Pathways to Financial Inclusion in South Asia:
The role of Microfinance

South Asian Micro Entrepreneurs Network Conference, India
March, 2016
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Acknowledgements

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MFIN is the first Self-Regulatory Organization (SRO) in the financial services sector recognized by the Reserve Bank of India to ensure NBFC-MFIs’ compliance with regulated norms and to promote responsible lending and client protection. MFIN works closely with other key stakeholders and plays an active part in the larger financial inclusions dialogue through the medium of microfinance.

IFMR LEAD is an India based non-profit research organization with a vision to facilitate inclusive development in the South Asian region. IFMR LEAD conducts rigorous action research to evaluate policies and practices to address the challenges of financial exclusion faced by low-income households, vulnerable communities and small enterprises. For more information on IFMR LEAD’s work, please log on to www.ifmrlead.org

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Ratna Viswanathan
CEO
Microfinance Institutions Network (MFIN)
March 2016
South Asia has emerged as the fastest growing region of the world over the course of 2014, and this trend is expected to continue in the coming years. Moreover, countries of the South Asian region have made significant strides in translating robust economic growth into poverty reduction and improved human development in the last few decades.

However, the incidence of poverty in the region still remains high. Nearly 399 million people in the region, which account for 40 percent of the world’s poor, live on less than USD 1.25 a day. Many countries in the region face a number of challenges in providing a healthy standard of living and basic public goods to their populations. While South Asia has the world’s largest working-age population and a quarter of the world’s middle-class consumers, it is also home to the largest number of poor and undernourished in the world, and several fragile states of global geopolitical importance. Thus, for South Asia to achieve its growth potential and remain the vibrant economic spot in the world economy, it is crucial for all stakeholders to promote an inclusive development model that reaches out to the poorest and most vulnerable sections of society.

While the region is witnessing substantial growth, poverty alleviation and livelihood promotion remains a huge challenge. Two billion people – or 38 percent of adults in the world – do not use formal financial services. A significant portion of these adults, i.e. 625 million live in South Asia (Global Findex, 2014). Financial inclusion has proved itself to be a potent tool world over for achieving sustainable development. It connects people and businesses to the formal economy, to markets and to better social welfare mechanisms. It fosters economic productivity and progress in numerous development sectors, builds entrepreneurship and helps people achieve what is most important to them. The UN General Assembly on December 15, 2015, adopted a resolution stressing the importance of financial inclusion as a key tool for implementing many of the vital development goals enshrined in new Sustainable Development Goals (SDGs). South Asia is no stranger to financial inclusion initiatives, and has been the cradle of microfinance. Nearly four decades since its early origins in Bangladesh, microfinance remains a strong pillar for promoting access to financial services in South Asia, by addressing last-mile problems, and bringing millions of people from poor and vulnerable sections into the fold of the formal financial system.

The Report ‘Pathways to Financial Inclusion in South Asia: The role of Microfinance’ gives an insight into the journey of financial inclusion in the countries of Afghanistan, Bangladesh, India, Nepal, Pakistan and Sri Lanka, through the lens of microfinance. It captures the rich history of the evolution of microfinance in each of these countries, along with the current state of financial inclusion. These countries are part of the South Asia Micro-entrepreneurs Network (SAMN) - a regional microfinance industry association working to enhance financial inclusion among low-income populations in South Asia.

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1 South Asia Economic Focus Spring 2015, World Bank
2 UNSGSA_Thoughts_on_Financial_Inclusion_in_post2015_development_2013_09_15
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Financial inclusion is referred to as having quality access to financial services by diverse providers and having the financial capability to use these services. The FI2020 report defines financial inclusion through five pointers:

- Having access to a full range of financial services like credit, savings, insurance and payments.
- Being provided these financial services with quality: convenient, affordable services provided with dignity and full client protection.
- Providing access to all: including those excluded and underserved. Special attention to be paid to people in rural areas, women or people with disabilities.
- Having access accompanied with knowledge of services and thereby providing with financial capability.
- Providing services by a range of providers, with a proper regulatory framework and financial infrastructure in place.

Such a financial system that is accessible by all reduces the growth and dependence on informal sources of credit, which can often be exploitative in nature and are known to charge high interest rates. Such a financial system, by providing avenues for safe and secure borrowing and saving practices, apart from other financial services, boosts efficiency and inclusive growth.

Financial inclusion has become one of the principal development concerns of our times. This has been particularly evident during the past few decades where the financial meltdown exposed the frailties and inequities of the global financial system. Nevertheless, attempts are being made globally to bring financial services to more number of people cross sections. The term ‘financial inclusion’ has acquired universal acceptance as both a mere access to financial services as well as deeper processes. Much of the literature and discussion around financial inclusion today although is limited to increasing the extent of availability of banking and financial services to the unbanked over its quality or sustainability. There is a general consensus about the many benefits of expanding the financial markets to facilitate greater reach of credit, savings and payments services to the under-banked sections of the society, as well as, widening access to insurance and pensions. However the appropriateness of financial services, especially for poorer segments of the population is interlinked to concerns like over-indebtedness or having multiple borrowings.

Global scenario

Financial inclusion today is not just a concern limited to the developing or underdeveloped countries alone but is a concern for even developed countries. Financial inclusion is a multidimensional phenomenon at a global level. Although financial growth and economic development are closely related concepts, many of the developed countries face the challenge of achieving an all-inclusive growth model. An all-inclusive financial system means providing every household with not just access to a range of modern financial services like savings, credit, insurance, and

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1 FI2020 report published by Accion
payments, but also sufficient education and support to help customers make good decisions for themselves. These products and services need to be provided to customers at affordable rates and should be available within reasonable physical proximity, as well as, regulated in order to protect clients. The map below shows the percentage of people around the world that do not use some form of financial services. Even within the high income OECD countries, eight percent of people do not have access to any formal or semi-formal financial institutions (Mckinsey 2010).

Financial inclusion in South Asia
An inclusive financial system is increasingly becoming a priority in policy circles of South Asian countries. A leading role towards financial inclusion is being taken by the banking sector in different developing countries. Several measures to achieve greater financial inclusion are being initiated by Reserve Bank of India (RBI). These include facilitating ‘no-frills’ accounts and ‘General Credit Cards’ for low deposit and credit. In Bangladesh, through a responsive regulatory environment and emphasis on digital financial services the banking sector’s credits are facilitating towards financial inclusion. In both Bangladesh and India, among other developing countries, alternate financial institutions such as micro-finance institutions and ‘Self-Help Groups’ are also being promoted. The microfinance sector has expanded and diversified filling the gap left by the retreat of commercial banks from rural areas, due to the insurgency and cost savings measures in Nepal. In Sri Lanka the coverage of microfinance services have reached more than 60 percent of the poor (World Bank Report 2012). Microfinance Institutions (MFIs) are
key financial institutions playing a leading role in the South Asian region in terms of financial inclusion and providing access to finance to the poor. The financial products offered and the nature of the sector in the region however is firmly rooted in the poverty discourse. This trend is not surprising since poverty is an enduring infliction in most of the countries of this region. Microfinance sector in these countries since its very inception has maintained a poverty discourse characteristic.

