this presentation, I shall focus on a few changes and continuities I consider important.

A. Changes

Perhaps, it is pertinent to begin this discussion with the changes in the concept of microfinance. As noted by the Consultative Group to Assist the Poor, a consortium of multilateral and bilateral development agencies and few private foundations working together to

¹ The views expressed in this paper are those of the author and do not reflect those of the Asian Development Bank.

build financial systems for the poor in developing countries, at the early stages of the modern microfinance industry, the term “microfinance” was easily understood as “a credit methodology that employs effective collateral substitutes to deliver and recover short-term, working capital loans to microentrepreneurs or potential microentrepreneurs.” This narrow definition has undergone a transformation over the years. Today, the term encompasses a broad spectrum of financial services that includes not only microcredit but also savings, insurance, payment services, and money transfers.

The perspectives on the target group for microfinance have also changed in recent years to include low-income men, women, youth, children, and the poorest of the poor. The inclusion of the poorest of the poor in the target group seems to have been influenced by the work of the advocacy groups such as the Microcredit Summit Campaign and the encouraging results shown by pioneering MFIs such as the Grameen Bank, BRAC, and ASA in Bangladesh. Similarly, vulnerable nonpoor groups are also considered an important target group for microfinance because if they are left out of formal financial services, they could become more vulnerable to external shocks and easily fall into poverty. Also, the small enterprises of the nonpoor generate employment opportunities for the poor. More importantly, it is argued that serving some nonpoor helps MFIs achieve a higher level of efficiency and financial sustainability in a shorter time than otherwise would be the case. These changes in perspectives have essentially broadened the potential market for the service providers.

The notion that microfinance is a separate segment of the broader financial system is also undergoing changes. Today an increasing number of promoters, practitioners, academics, and policy makers tend to believe that if microfinance were to achieve its full potential, it must be integrated into the broader financial system. The recognition that no real or imaginary walls should exist between microfinance and the broader financial system compels us to consider microfinance as the lower end of the broader financial system rather than as an isolated marginal sector that needs to be served only by narrowly focused niche market MFIs.

With the wide acceptance of the new perspectives of microfinance, the institutional composition of the industry has undergone a major change. About 2 decades ago, the institutional landscape of microfinance in most countries was relatively barren with little or no involvement of formal financial institutions except Bangladesh and Indonesia. Grameen Bank was a major source of formal microcredit in Bangladesh while BRI-unit desas were a major source of both formal microcredit and deposit services in Indonesia. In addition, a state-owned pawning company, Perum Pegadaian, also played a major role in serving the poor with microcredit. In countries such as Cambodia, Nepal, and Philippines, NGOs were the major service providers. Many promoters and practitioners believed that only entrepreneurs with a social mission can provide financial services for the poor. The commercial banks shunned serving the poor and low-income households in virtually all countries.

Today's microfinance institutional landscape is diverse in most countries. The diversity has resulted from a number of developments. A number of NGOs have transformed themselves into regulated financial institutions. ACLEDA Bank in Cambodia is a case in point. More than 14 other NGOs in Cambodia have become licensed, regulated financial institutions. Mongolia's Xac Bank and Nepal's Nirdhan Bank, India's Share Microfin Ltd, Spandana, SKS, and Opportunity Microfinance Bank in the Philippines are some examples of regulated MFIs established through the transformation of NGOs. In some others, the entry of new microfinance banks into the industry has made the landscape diverse. In Pakistan, the Asian Development Bank helped the Government introduce the Microfinance Ordinance in 2001 to allow the establishment of regulated MFIs. As a result, five new microfinance banks have entered the industry in recent

years. In the Philippines, the diversity has increased partly due to the increased role of rural banks and cooperatives in microfinance. According to the Central Bank of the Philippines, a total of 550 branches of 223 thrift, rural, and cooperative rural banks are significantly involved in microfinance in addition to about 4,000 savings and credit cooperatives and over 200 NGOs. In 2005, two pioneer microfinance NGOs opened microfinance thrift banks: Dunganon Bank by the Negros Women for Tomorrows Foundation and Kauswagan Bank by TSKI. Afghanistan, Papua New Guinea, and Tajikistan each have also established new microfinance banks in recent years. The third driver of institutional diversity is the increased role of cooperatives, with cooperatives playing a significant role in countries such as India, Philippines, Sri Lanka, and Viet Nam.

