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**Microfinance for Inclusive Growth[[1]](#footnote-1)**

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I would begin my submission today by asking a fundamental question:

Why Microfinance? Why separate Microfinance Institution (MFIs) from other financial institutions? My answer is that Capital markets in developing countries are imperfect and poor are unable to access these markets. Thus to address this ‘market failure’ and provide avenue for low-income families to access financial service the MFIs have to be set up separately from commercial banks. There is a clear ‘public good’ element associated with Microfinance and hence the role of the Government intervention in this sector becomes justifiable compared to commercial banks where the Government is ought to be confined to regulator and supervisor only.

This other distinguishing feature of Microfinance is that it has to meet double bottom line i.e. to combine financial sustainability with social performance.

What is the evidence about the impact of the Microfinance? Although it would be unfair and unrealistic to think that Microfinance is the panacea for poverty alleviation but studies do show that it helps in smoothing consumption, reducing vulnerability and modestly increases income and assets of the poor households.

In absence of Microfinance, the access to financial services for the poor remains constrained. Their only asset i.e. labor dose not earn adequate incomes to be able to cross the poverty line. But in combination with capital, they can generate additional income, repay the loan and reinvest some of the earnings in human capital i.e. health care and education of their children as well as in physical asset formation. If this process persists for a while and access to finance remains unhindered the probability of their getting out of poverty increases. Human capital investment in their children does provide a safe exit from inter-generational poverty trap. Investment in female education enhances the chances even further. This, in essence, is the relationship between Microfinance and Inclusive Growth. If this is theoretical linkage, what is empirical evidence to substantiate this theory?

It is analytically difficult to disentangle the effect of one variable i.e. Microfinance from all others that impinge upon the growth process but I would venture to suggest that it would be fair to surmise that access to finance through Microfinance Institution by 55 percent of the poor population over two decades has certainly contributed to poverty reduction in Bangladesh. The improvement in social indicators such as fertility rate, maternal mortality rates, and female literacy rate recorded by Bangladesh compared to other South Asian countries can either be described as the collateral benefits associated with reduction in poverty or determinants poverty reduction in poverty or determinants of poverty reduction. The correlation is clear but the causation is not.

Now I turn to the situation of Microfinance in Pakistan. I feel proud of having taken the initiative of bringing MF into formal banking sector but am at the same time conscious that despite a passage of 12 years the progress has not been that great.

Microfinance as a part of the formal banking system introduced in Pakistan in 2000. Nine MFBs have been established and two of the World’s largest MFIs have stared their operations. Branchless banking initiatives using telecos networks and mobile phones are beginning to reach out the unbanked population. But the penetration of Microfinance has remained stagnant around 2million borrowers or 9% of the target market. Credit growth has touched Rs. 43 billion or 1.1% of the total advances of the banking system while savings have reached Rs. 25 billion or 0.36% of the total deposits of the banking system very miniscule amounts in relation to potential and also compared to other South Asian countries. A 2011 World Bank Study on Microfinance in South Asia placed Pakistan in the low coverage category. The scope for further expansions and outreach is quite large. A study by Pakistan Microfinance Network in 2010 summarizes the results of eight assessments of Microfinance by different donors/ agencies. The key findings of this study were:

1. All studies found that income indicators improved significantly for microfinance clients- both for households and businesses.
2. Most studies showed that microfinance clients have higher level of consumption than non-clients and spent more on health related expenditure with limited evidence of impact on spending on Children’s education.
3. Asset accumulation requires more time and the studies were conducted within couple of years of program participation and hence there was very little evidence to show.
4. In nearly all the studies the overwhelming majority of respondent felt their quality of life had improved.
5. The evidence that participation in a microfinance program results in more empowerment was mixed.

Based on these current developments, I would therefore like to look forward and offer some food for thought for all the stakeholders involved in the Microfinance Industry for their consideration.

My first observation is that the concentration of Microfinance has been too much in the non-poor districts of Pakistan such as Karachi, Lahore etc. A cursory look at the 80 deprived or backward districts of Pakistan where poverty, literacy, poor health status, malnutrition, gender disparities are widespread shows that Microfinance Institutions are either missing or doing very little in these districts where most of the poor live. Unless Income generation opportunities even at small scale become available to them it is unlikely that the people of these districts would get out of the poverty trap. I am fully aware of the poor security situation prevailing in some of these areas particularly in KPK and Baluchistan but there are districts in Southern Punjab and Rural Sindh which can certainly be accessed and these services can be provided.