The modern microfinance movement in South Asia was born in Bangladesh in the 1970s as a response to poverty conditions among its vast rural population. The astonishing rate of growth in Bangladesh, especially during the 1990s, led to the creation of a new opportunity for microfinance worldwide. Microfinance institutions grew to include millions of clients during this phase. The start of the twenty-first century reinforced this trend, as the Bangladesh numbers continued to grow impressively. Around this time in India a substantial microfinance system based on Self-Help Groups (SHGs) developed. Other countries of the region made slower and later starts but have since established active microfinance sectors actively aiming towards poverty alleviation through concepts of financial inclusion. The rationale for the sector assuming such inclusion characteristic is related to the findings of various studies that point to a direct correlation between poverty and financial exclusion. Thus, the sector in South Asia firmly focuses on poverty and poverty alleviation with the premise that if microfinance can improve its outreach to the poor then it is directly contributing to financial inclusion. Like financial exclusion, lack of financial capability has also been seen as being clearly linked to poverty. Merely making financial products available to the excluded population does not ensure its usage. Thus, it becomes clear that the process of financial inclusion must necessarily be accompanied with attention to financial capability and capacity to use the products to which access is provided. Financial literacy is a means to provide such capacity and capability towards ensuring an actual inclusion within the financial sector. This process hence makes the inclusionary process a broad-based one that goes beyond limited service delivery and encompasses improvements in capability to use financial services as well as pushing for an outward movement from poverty.

South Asian MFIs stand out by serving the most number of poorest and marginalized clients compared to any other region. MFIs from the region serve the lowest average loan balances, both in absolute terms and relative to local income levels. Moreover, South Asian MFIs remain resolutely focused on serving women, with an average outreach of nearly 85 percent to women borrowers (MIX report 2005). Of the other regions, only Middle East and North Africa comes close to similarly small loan sizes, due to the predominance of small solidarity group loans in that region’s portfolio.

The Little Data Book on financial inclusion 2015 brought to the fore a comparative picture on various crucial components of financial inclusion across various regions. This looks at the reach of formal banks and other financial institutions. Table 1 shows the inadequacy of the reach of formal financial institutions in terms of the basic financial services of savings and credit in the South Asia countries as against Latin American countries.

From Table 1, it can also be seen that in South Asia 37.4 percent women are financially included as compared to 48.6 percent in Latin America and 93.8 percent in OECD countries. While orchestrating alternate or improvised principles of financial systems for inclusion, women of the marginalized households are at the fulcrum of the interventions whether it is at the policy front or in practice. They are the borrowers and are at the forefront to link their families to the much needed financial services. Various studies have documented that this link flows down to the male members of the family including fathers, brothers, husbands and sons. While women are considered to be reliable borrowers they often might not end up being the primary users. Despite the low rate of financial inclusion however, women remain the main recipients of microfinance services in South Asia. Even in more conservative countries such as Afghanistan, the activities of the sector have focused on women, according them recognition as economic agents.
Socio-cultural practices based on a strong patriarchal ideology are predominant in the South Asian region. This curtails women's mobility, and prevents them from utilizing opportunities to enhance their capabilities. Not all the spheres of gender discrimination are quantifiable, but even within the limited arenas of labor markets, socio-cultural influences on education, nutrition, health and political participation, women in most of the South Asian countries face unequal treatment.

Women in South Asia participate in economic activities and contribute their labor actively. Yet, due to the nature of their work, which is intertwined with household activities at times and is often unpaid, on the one hand, and the flawed definition of economic activity, on the other hand, women’s economic participation remains statistically invisible. Despite the conceptual, methodological and definitional flaws however, statistics on women’s work from the respective national data sources reveal nearly one-third participation of women in the labor force. Maldives and Pakistan are the two countries where female percentage of labor force is relatively lower; while Bangladesh and Nepal are the South Asian nations where the share of women labor force is higher compared to other countries in the region (see Table 1). The region as a whole has been witnessing rising levels of women’s economic participation over the years. The factors that have aided or influenced these trends differ from country to country. Nevertheless, the characteristics of women’s labor, in terms of the nature

<table>
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<th>Table 1: Comparison of status of Financial Inclusion</th>
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<tr>
<td></td>
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<tr>
<td>Accounts (% age 15+)</td>
</tr>
<tr>
<td>All adults</td>
</tr>
<tr>
<td>Women</td>
</tr>
<tr>
<td>Savings in the Past Year (% age 15+)</td>
</tr>
<tr>
<td>Saved at a financial institution</td>
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<td>Saved for old age</td>
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<tr>
<td>Credit in the Past Year (% age 15+)</td>
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<tr>
<td>Borrowed from a financial institution</td>
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<tr>
<td>Borrowed from family or friends</td>
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<tr>
<td>Borrowed from a private informal lender</td>
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Source: The Little Data Book on Financial Inclusion 2015, World Bank Group

Financial inclusion of women in South Asia

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2 Rustagi, Preet. “Situation of Women in South Asia: Some Dimensions.”
of tasks undertaken and the wages earned, remains by and large unchanged.

Majority of the women are undertaking manual, non-mechanized, low or unpaid tasks. Even among those entering the paid labor market, women face gender discrimination in access to jobs, and gender inequalities in pay and job security. An overwhelming majority of economically active women in Nepal and India work in agriculture (see Table 2).

By and large, among the secondary sector activities of industry, manufacturing and so on, women's enumeration is low. The majority of South Asian women work in the informal sector or as unpaid family helpers. Among the economically active women workers in India, 96 percent are in the unorganized sector. In Nepal, 75.3 percent are self-employed and 28 percent are unpaid family members. In Pakistan, 65 percent of the female labor force that is officially enumerated is in the informal sector. The percentage of women earning a living in the informal sector in Bangladesh in 1995-96 was 75 percent (HDSA 2000). Women workers are demanded for their docility, lower probability of organizing or fighting for better wages and work conditions. The patriarchal norms that are prevalent make it easier to manage women as workers.

There has to be a multi-pronged strategy to deal with diverse factors affecting women negatively. Their access to mainstream financial resources to meet their life cycle needs is seen as an important step forward towards empowerment and self-reliance of women. Of the unbanked worldwide, 55 percent, or 1.1 billion, are women, according to Findex. The gender gap varies widely across the regions, however South Asia and the Middle East and North Africa have the largest gender gaps as can be seen from table 3 below.

Microfinance emphasizes on female-oriented lending, as it attempts to improve the status of women and bring down the existing gender gaps in financial inclusion by doing so. In South Asia particularly, microfinance schemes have largely been centered on women. It is argued that by providing women with initial capital, they will be able to support themselves in a manner that would encourage sustainable growth of their enterprise and eventual self-sufficiency.

Apart from the gender gaps, there exists a highly diverse landscape for financial inclusion in South Asia. All the six countries being looked at in the report have a unique modern history of financial systems development.

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Table 2: Sectoral Distribution of Labor force in South Asia

<table>
<thead>
<tr>
<th>Country</th>
<th>Percentage Labor Force in</th>
<th>Percentage of Female Workers</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Agriculture</td>
<td>Industry</td>
</tr>
<tr>
<td>India</td>
<td>62</td>
<td>11</td>
</tr>
<tr>
<td>Pakistan</td>
<td>47</td>
<td>20</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>59</td>
<td>13</td>
</tr>
<tr>
<td>Nepal</td>
<td>93</td>
<td>1</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>49</td>
<td>21</td>
</tr>
</tbody>
</table>


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3 Situation of Women in South Asia: Some Dimensions
Table 3: Account penetration by gender across the world

<table>
<thead>
<tr>
<th>Region</th>
<th>2011 Male</th>
<th>2011 Female</th>
<th>2014 Male</th>
<th>2014 Female</th>
</tr>
</thead>
<tbody>
<tr>
<td>East Asia and Pacific</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>Europe and Central Asia</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>High-income OECD economies</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>Latin America and Caribbean</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>Middle East</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>South Asia</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
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Bird’s eye view of the six countries discussed in the report

**Afghanistan:** Afghanistan’s modern financial system is still in the initial stages. The history of banking in Afghanistan bears the marks of decades of war which had led to the collapse of the formal banking system in Afghanistan. Microfinance services in Afghanistan are currently provided by three sources (i) formal institutions, such as banks (ii) semiformal institutions, such as Non-Governmental Organizations (NGOs) and (iii) informal sources such as moneylenders and shopkeepers. The six state owned banks which had been operating in Afghanistan prior to the war had stopped their operations though they still existed legally and had some assets. Before the end of the war, the banking sector in Afghanistan was merely operational and formal economic activity in the country was minimal.