The entry of conventional commercial banks into the microfinance market is further enhancing institutional diversity. Unlike in the Latin American region, this has not become a major phenomenon yet in the region. However, in a number of countries, they have begun to penetrate the market. India appears to be at the forefront of this development. The ICICI Bank, the second largest commercial bank in the country, is expanding its financial services to the poor households through a multipronged approach—directly providing credit facilities to self-help groups, and providing wholesale credit facilities to microfinance NGOs and nonbank finance companies to fund their lending operations to the poor. ICICI claims that it now serves over 1 million poor clients. In addition, many other private and state-owned commercial banks, such as the Syndicate Bank, Yes Bank, and Indian Bank, have entered this market. Global banks such as ABN-AMRO, Citibank, and HSBC have also launched microfinance operations in India. The rural banking program of ANZ Bank in the Fiji Islands aimed at serving poor, rural households is another example of commercial bank involvement in microfinance. Sri Lanka's Hatton National Bank is also well-known for its microfinance operations.

Another source of institutional diversity is the entry of nonfinancial companies. Telecommunication companies in a number of countries have entered the market in a variety of ways. Globe Telecom and Smart Telecom in the Philippines have been offering cell-phone-based money transfer and payment services. Successful cell-phone-based microfinance programs are found in other countries such as South Africa. Their entry has also brought other nonfinancial institutions like gas stations, pharmacies, grocery stores, and fast-food outlets into the microfinance institutional landscape as agents or sales outlets. In the Philippines, Globe Telecom is also working with a number of rural banks to facilitate loan disbursements and recoveries through cell phones.

The credit-focused, single dimension characteristic of the microfinance industry has also changed significantly in recent years. With the maturity of the pioneering institutions and institutional diversity, the products and services that the industry offers have become much broader and more demand driven. This change is best reflected in the operations of the Grameen Bank. In August 2002, Grameen Bank discarded its 20-year-old model of microcredit based on the group-liability system; now each member's loan is secured against his or her word. The new approach offers flexible loan arrangements for terms of 3 months to 3 years and variable repayment schedules to avoid seasonal difficulties. Many other MFIs in Bangladesh and other countries now offer loans with different maturities and repayment schedules. MFIs also provide credit for a wide range of purposes including consumption smoothing, housing, emergencies, health, education, and meeting expenses related to many life cycle events.

Many MFIs and other financial institutions serving the poor now pay much greater attention than before to deposit services. In the 1980s, only BRI-unit desas in Indonesia and cooperatives emphasized deposit services for the poor. The industry currently includes many

institutions providing deposit services on a large scale. The Grameen Bank now offers a savings facility that enables members to deposit and withdraw at will. In addition, the bank has introduced a contractual savings account called the Grameen Pension Scheme with 5- or 10-year terms for members. These deposit services have enabled it to mobilize a vast amount of resources and to become a true financial intermediary. At the end of 2006, the Grameen Bank's outstanding deposits amounted to about \$639 million, consisting of \$394 million of members' deposits and \$245 million of nonmembers' deposits. The ratio of outstanding deposits to loans outstanding was 133%. Other MFIs with impressive records in deposit mobilization include Khan Bank and Xac Bank in Mongolia, and ACLEDA Bank in Cambodia. At the end of 2006, Khan Bank had 952,539 deposit accounts and the ratio of deposits to loans outstanding was 124%. The total deposit volume of ACLEDA Bank increased from \$5.7 million at the end of 2002 to \$61.9 million at the end of 2005 while the number of depositors increased from 19,070 to 92,413 in the same period. In most cases, the menu of deposit products has also become increasingly diversified because of the demand-driven approaches that these institutions adopted. While the bulk of the deposit amounts in most cases come from the nonpoor, most of the accounts are held by the poor. In effect, these institutions are effectively intermediating local capital to serve poor people.

Some MFIs also provide payment and money transfer services to poor households. The First Microfinance Bank in Pakistan began to provide domestic money transfer services a few years ago and has been able to expand this operation substantially in recent years. ACLEDA Bank has dramatically increased the number and volume of domestic money transfers. In 2001, the domestic money transferred amounted to \$7.0 million in 886 transactions; in 2005, the amount increased to \$286.7 million in 98,171 transactions. Adhikar, a small NGO-MFI based in the Indian state of Orissa, provides money transfer services to migrant workers in competition with post offices.

An increasing number of institutions are also providing microinsurance services on their own or as agents of established mainstream insurance companies. Early this year, Opportunity International established a microinsurance company in the Philippines while CARD-MRI in the Philippines began its microinsurance operations a few years ago. Microinsurance services are expanding in Bangladesh, India, and Sri Lanka as well.