Second, in setting up the stand-alone Microfinance banks (MFIs) it was my expectation that these banks will continue to work in tandem with the Non-Governmental Organization (NGOs) engaged in Social mobilization. Without the prior preparatory work of mobilizing the poor, screening their credentials, monitoring the utilization of credit and collection of savings and providing them technical support and guidance the credit growth will always remain restrained and the number of borrowers much lower than desired. This synergetic work between the MFBs and NGOs will reduce the cost of borrowing as heavy administrative costs of mobilization and monitoring will be borne by the NGOs while the borrowers will be charged the actual cost of capital without any whistles and bells wrapped around it. Unfortunately, this is not happening but I am very hopeful that Rural Support Network (RSPN) and Kashf Foundation can play this role in respect of the NRSP Bank and Kashf Bank. I am sure this will reduce the high interest rates we charge the borrowers as a sector’s high operating cost to loans ratio (presently 22%) will come down. NGOs will continue to rely upon Philanthropy, Corporate Social Responsibility (CSR), Charity, etc. for financing their operations. A lot of popular criticism that the poor have to pay exorbitantly high charges for their loans when they have almost a perfect record of repayment while the rich pay relatively much lower price for their large loans on which the default rate is quite high will die down if this line is drawn.

Third, the savings and deposits of the recipients of microfinance services remain inadequate in relation to their total funding requirements. It is also not very healthy that three fourth of the total deposits of the whole Microfinance industry are concentrated in one or two banks. The remaining seven banks are dependent on non-deposit funding sources. So far, the SBP Guarantee Fund, the ADB line of credit, the PPAF onwards lending from the World Bank loans have been major sources of funding to this Industry. But these are neither viable nor sustainable solutions over long term. a recent study by Mohsin Ahmed and Aban Haq clearly shows that by 2016, the savings and deposits would take care of only one half of loan funding while the remaining balance will have to be raised from other sources. Even three years from today the number of borrowers will be only 3.4 million or 12.5 % of potential market. It should be recalled that the SBP had set a target of 10 million borrowers by 2015. If we look across to Bangladesh almost two-thirds of the loans by Grameen Bank are funded from the compulsory savings of the members. Social enterprises are run on the principle of market profitability but the profits or retained earnings are appropriated for the benefit of the poor and the Microfinance clients are a model that needs to be examined and experimented in Pakistan. After all, BRAC in now present in Pakistan and they should be approached to assist us designing and delivering this model.

Although I must honestly say that in view of the ‘public good’ nature of Microfinance the Government which wastes billions of rupees on many inefficient projects should be able to find Rs. 40-50 billion or 1% of its total expenditure of Rs. 4000 billion for Microfinance either though the PPAF lines of credit or boosting SBP Microfinance Guarantee fund. In my view, this is one of the cost-effective methods for attaining the goals of financial inclusion and reaching out the poor for their income generation activities.

Fourth, the capital base of Microfinance banks has to be gradually increased to expand their capacity to lend. In the original design of Microfinance regulatory framework we had built in flexibility for the scale of operations by allowing local, regional and national level licences with variable capital requirements. I am afraid that most of the nine MFBs are national level institutions while the demand for District or Provincial banks has been minimal. We should ask ourselves as to why there has been a dominance of national level banks. What are the reasons as to why other forms of licences are not sought after? Are there any changes in the regulatory framework that are hindering this process? An objective study of this issue may enlighten us some more.

Fifth, the transformation of Micro finance operations from NGO to Regulated MFI has been a subject that has been attracting our attention for a very long time. I recall that I delivered a paper on this subject at Microcredit Summit at Halifax, Nova Scotia almost seven years ago. Why is that the NGOs administering Microcredit with some notable exceptions are not opting to become a regulated entity. Even today according to Micro Watch, the split between regulated and unregulated institutions is approximately even. On the face of it, the argument in favor of a regulated entity is quite persuasive. They will be able to mobilize public deposits; access private sources of capital, improve governance and transparency and ultimately reach significant scale and financial sustainability. An ADB study of 2004 did indeed come to the conclusion that most transformed MFIs had achieved encouraging results. They found new shareholders, increased equity capital, improved governance, achieved intuitional sustainability and improved outreach to the poor. On the other hand, the growing ‘informalization of economy does suggest that economic actors do wish to remain away from the clutches of the regulator , tax collector, auditor and other public officials who descend upon them when they enter the formal sector. It is also possible that the existing NGOs are so small in size that they do not possess the necessary wherewithal to move towards transformation. My hunch is that both these factors are partially hinging upon the slow process of transformation. In Bangladesh, four largest institutions cover 73 percent of the country’s microfinance clients. Thus, scale of operations does make a difference in bringing about efficiency. Transaction costs decline as the size of the loan rises.

Sixth, one of the biggest and fastest rising risks identified in 2011 by a survey of the microfinance sector was Macroeconomic trends of the country. The respondents rightly felt that they had the lowest ability to cope with this risk which falls unambiguously in the domain of the economic policy makers and economic managers. Let me conclude by hoping that not only for the sake of Microfinance sector but for the whole country we would soon have macroeconomic stability, resumption of fast growth, job creation and poverty reduction. The benefits of sane policy and management should be widely shared and not confined to a small privileged minority.

1. Keynote address at Microfinance summit Pakistan 2013, Islamabad, July 09, 2013 [↑](#footnote-ref-1)