With the creation of a democratically elected Government, key changes were made to reinvigorate the banking sector.

Da Afghanistan Bank (DAB) and Ministry of Finance are the two entities in the regulatory sphere in Afghanistan. While Ministry of Finance is responsible for collecting revenue and providing budget formulation, payments processing, and other services to various government agencies, DAB is responsible for licensing, regulating, as well as, supervising banks, money service providers, payment system operators, and other relevant entities. Issues of security and culture of banking have been the biggest obstacles for limited and low productivity growth for banks in Afghanistan. The Government introduced new financial sector legislation in 2002 for strengthening DAB for monetary control and banking supervision and in establishing a commercial banking sector. At present there are 15 licensed banks in the country including three state owned banks, seven private sector banks and five foreign banks. While Da Afghanistan Bank still offers some commercial banking functions, these activities are being phased out as the commercial banking sector is growing in capacity and has gradually been offering the full spectrum...
of services. The Banking sector has created an apex body called the Afghanistan Banking Association in 2004 to represent member banks for the protection of its interest and lobbying for it in dialogues with the DAB. In addition, there is one leasing company and two insurance companies, which have recently started operations in Afghanistan. However, the provision of financial services by the formal sector is limited to urban areas and the informal sector. The Hawala dealers still meet most of the transfer and remittance service needs in the country. According to World Bank estimates, economic activity between 80 and 90 percent in Afghanistan occurs in the informal sector, and almost all credit and other financial transactions are still carried out in the informal sector (World Bank Report 2012).

A diverse range of institutions, programs and strategies are in place in these six countries to promote delivery of financial services to the poor, in order to strive towards financial inclusion and poverty alleviation. From cooperative models, lending through SHGs, instituting Regional Rural Banks (RRBs), a combination of varied methods are being used in the countries to make financial services more inclusive for all. Despite the various efforts however, there are many impediments in the way of attaining universal financial inclusion.

**Bangladesh:** The iconic story of microcredit, which is a leading force in striving towards financial inclusion, first started in Bangladesh more than forty years ago. The idea to establish microfinance institutions traces back to 1970s when Muhammad Yunus was struggling to develop a model of microfinance to eradicate poverty in his home country Bangladesh. This struggle eventually led to the worldwide influence of the Grameen model of microfinance.

During the late 1970s, when the “Jobra” experiment (the action research was examining the possibility of designing a credit delivery system to provide banking services targeted at the rural in the world) was underway under Professor M. Yunus, the “Dheki Rin Prokolpa” was initiated by the Bangladesh Bank in collaboration with the “Swanirvar Bangladesh”, and several other pilot schemes were initiated by a handful of the NGOs who were active then. The success of “Jobra” experiment was implemented in other parts of the country with the support of Central Bank of Bangladesh. The 1980s saw the emergence of many microcredit programs by NGOs following the Grameen bank model. At that time, it was difficult to conceive that these initiatives would lead to a major microfinance movement, which would make Bangladesh known to the rest of the world.

Unhindered experimentation in the fields led to a massive expansion of microfinance activities during the 1990s. This rapid expansion of the sector drew attention of policymakers, academia and development practitioners from all quarters. This was followed by a period of coping with the rapid growth and challenges that emerged thereof, and trying to shape the course of the social and economic dynamics initiated by the introduction of microfinance. With a view to meet the demand for fund for re-lending by the development partners (NGO-MFIs), and due to an urge to coordinate the flow of such funds to appropriate use, the Palli Karma-Sahayak Foundation (“Rural Employment Support Foundation”) came into being in 1990. Over the years, its share in the revolving loan fund of the MFIs increased – from 9 percent in 1996 to 24 percent in 2002.

In recent years, MFIs have moved from the margins of the financial system towards the mainstream. It is now more widely accepted that populations traditionally excluded by the formal financial sector can not only make their way out of poverty but also be a profitable market niche for innovative banking services.

**India:** Similar to the Bangladesh story, there is a long history of financial inclusion in India. From the bank nationalization drive in the late 1960s to the establishment of Regional Rural Banks in 1976, direct credit (which is traditionally been understood to mean opening new branches in rural and unbanked areas) has been a part of the Indian financial sector for quite some time.

In the Indian context, microfinance has emerged broadly in two forms or models viz., the Self-help Group (SHG)-Bank Linkage program (SBLP) and the Non-governent organizations-Microfinance Institutions (NGO-MFI) model. The SBLP was introduced as an alternate methodology to take institutional finance to excluded sections of the population.
population, and was promoted by the National Bank for Agriculture and Rural Development (NABARD) since 1992. This alternative methodology promoted a community managed and owned approach of institutional finance to the poor. The origins of the SBLP can be traced back to the 1980s when it was first experimented by the Mysore Resettlement and Development Agency (MYRADA), under the leadership of Aloysius P. Fernandez. Today, this approach is among the most widely recognized models of inclusive finance in India. The model hinges on providing self-help groups with linkages to formal credit and savings services by institutions such as banks and cooperatives.

The 1990s also saw the emergence of the NGO-MFI model, led by NGOs working on livelihood programs for poor and vulnerable communities. Struck by the apathy of the mainstream financial system towards the financial needs of marginalized households and enterprises, NGOs explored the bank financing channel through development organizations and self-help groups. These organizations saw the potential of Bank linkage or intermediation as an important development strategy. Thus, the foundation for several of India’s prominent microfinance and community development finance institutions such as BASIX, Share, Spandana, SKS, Gramin Bank, Rashtriya Gramin Vikas Nidhi (RGVN), Adhikar and Village Welfare Society (VWS), PRADAN, and Nav Bharat Jagriti Kendra was laid down during this period. It is this movement that set the tone for MFIs becoming intermediaries between largely public sector development finance institutions and group or individual borrowers. The NGO-MFI model in India has been extensively supported by Small Industries Development Bank of India (SIDBI) and onlending institutions such as the Friends of Women's World Banking.

Today, both the SHG-Bank linkage program model and the MFI model (with separate category of non banking financial companies for the microfinance sector notified by the RBI) are rapidly expanding as a result of the joint efforts of the industry and an enabling policy environment. The Indian banking industry’s contribution in promoting these models by providing debt-capital is significant and commendable as well.

Another pioneering community-based finance model in India that emerged in the early 1970s was the Swashrayi Mahila Sewa Sahakari Bank (SEWA) - a leading example of a Women owned and managed Cooperative Bank. Set up in 1974 as an urban cooperative bank, SEWA is the first and largest cooperative of its kind in India. Led by its founder Ms. Ela Bhatt, the Bank’s policies are formulated by the self-employed women members as shareholders and their own elected Board of women workers.

**Nepal:** Just as in India, microfinance in Nepal originated in the credit cooperatives and later through some government rural welfare oriented development programs. During the first phase of credit cooperatives in Nepal, credit provision was intended for the agricultural sector. Agricultural Development Bank and Small Farmer Development Program were initiated to cover the shortfall of funds by the credit cooperatives for agricultural lendings to small groups of farmers.