The orientation of microfinance has also changed to some extent. Most pioneering MFIs considered microfinance as a social-mission-oriented activity that cannot be undertaken on a commercial basis. While social orientation remains important, today a core group of microfinance service providers considers microfinance as a commercial operation and operate on a commercial basis.

The commercialization has also made the industry more competitive. In countries where NGOs geographically segmented the market based on mutual agreements because they assumed competing among themselves was not in the interest of their target clientele, these NGOs now seem to compete openly and fiercely with each other. The competition and commercialization have led MFIs to become more efficient than before. Most leading MFIs have managed to reduce their operating expense ratios (OERs) significantly in recent years. According to one study, many leading MFIs in India have made a quantum shift out of high-OER category (over 25%) to low OER category (less than 10%) in the last 3 years. Spandana, a leading nonbank finance company (NBFC) in southern India reduced its OER from 7.24% in 2003 to 5.77% in 2006 while Share Microfin Ltd, another major NBFC, reduced its OER from 26% to 10.4% in the same period. Similar improvements are observed in other countries. In Cambodia, ACLEDA Bank has reduced its OER from 23.1% in 2003 to 16.9% in 2006 while

AMRET reduced its OER from 27.6% to 20.3% in the same period. In Bangladesh, BRAC reduced its OER from 14.8% to 12.9% between 2003 and 2006, and Buro Tangail reduced the OER from 19.9% to 15.1% in the same period.

The competition and improvements in efficiency in microfinance markets in Bangladesh, Cambodia, southern states of India, and Mongolia have already brought benefits to the clients in terms of more flexible and higher quality services, better products, and lower prices. In Cambodia, ACLEDA Bank and AMRET reduced their interest rates on loans during the last 4 years several times. A number of major MFIs in India have also reduced their interest rates in part due to competition. In Bangladesh, ASA reduced its flat interest rate from 15% per year to 12.5% per year in January 2007. ASA also reduced the compulsory deposit required to borrow from 10% to 5% of the loan amount.

Another important change is the emergence of profit-making MFIs. Profitable MFIs were rare until the second half of 1990s. Today, they exist in most countries and some of these institutions report returns on assets (ROAs) and returns on equity (ROEs) that are far in excess of those reported by most conventional financial institutions. For example, Khan Bank in Mongolia reported an average ROE of over 36% during the last 5 years while the ROE and ROA were 57.3% and 4.4%, respectively, for 2006. In 2006, BRAC's ROE was 23.27%. The ROE of ASA varied between 28.16% and 37.85% in 2001–2005. The average annual profits of BRI-unit desas amounted to \$199 million in 2001–2006 while in 2006, units reported \$329 million in profits. In India, both Share Microfin and Spandana, two NBFCs, have reported impressive profitability ratios. The annual average ROE of Share Microfin amounted to about 22% for the last 3 years while Spandana's annual average ROE for the same period amounted to 95%.

The microfinance industry has also reduced its dependency on donor grants and concessional funding in recent years. The increased deposit mobilization from the public, emergence of commercial and semicommercial microfinance investment funds and lenders, wholesale credit facilities from established commercial banks, and increases in retained earnings of the MFIs have contributed to this trend. The deposit-to-loan ratio of some microfinance banks such as the Grameen Bank and Khan Bank (Mongolia) now exceeds 100%. According to a recent study, the volume of international private lending for the global microfinance industry has exploded in the last 3 years: in 2005 alone, outstanding loans doubled to nearly \$1 billion. Commercial financing from domestic banks has reached quite significant levels in India. In the Philippines, rural banks finance their loan portfolio from commercial debt and public deposits. In a number of other countries in the region, debt financing by commercial banks are gathering some momentum. BRAC in Bangladesh, for example, completed a large securitization deal with a consortium of commercial banks in 2006 to fund its operations.

B. Continuities

Although the microfinance industry has undergone some fundamental changes, some initial characteristics seem to still continue in many countries. Thus, today's industry may be described more as one in transition rather than one that has been completely transformed.