Historically, the NGO legal form dominated the microfinance landscape but with the commercialization of the sector, there has been a growing tendency for NGOs to transform to Microfinance Development Banks (MFDBs). Nepal was the first country in South Asia to introduce specific regulations for the microfinance sector. The Development Banks Act, 1996 and the Financial Intermediary Societies Act (FISA), 1998 were both aimed at stimulating the growth of financial services in the rural, mostly unbanked areas of the country. Due to the early (1998) introduction of the MFI licensing system in Nepal, most of the larger MFIs in the country were able to offer deposit services. However, as with MFIs in other countries, public confidence has grown with the longevity of the institutions and the savings orientation of MFIs in Nepal has improved considerably. With the promulgation

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4 Nepal Microfinance Review Microfinance rising above the turmoil by Micro-Credit Ratings International Limited, 2012
of the Development Bank Act in 1995, Nirdhan was the first NGO (1998) to transfer its microfinance portfolio into an autonomous microfinance rural bank (Nirdhan Utthan Development Bank).

**Pakistan:** Pakistan like some of its neighbors has had a rich history of cooperative movement and large diversity in its informal credit systems. Cooperatives along with the informal credit systems formed the basis for the emergence of the modern microfinance sector in Pakistan. The emergence of the Pakistani microfinance sector is usually traced to two pioneering development institutions – The Aga Khan Rural Support Program (AKRSP) and the Orangi Pilot Project (OPP). AKRSP organized and mobilized Village Organizations (VOs) and animated them as partners in developing the health, education and income generating initiatives in the Northern Area of Pakistan.

While AKRSP pioneered development service provision in the rural and agrarian frontiers of North Pakistan, OPP took up the challenge of tackling urban poverty in the biggest slum settlement in Pakistan’s port city and commercial capital – Karachi. OPP was established in 1987 and its development services include housing, sanitation and education. OPP realized early on that microfinance is a specialized activity not to be mixed up with other development interventions and therefore established Orangi Charitable Trust (OCT) in 1989. OCT focused exclusively on microfinance. Unlike many rural focused microfinance programs, OCT used the “individual lending methodology” and had carefully segmented its market. The Comilla Model (a rural development program launched by Pakistan academy of rural development) piloted a methodology for stimulating agricultural and rural development, based on the principle of grassroots cooperative participation by the people. However, this model failed to attain its goals of building strong cooperative institutions due to government interference.

**Sri Lanka:** As in India and Bangladesh, microfinance in Sri Lanka originated with the cooperative movement. The first cooperative bank in the country was established in 1964. Almost parallel to it, other cooperative financial institutions like Thrift and Credit Cooperative Societies (TCCS) were setup. The 1980s and 1990s saw growth in the number of NGOs providing microfinance. Moreover, a number of commercial banks entered the microfinance sector primarily as part of their Corporate Social Responsibility (CSR) activities—either through their own microfinance programs or as intermediaries for the credit programs implemented by the Central Bank. Sri Lanka’s microfinance sector saw further growth in the post-tsunami period due to an influx of donor funds into the sector (Srinivasan and IPS 2008). Recent years have seen the growth and expansion of MFIs, particularly in the northern and eastern parts of the country.

Interestingly in Sri Lanka, the microfinance sector and the mainstream financial sector that are conventionally believed to be serving distinct segments of the market, have overlapped in recent years, serving the financial needs of a broader group of households across a range of income groups. Commercial banks and other formal financial institutions have moved down-market, providing financial services to the lower-income groups, while some MFIs have diversified their services and products, enabling them to attract clients from middle- and higher-income groups. This convergence between the two sectors has contributed to a great extent to the high level of financial access and increasing multiple “clientship” (i.e., accessing multiple financial institutions) in Sri Lanka’s financial sector (Tilakaratna 2012)

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5 The Development of Microfinance in Pakistan by Amer Saleem Khan & Stefan Platteau, 2006
6 The Development of Microfinance in Pakistan by Amer Saleem Khan & Stefan Platteau, 2006
7 Financial Inclusion, Regulation, and Education in Sri Lanka, Saman Kelegama and Ganga Tilakaratna
ABDI Working Paper Series No. 504 November 2014
Challenges and limitations

Financial inclusion is essential for bringing about any improvement in the living conditions of the poor and the marginalized; from poor farmers to rural non-farm enterprises. In the six countries under discussion, the role of microfinance institutions have been vital in improving financial inclusion. However, there are several key challenges and barriers that are faced by these financial institutions in their operations even today.

Reach and Depth: Financial inclusion refers to more than just access to financial services. It represents quality and continued availability of these services to the underserved and financially excluded. While South Asia excels in credit delivery, it serves fewer clients with savings services than other regions. Defining financial inclusion as more than just access of credit services to the unbanked or underbanked, with emphasis placed on range of products and delivery mechanisms available requires striking a balance between access, affordability as well as sustainability. After the jolt faced by the microfinance sector a few years ago, more emphasis is now being paid on the quality of financial services being provided rather than just the quantity of the services being extended to clients.

On a related note, despite a positive picture in terms of access to financial services to the poor in South Asia, sustainability has not yet made its mark on growth throughout the region. This even when a sustained and in-depth growth of financial services is essential for achieving goals of poverty reduction, health, education and gender equality.

Inspite of the success of MFIs and other organizations, few models have been established that meet the multiproduct needs of the economically active poor at a meaningful scale. Long-standing barriers continue to pose challenges, particularly in the areas of distribution, human capital, risk management, product development, and regulations. Distribution is a significant challenge, particularly because many currently unserved people live in areas that are not covered by traditional financial-services institutions. In emerging markets, formal banking extends to only about 37 percent of the population. This translates into only one bank branch and one ATM for every 10,000 inhabitants. The average is misleading, as the majority of the infrastructure is concentrated in urban areas.

Interest rates: For financial inclusion to be successful, small loans need to be provided to those in need at an affordable cost. This forms another big challenge to microfinance institutions. Although through access to microcredits, borrowers can receive loans at a lower price than with these informal lenders, borrowing through informal lenders is still high in South Asian countries. This is seen to be associated with convenience of doorstep service, quick loans, and little or no documentation that is needed when borrowing from informal sources. MFIs and banks are not able to satisfy the demands from low-income families. Research in India, Nepal as well as Pakistan points towards higher rate of borrowings from money lenders and other costly informal sources than MFIs. Although the microfinance sector has grown tremendously in the region in the past few decades, and has begun addressing the gaps in its financial services, the sector is still far from satisfying the needs of those at the “bottom of the pyramid”.

Number of loans and over indebtedness: The rapid emergence of MFIs (of both non-profit and for profit varieties) was followed by major crisis. In many cases the crisis took place in the same developing countries, which were seen as success stories for microfinance earlier.

A problem that became evident through the various microfinance meltdowns that of the tendency of competition between microfinance providers, their quest for increasing their client numbers at a rapid pace, were seen to be at the heart of the crisis in the microfinance sector. The rapid expansion of MFIs, which was once again driven by incentives, created overstretching in a number of ways. Staff were employed without adequate training, monitoring became more difficult and the internal controls that could control fraud were relaxed. Competition also eroded the credit discipline of the MFIs themselves, as the incentives of middle managers downwards were increasingly oriented to maximizing the number of loans and clients. Such competition could in turn aggravate the associated problems of multiple borrowings by
clients (which are not always used for income generating purposes) and over-indebtedness of the borrowers. The overstretching of the microfinance work force and competitive pressures created an environment for collapse of quality and credit checks, as well as, fostering aggressive loan origination policies based on staff incentives for loan volumes.

This crisis and pressure visible on the microfinance sector brought to the forefront debates on the modes of financial inclusion and models of development to be used for inclusion. These challenges of high interest rates, over-indebtedness, as well as reach and depth of microfinance sector are closely associated with the debates around the models of financial inclusion.

The developing countries across the globe face a challenge of inclusion in the choices they make for the model of development. Market based development is slowly overshadowing the other choices for the simple reason that it determines the movement of capital and resources. The Governments while committed to the liberalization growth model, pledge themselves to include marginalized communities into the growth model. This requires inclusiveness in the way policies are conceived, legislations are formulated, markets are understood, institutions are formed and products and services are designed. While intentions are clearly spelled out for inclusion, policies and institutions conceptualized to address the growth needs and requirements, largely center around the requirements of the macro economy. Market rule of the survival of the fittest puts all the resources into serving the resourceful. Micro economy that forms the foundation of the socio economic pyramid and represents the mass requires completely different policy and institutional response in alignment with the elements of their economy. Though it is a fact that multiple elements need to converge to give sustained relief to a poor household from drudgery, access to client friendly financial services is a crucial such element that can play a pivotal role to lead the change. Welfare schemes under public policy generally dominate the response to the needs of the micro economy. While welfare schemes are crucial to support poor families to deal with stress and adverse conditions, it cannot support entrepreneurial exertions of the enterprises at the tail end of the value chains. It is required to combine welfare with crucial economic components to support economically active but marginalized households to strengthen their linkage with the markets and ensuring judicious surplus distribution. Availability of client friendly financial services would be an important component to ensure that.

**Universal access in South Asia: the journey ahead**

Seven out of every 10 microfinance borrowers live in India (32 million) or Bangladesh (22 million). Despite tremendous growth and development of the sector, the leading role of banking in promoting financial inclusion and getting people out of poverty, the microfinance movement in South Asia has not achieved its full potential as yet. As of 2014, only 29 percent of adults in Bangladesh had bank accounts at a bank or other financial institutions (Global Findex Report 2014). On the supply side, there existed only 68 commercial branches per 1000 km² in the country (Brookings financial and digital inclusion project report 2015). In India, most people (67 percent) preferred taking loans from people within their community networks and relied on friends, neighbors and relatives. While only 11 percent borrowed money from a bank, 12 percent borrowed it from moneylenders. In terms of coverage, at the end of 2014, banks had opened banking outlets in 1,83,993 unbanked villages in India, comprising 7,761 branches, 1,63,187 BCs and 13,045 through other modes. However, villages covered by all modes still only represent less than 38 percent of total unbanked villages (Inclusive Finance India report 2015).

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In Afghanistan, which is in its nascent period of modern banking, in 2013 there were about 0.6 commercial bank branches per 1,000 km² and about two bank branches for every 100,000 adults. As of 2014, only about 10 percent of adults in Afghanistan had an account at a formal financial institution (Brookings Financial Inclusion Report 2015).

As is evident by the data stated above, use of services is as crucial a component of financial inclusion, as access. In this context, it is important to give equal weightage to the supply side represented by institutional initiatives as the demand side projected by people’s needs and capacities.

However, despite these limitations, Asia has been leading the global exposure to microfinance: it is estimated that in 2010, 75 percent of the world’s microfinance borrowers (around 74 million borrowers) were based in Asia (Microfinance Information Exchange, 2012). Microfinance has been seen as contributing not only to poverty reduction and financial sustainability, but also to a series of ‘virtuous spirals’ of economic empowerment, increased well-being and social and political empowerment for women themselves, thereby also addressing goals of gender equality and empowerment (Mayoux and Hartl 2009). With increasing number of people accessing microfinance services there is a need for more emphasis on digitization of financial services, as well as, having better mechanisms in place for accessing and using services apart from client protection. ‘Responsible finance’ is a key concept that should be used in order to provide safe access, usage as well as increase capabilities of clients using financial services.
The Financial Inclusion Story in Afghanistan

Afghanistan is a landlocked country that is also one of the poorest in the world. It has been affected by conflict for over 23 years. An estimate of current population of the country is around 32 million as of 2015. The country has primarily a rural economy where agriculture has been traditionally the major activity for a large proportion of the population. This sector however has suffered majorly from conflict, natural disasters, as well as, low investments. About half of Afghanistan’s rural population lives in areas inaccessible for part of the year. This inaccessibility adds to the lack of adequate levels of health, as well as, education services in the country. On the governance front, the authority of the Government is very limited outside the capital Kabul. Many regions of Afghanistan are still under the control of Taliban militant groups and warlords.

This lack of stability and security has severely limited economic growth and development in the country. However, there has been an improvement in economic prospects in the past few years with the overthrow of Taliban and influx of development assistance in the country. According to the IMF the Afghan economy has grown at a rate of 11.4 percent per year in real terms since 2002. This strong growth can be attributed to the reconstruction efforts fueled by development assistance and the recovery of the agriculture sector. Livestock activities are an integral part of most farming systems in Afghanistan. Apart from livestock farming, opium production in Afghanistan forms a big industry. Unaccounted by official statistics, Afghanistan is presently one of the largest opium producers of the world.

International Labour Organization’s report (2002) on Crisis Response and Reconstruction in Afghanistan analyzed the key challenges before the country in its struggle to build the nation post war. It identified employment creation as an important factor other than political

1 The Worldfact Book, CIA – Afghanistan 2015
2 Afghanistan Opium Survey 2014
and security transitions that can play a major role in contributing to the socioeconomic transition required to orientate Afghan society and the economy towards peace. Agriculture has been traditionally the major activity for a large proportion of the population though the sector has suffered from 25 years of conflict, destruction of its infrastructure, low investments and natural disasters. Livestock activities are an integral part of most farming systems in Afghanistan. ILO report further delineates that Afghanistan in its development process must recognize diversified livelihood strategies and rural-based activities will have a key place in this. The particular needs of the socially disadvantaged (women, widows, disabled and children) were also advised to be given special focus. The continued instability has made access to any sort of financial services very difficult. Even with the very recent focus towards reconstruction in Afghanistan, both telecommunications and banking services remain limited. There exists a wide spread mistrust of the banking system. Even with some access to financial services, distance acts as a barrier in accessing these services. However, with more than 80 percent of the population connected with 3G mobile networks, there is great opportunity for utilizing this network for mobile financial services (Brookings 2015 report).

**Origin of microfinance**

At the end of 2001, Afghanistan's formal financial system was virtually non-operational, with insolvent public financial institutions, and no private banks. Hence, dependency on informal sources of finance (such as family and friends, moneylenders and shopkeepers, traders, and landlords) increased. The underlying fear about the future made Afghans⁴ simply lack trust in the banks. This, compounded by the limits that Shari'ah, or Islamic law, places on banking, drives them to consider money liquidity the primary factor in handling their money.

Microfinance programs had limited outreach (approximately 10,000 clients at the end of 2001)⁵ and weak institutional structures. Savings services were limited to a few informal schemes and in-kind saving such as opium in poppy-growing areas.

The Afghanistan Microfinance sector joined country-building efforts of reducing poverty, creating jobs and improving livelihood through enhancing access to financial services. Because of its development focus embedded with delivery of financial services the microfinance in Afghanistan is more locally known as ‘development finance’. The development finance institutions in Afghanistan mainly offer microcredit services to the unbanked, low income and poor households in rural, peri-urban and urban areas.