While a core group of MFIs has grown to become flagships in the region, as a proportion of the region's universe of MFIs, they constitute a small proportion. A majority of MFIs in most countries have been unable to become dynamic, efficient, and multiservice financial institutions. The industry operates with a large number of small institutions and a small number of relatively

large institutions. For example, although there are over 1,000 MFIs in Bangladesh, the four largest institutions (Grameen Bank, BRAC, ASA, and Proshika) account for over 70% of the total client outreach. Similarly, there are over 400 MFIs, excluding cooperatives in the Philippines, but the largest 10 MFIs account for over 60% of the total client outreach of about 1.7 million.

In many countries, the majority of institutions have not become sustainable despite being in the market for many years. As a recent report on the Philippines microfinance market noted, “maturity has not necessarily brought sustainability, as many institutions still struggle to turn a profit.” In virtually all countries, MFIs that follow international best practices and making serious efforts to achieve and sustain financial viability are limited to a small number of institutions.

The industry’s overall commercial orientation and viability are significantly undermined by continuation of various government-sponsored or government-owned microfinance programs operated in a noncommercial manner. For example, in Bangladesh where the microfinance market has been very dynamic, the Bangladesh Rural Development Board (BRDB)—a government bureaucratic nonfinancial institution—is extensively involved in microfinance. The BRDB reported reaching over 4 million clients at the end of 2005. However, BRDB’s operations lack transparency, are characterized by poor loan recovery rates, and involve large subsidies. Rent seeking is widely believed to be rampant in its microfinance operations. Similarly, Bangladesh Krishi Bank (the state-owned agriculture bank) also continues to operate microfinance programs despite its many institutional weaknesses and operational inefficiencies.

Many other countries, such as the People’s Republic of China, India, Indonesia, Philippines, Sri Lanka, and Viet Nam, to name a few, have inefficient and noncommercial state-owned or state-sponsored microfinance programs. In the case of Viet Nam, the state-owned Viet Nam Bank for Social Policies (VBSP) reported 4.1 million active borrowers with a total of \$1.09 billion outstanding loans at the end of 2005. It continues to provide loans at highly subsidized interest rates ranging from 0.5% to 0.65 % per month. Not surprisingly, VBSP’s ROA and ROE were both negative 4.6% and 15.3%, respectively, at the end of 2005. However, VBSP has increased its number of active borrowers by 600,000 between the end of 2005 and end of 2006. The continuous injection of government subsidies sustains its operations although they severely undermine the development of sustainable commercial microfinance.

Unlike in most Latin American countries, many policy makers and practitioners in the region continue to believe that the industry should not aim at profit because its primary target market consists of poor households who suffer from not only lack of access to financial services at reasonable prices but also from other multiple disadvantages. This notion appears to have a very strong influence on the persistence of unviable, noncommercial state-owned microfinance programs and many other inefficient and unviable nongovernment microfinance initiatives. This notion also has led many MFIs to charge interest rates that are inadequate to cover their costs and has led many funding agencies, including governments, to continue subsidies to sustain operations of noncommercial service providers.

Also, the notion that the “poor are too poor to bear cost recovery interest rates on microcredit” has contributed to the persistence of interest rate caps on microcredit in a number of countries. While some poor people are unable to bear generally high costs associated with institutional microcredit and other financial services, international experience in microfinance has shown interest rate caps are not the answer to this issue. A sustainable solution to the issue lies in building more efficient and strong financial institutions that are capable of harnessing both scale and scope economies and making financial systems more competitive.

III. Conclusions

Modern microfinance has evolved over the last 3 decades to become an industry of significant scale. The evolution began from initial experimental efforts and programs focused primarily on providing microcredit to narrowly defined target groups consisting largely of poor women. From being a niche market operation undertaken by socially oriented, noncommercial institutions, it has become a more commercial financial service. However, the region's microfinance industry has not undergone a full transformation to become fully integrated into the broader commercial financial system. Significant changes have taken place in microfinance and a small core group of highly commercial and professional market-oriented institutions has emerged. In most cases, the institutions in this core group report much better profitability in terms of ROAs and ROEs than the conventional financial institutions.

However, the bulk of the industry has yet to become sustainable and commercial. Hence, the region's microfinance industry may be better described as one in transition. While the achievements to date are encouraging, the current state of affairs in the microfinance market presents both challenges and opportunities for those interested in sustainable development of financial services for the poor and low-income people. A more commercial industry must be built to reduce the still wide gap between the massive demand for and the meager supply of sustainable financial services for the poor through innovative approaches. Creating an enabling environment for sustainable microfinance and building strong retail capacity remain the most critical needs in many countries in the region. This requires the development community to work together in close cooperation with a firm commitment to build inclusive financial systems.