Strong support from the international community in 2002 brought strength and revitalization of the financial sector. The Emergency Micro Credit and Rural Micro Credit Programs were initially established for the purpose of improving the economic security of the population and expanding income-generating activities. As part of the reconstruction and rebuilding efforts, the Government of Afghanistan extended support for the development of a financial sector that would provide access to finance for the poor with the assistance from international donors. In 2003, the Microfinance Investment Support Facility for Afghanistan (MISFA) was established as an apex institution. MISFA was established under the Ministry of Rural Rehabilitation and Development (MRRD) as the vehicle through which Government and donors would channel funding and technical assistance to build an inclusive development finance sector in the country. Since inception MISFA has been constantly supporting the microfinance sector in the country, by extending both financial and technical assistance to MFIs.

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⁴ Jan Chipchase, Mark Rolston, Cara Silver, and Joshua Blumenstock, *IN THE HANDS OF GOD- A Study of Risk & Savings in Afghanistan. 2011*

⁵ Afghanistan: State of Microfinance in Afghanistan (2009)
In 2002, there were estimated to be about 500 NGOs working in Afghanistan of which 20 to 25 were providing some kind of credit services, though half of those had tiny programs that were not designed to be sustainable. These achieved limited outreach and low sustainability due to a handout approach, hyperinflation and interest rate caps imposed for religious reasons.

In 2003, the urban department of the Emergency Micro Credit Program was converted into the First MicroFinance Bank (FMFB-A); the first private commercial bank to be licensed and incorporated in Afghanistan under the new regulatory and institutional framework. Since its inception, the bank has grown rapidly.

In March 2006, MISFA registered as a limited liability non-profit company whose sole shareholder was the Ministry of Finance of the Islamic Republic of Afghanistan. MISFA Ltd is an independent apex organization with a number of implementing partners on the ground. In most cases, MISFA functions as either the exclusive or primary provider of funds to its partners. The legal status of MFIs has been transformed from NGOs to that of non-profit companies registered with the Afghanistan Investment Support Agency (AISA), as permanent institutions under the laws of Afghanistan.

Growth of development finance
The financial inclusion agenda is delivered through Banks, FIs, MFIs, Community based Saving Promoting Institutions (CSPIs) and Insurance Companies.

Initially, the development finance sector experienced an exponential growth targeting on numbers – outreach and loan disbursement. In 2010 December, the sector had 14 MFIs, 287,669 active borrowers with $123,731,287 as gross loan outstanding (Ref: MISFA Sector Updates’ Dec’2010). The sector however saw negative growth in the following phase. Singular focus on quick outreach during 2006-2009 had resulted in unbridled growth and competition, multiple lending to clients and incidence of ghost clients, resulting in high Portfolio at Risk and a negative opinion about microfinance. This subsequently led to closure or merger of some MFIs. Six microfinance institutions were folded into Mutahid Development Finance Institution in 2011. In late 2012, BRAC, the largest MFI in the country, and ASA closed operations. Out of the initial 16 MFIs, only five are still operating (FINCA, FMFB, HFL, IIFC Group, and OXUS), and six MFIs have consolidated into one entity, Mutahid Development Financial Institution. The deteriorating security situation impacted the performance of MFIs to the extent of having to withdraw from remote rural areas and portfolios being restricted to peri-urban areas. Main sources of funds for the sector are local donors such as MISFA, Government projects especially for agriculture lending, and international donors such as USAID, DFID, IFAD, Italian Cooperation etc.

As of the end of 2014 there were 14 DFIs promoting development finance program in the sector, with an outreach of 168,176 active borrowers in 19 of Afghanistan’s 34 provinces. Over 39 percent of the borrowers were women. The outstanding portfolio of the sector stands at over AFN 7,345,207,824 (US$ 127 million). The PAR>30 days for the sector is 2.1 percent, showing a substantial improvement in portfolio quality compared to 3.2 percent in year ended December 31, 2013.

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7 Micro View, Issue 7:Quarter-4 (Oct-Dec’ 2014) by AMA
8 Micro View, Issue 6:Quarter-3 (Jul-Sept’ 2014) by AMA
The analysis of the status of financial inclusion in Afghanistan however still shows a bleak picture. Table 3 states that despite various initiatives and interventions, only 10 percent of the adults have bank accounts up till 2011.

Source: AMA⁹

Table 3: Source¹⁰

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⁹ AMA is the national network of Development Finance Institutions (DFIs) in Afghanistan.
¹⁰ The Little Data Book on Financial Inclusion, World Bank. 2015
Contours of development finance services

In Afghanistan, loans can be delivered to individuals and groups with or without collateral and may or may not contain a savings requirement. There are variations in the microfinance system across different MFIs, although they operate under the general policy guidelines as prescribed by MISFA (Microfinance Investment Support Facility in Afghanistan). These variations occur in terms of targeted groups, nature of financial services provided, and the presence of capacity building components built into the loans. For example microfinance organizations like PARWAZ only offers loans to urban women, while FINCA another MFI cooperates with donor organizations such as USAID to contribute to nationwide programs such as ARIES (Agriculture, Rural Investment and Enterprise Strengthening) and has established FAMA (FINCA Afghanistan Microfinance Academy) to train its employees in training its clients.

Each MFI has different loan cycles, with different amounts that can be borrowed after the end of a repayment cycle. Most MFIs require that savings be made before loans can be accessed. Some MFIs only give group loans, whereas others provide loans to individuals and groups. The Murahaba credit system utilized by FINCA is the world’s first Sharia law compliant microcredit system. Under Sharia law, interest on loans is considered as sinful. To avoid this label, the Murahaba system charges “administrative costs” for its loans, which include interest calculated annually and payable by the borrowers as the service cost of their loan.

Interest rate
Debate around interest rates in Afghanistan is moving around interest free loans mostly in rural areas. In some cases, the communities do not accept interest-bearing loans, which provides scope for Islamic loan products.

Theoretically speaking, there is no concept of loans and credits in Islam for financing trade, industry and agriculture except Qard Hassana (a loan contract between two parties for social welfare or for short-term bridging finance) and where profit and loss sharing is not feasible like interest free loans given by federal government to provincial governments for their developmental needs. Islamic financial institutions, therefore, involve themselves in financing (short, medium, and long term) for the working capital requirements, and also contribute to the capital of an enterprise by participating in its equity. These financings are on profit and loss sharing basis. Islamic banks also mobilize resources on profit and loss sharing basis as distinct from interest payments to depositors on predetermined rates. Prohibition of interest is ordained in Islam in all forms and intent.

Regulation
Afghanistan does not have specific regulations to address microfinance activities and diverse laws apply to the different providers of microfinance services. The Central Banking Law and the Commercial Banking Law were promulgated in September 2003, clearing the way for new commercial banks to be licensed. The first banks to be licensed were Standard Chartered (United Kingdom), the First Microfinance Bank of Afghanistan, and the National Bank of Pakistan.

The current regulatory environment for microfinance sector in the country is flexible. The Community-Based Saving Promoting Institutions (CSPIs) need to register with the Ministry of Economy. The legal status of MFIs has been transformed from NGOs to that of non-profit companies registered with the Afghanistan Investment Support Agency (AISA), as permanent institutions under the laws of Afghanistan. AISA, however, does not have any regulatory control over the MFIs. The Central Bank of Afghanistan also has no role in regulating MFIs. MISFA is playing the role of a de facto regulator for its partner MFIs only. The conspicuous absence of any strong regulation may be viewed as advantageous to some of the DFIs; on the other hand, the same situation turns out to be a

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12 Islamic Banking System in Afghanistan
constraint to generate confidence among the potential investors. Lately, Afghanistan Microfinance Association (AMA) has developed an industry code of conduct to promote self-regulation among DFIs in the country. The Deposit-taking Microfinance Institutions (DMFI) Regulation, approved by Afghanistan’s Central Bank in December 2014, enables MFIs to transform into deposit taking MFIs and be formally regulated by Da Afghanistan bank (DAB).

In June 2005, a new law on NGOs came into force. The law established a new legal framework, replacing the previous Regulation for the Activities of Domestic and Foreign NGOs in Afghanistan enacted in 2000 under the Taliban regime. This new regulatory framework previews two different types of registered, non-governmental and not-for profit organizations with legal entity status.

None of the MFIs are reporting to the Central Bank of Afghanistan and Ministry of Finance. The sector is working in self-monitoring system following the sector Code of Conducts and Code of Ethics developed by AMA last year and initiatives like inclusion of MFIs in Credit Registry etc.; these however need further investment and integration into MFI practices before any outcomes are visible. The DMFI regulation that will allow MFIs to transform into deposit taking MFIs will enable MFIs to offer the much needed deposit services to unbanked clients.

**Growth imperatives**

Research by Afghanistan Research and Evaluation Unit (AREU) on the impact of microcredit on informal credit systems and rural livelihoods illustrated the viability challenges MFIs were facing. These challenges were linked to having invested little effort in determining the viability of clients by understanding the social and economic contexts in which they were to invest their loans or in offering loan products meeting client needs. This showed a lack of understanding of the interconnections between MFI viability and that of clients. Based on a growing understanding of these connections and recent lags in growth and performance, the Microfinance Investment Support Facility for Afghanistan (MISFA) has introduced a series of reforms at the sector level to refocus MFIs on quality instead of growth. These reforms include requiring partner MFIs to prepare more reliable business plans, have a trainer on staff to address capacity gaps in management and credit operations, and create internal audit units to improve control systems and reduce opportunities for fraud. To track MFI progress in implementing these

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**Women and microfinance**

The role of women in making microfinance a success has been high in South Asia. This holds true for even Afghanistan. For a society where women have historically been restricted to the household, having thousands of Afghan women microfinance clients is a breakthrough and a clear indicator of success.

- Nearly 70 percent of microfinance clients in Afghanistan are women.
- While only 12 percent of male clients started new businesses (most investing loans in pre-existing businesses), nearly 36 percent of female clients started new businesses.

*Source: (Baseline impact study’s key findings: State of the sector report 2014)*

Participation of women gives women the opportunity for greater mobility, development of skills and knowledge and thereby contributing towards greater self-confidence. 80 percent of female clients interviewed for the study reported that their family’s, friends’ and other relatives’ perception of them has improved since joining the microfinance program.

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reforms, MISFA has institutionalized an MFI report card system.¹⁴

MISFA reforms have initially targeted MFIs’ internal structures, capacity and control systems. However, they also recognize the need to consider greater diversity of loan products and methodologies to meet client needs. To support diversification in the future, after internal reforms are in place, MISFA has committed to an action research agenda to investigate demand for savings products, agriculture and livestock loans, and Islamic finance products.¹⁵

The sector went through a consolidation in 2010-2013 where it resulted in closure of some two-three MFIs and merger of six MFIs into one. With the deterioration of security in rural areas, some of the MFIs closed down their branches thus a considerable amount of loans remained unpaid which affected the operations of other MFIs in the neighboring provinces/districts.

### Challenges ahead

Development finance in Afghanistan has survived various challenges over the last 12 years of evolution most of which are typical of any conflict-affected country – lack of security, poor infrastructure in country and limited avenues of livelihoods for clients. These lead to high costs of operations (higher expenses on security, transportation and personnel as compared to other contexts) as well as high portfolio risk. Lack of banking infrastructure in the provinces has proven to be a challenge for MFIs that rely on support from banks to facilitate transfer of cash in and out of remote areas. As of now, only four out of seven MFIs (including one Microfinance Bank (MFB) and one Financial Institution (FI)) have attained operational self-sufficiency. The security situation deteriorated badly during 2013-14, forcing organizations to withdraw from some rural areas and concentrate in the urban and semi-urban areas severely impacting their scale. The withdrawal of US and foreign troops and the reduction in foreign aid has had a severe dampening effect on the economy and also on the development finance sector.

### Growth of mobile ecosystems:

Mobile takeup in Afghanistan has been high. As of 2015 there were about 39 percent unique mobile subscribers. However less than one percent of adults over age 15 used mobile money, with almost no adults in the bottom 40 percent of the income scale using the service — thus, creating significant room for growth (Global Findex 2014).

As of mid 2015, according to the GSMA’s Mobile Money for the Unbanked Deployment Tracker, the country has made several efforts towards getting active with mobile money services. Telecommunications company Roshan’s M-Paisa service, Etisalat’s mHawala service, and Afghan Wireless Communications Company (AWCC)’s My Money service (provided through subsidiary Afghan Besim Mobile Money Co are some of the examples. Roshan amongst them has the largest market share of Afghanistan’s mobile network operators (MNOs). The service M-Paisa by Roshan offered merchant payments, airtime top-ups, person-to-person domestic transfers, bill payments, and loan repayment and disbursement, as well as links to other banking products (Brookings report 2015).

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¹⁴ Paula Kantor and Erna Andersen, Building a Viable Microfinance Sector in Afghanistan. AREU 2010

¹⁵ Paula Kantor and Erna Andersen, Building a Viable Microfinance Sector in Afghanistan. AREU 2010
A significant challenge in Afghanistan is limited awareness on development finance among external stakeholders – Government departments/ministries, religious leaders, the police, judiciary etc. especially at the provincial level. It is understood that the traditional microfinance is still considered as ‘non-Islamic lending’ in certain pockets of the country, and faces resistance from religious leaders, who continue to have a strong influence on community. In addition, continuous advocacy efforts are required to solicit support from the provincial administration and from the police and judiciary for resolving issues in the field.

Another limitation in building and sustaining development finance is the lack of an enabling legal, regulatory, and supervisory environment for the DFIs to operate. More legitimacy in regulation may also facilitate inflow of investments in DFIs; source of funds for institutions is currently limited to MISFA which may become a challenge in future.

There is a regional skewedness and urban-rural imbalance in terms of loan portfolio. Since 2014 it is observed that majority of client coverage is in the urban and semi-urban areas, owing to growing insecurity and high operational costs in rural areas. Microfinance sector in the country is small; it is also concentrated with 53 percent of the gross loan portfolio in just three provinces: Kabul, Balkh, and Badakhshan. 52 percent of borrowers are in Kabul, Balkh, and Badakhshan. The market is dominated by First MicroFinance Bank (FMFB) Afghanistan, which accounts for half of the sector’s borrowers and portfolio16.

However, the biggest challenge is to reorient 80 percent and 90 percent of the economic activity in Afghanistan that occurs in the informal. The informal Hawala system (unofficial brokers providing money transfer services based on an honor system) is deep rooted in Afghanistan and hence is an obstacle in scaling up formal systems of finance. According to 2013 report by the International Finance Corporation Afghanistan’s Hawala network is less expensive and a more trusted than other transfer services. At the end of 2013 there were an estimated 3,000 to 5,000 Hawala agents in the country (Brookings report 2015).

**Way forward**

While there have been efforts towards digital financial inclusion in Afghanistan, which have been looked at briefly in this chapter, there are numerous challenges that face the nascent industry in Afghanistan. Being a nascent industry however, there are also huge opportunities and potential to attaining financial inclusion. Building stronger infrastructure, tapping into the mobile services offered, as well as using the informal lenders as a pool to expand into the remote interiors of the country could be some of the possible ways forward.

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16 Micro View, Issue 7:Quarter-4 (Oct-Dec’ 2014) by AMA
Pathways to Financial Inclusion in South Asia: The role of Microfinance

Chapter 3

Bangladesh’s Journey to Financial Inclusion

“With a population of over 150 million inhabitants residing on an area of 147,570 square kilometres, Bangladesh is among the most densely populated countries in the world. The country’s geographical position also makes it one of the most vulnerable countries to climate change and natural calamities like cyclones and floods. In spite of these challenging conditions, Bangladesh has taken significant strides in reducing poverty and improving overall standard of living in the last two decades, as reflected in improved life expectancy, literacy, and food production measures. Poverty rate has come down from 59 percent in 1984 to 31.5 percent as of 2010. Between 1980 and 2014, the country’s Human Development Index value increased from 0.338 to 0.570, an increase of 68.7 percent. Moreover, in the past decade, the economy has grown at six percent per year despite frequent natural disasters and the global economic slowdown. The World Development Report 2013 notes that Bangladesh is among a small group of countries that have made significant progress in economic growth as well as human development indicators, in the last few decades.

Bangladesh’s laudable progress in economic growth and human development has been backed by poverty alleviation and welfare policies of the Government during the post-independence period (1971 onwards). At the same time, non-government organizations have played an instrumental role in Bangladesh’s post-war reconstruction, and contributed to its impressive strides in human development. Since their inception in the 1970s, organizations such as BRAC, Proshika, Association of Social Advancement, and Grameen Bank have focused on alleviating poverty and improving the socio-economic status and living conditions of the poorest sections of society. These organizations have been at the forefront of recognizing the importance of access to financial services as a tool to improve the lives of the poor and vulnerable, and spearheading initiatives to promote financial access especially in rural areas of Bangladesh.

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1 Bangladesh Bureau of Statistics, 2011
2 Human Development Report 2015, UNDP
Bangladesh’s financial architecture started developing with the establishment of public sector institutions at the time of its independence in 1971. Over the last 40 years several new generations of private banks, state-owned commercial banks and nearly 700 licensed Microfinance Institutions (MFIs) have emerged to service the needs of the poor, vulnerable and underbanked sections of society.

Microfinance in Bangladesh

Regarded as the birthplace of microfinance, and credited with giving the ‘Grameen model’ of credit delivery to the world, today Bangladesh is home to hundreds of organizations that offer financial services to vulnerable and marginalized groups. The microfinance industry in Bangladesh has achieved remarkable scale since its origins in the 1970s. As of 2014, NGO-MFIs have an outreach of nearly 20 million borrowers.

The beginnings of microcredit can be traced back to action research in the late 1970s, carried out by academics as well as practitioners from organizations that were set up to undertake relief and rehabilitation work in post-independence Bangladesh. The 1980s witnessed a growing number of non-governmental organizations experimenting with different modalities of delivering credit to the poor, as well as gradually scaling up their operations. Consequently, the 1990s saw a sharp increase in access to microcredit and expansion of microfinance activities that peaked in the early 2000s. The significant rise of microfinance institutions during this period can be attributed to a number of enabling factors such as the visionary leadership at the helm of large non-profit organizations, a conducive policy environment, capacity building and funding support from international donors, among others. Following a

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Figure 1: Microfinance in Bangladesh: Journey so far

- **1970s**
  - Emergence of NGOs
  - Launch of Grameen Project
  - Rural Banks and Cooperatives

- **1980s to mid-1990s**
  - Establishment of Grameen Bank
  - Expansion in outreach of NGOs
  - Establishment of PKSF

- **Mid-1990s to mid-2000s**
  - Rapid expansion in MFI operations
  - Establishment of Microcredit Regulatory Authority

- **2008 onwards**
  - Rapid growth followed by levelling
  - Emergence of new trends such as mobile finance, product diversification

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3 State of Microcredit in Bangladesh, Microcredit Regulatory Authority (2014)

4 Adapted from Microfinance in Bangladesh: Growth, Achievements and Lessons, Hassan Zaman (2004)
period of rapid growth and expansion up to 2007, the MFI industry in Bangladesh changed course with a levelling of activities in the near future. In recent years, the industry has recovered from the slowdown. Moreover, the early models of microfinance have undergone considerable refinement in order to cater to niche markets, evolving client aspirations and their different life-cycle needs. Figure 1 illustrates the journey of the microfinance industry in Bangladesh through its various phases of growth and development.

1970s: State initiatives and the origins of microfinance

The period following independence was focused on reconstruction, led by a new generation of visionaries who were keen on relief and rehabilitation, community development. Thus, non-governmental organizations such as BRAC, Proshika and Association of Social Advancement (ASA) emerged during this period. Around the same time, the Grameen Bank concept was first implemented as an action research project in 1976, when a Chittagong University team led by economics professor Muhammad Yunus began to lend small amounts of money to poor households in the nearby district of Jobra. Borrowers were organized into small groups of four to five people that met weekly with other groups to make loan repayments. The model leveraged the concept of ‘peer monitoring’ to improve loan repayments and ensure discipline among borrowers. The action research demonstrated its strength in Jobra and some of the neighboring villages during 1976-1979. With the sponsorship of the central bank of the country and support of the nationalized commercial banks, the project was extended to Tangail district (a district north of Dhaka, the capital city of Bangladesh) in 1979. With the success in Tangail, the project was extended to several other districts in the country, with the support of the central bank of Bangladesh and other commercial banks.

1980s to early 1990s: the ‘Grameen’ era

The success of the Grameen project paved the way for the establishment of the Grameen Bank under a special ordinance in 1983 and thus in 1984, Grameen Bank came into existence as a government-regulated institution. During this period, several NGOs also experimented with different ways of delivering credit to low-income households and vulnerable populations in Bangladesh, based on the Grameen model of providing loans for group projects compared to offering loans to individuals with peer monitoring. Hence, by the late 1980s, the predominant model became providing individual loans to a target group of poor households, with peer monitoring and strong MFI staff follow-up. The 1980s and early 1990s were a turning point for the capacity building of these large NGOs, which allowed them to scale up their microcredit programs. Often, these lessons were drawn from the implementation of large programs in sectors other than microcredit, such as health.

The early 1990s in particular was a period of rapid expansion of access to microcredit. International donors helped launch microcredit by funding poverty projects with grants, which were used by microfinance institutions to fuel branch expansion and scale-ups across the country. The emergence of the Palli Karma Sahayak Foundation (PKSF) in 1990, a wholesale financing institution, was also a significant development during this period. PKSF was established by the Government as an apex organization with the mandate to reduce poverty through employment generation. PKSF’s core functions include lending money to Microfinance and Development Institutions; building capacity and giving hands-on assistance to strengthen development institutions; advocating microfinance issues and helping develop an appropriate regulatory framework for the industry. The organization has played an instrumental role in contributing to the increase of access to microcredit in the 1990s by expanding the capital base for MFIs to onlend to poor and vulnerable households.

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5 Regulation and Supervision of MFIs in Bangladesh by Dr. Md. Kabir Ahmed Bangladesh Bank (2013)
Sharia-Compliant Financial Inclusion: Responding to the Financial and Cultural needs of the Poor

An estimated 72 percent of people living in Muslim-majority countries do not use formal financial services (Honohon 2007). Even when financial services are available, these may be viewed as incompatible with Islamic laws and principles. While conventional microfinance institutions in Bangladesh have made remarkable progress in client outreach, large segments of the population still remained excluded from the ambit of formal financial services. During the 1980s and 1990s, niche financial institutions emerged, which recognized this gap, and began to offer products that were consistent with Islamic financial principles. Table 1 illustrates the difference between the approaches of conventional microfinance institutions and Sharia-compliant microfinance institutions.

Table 1: Difference between conventional MFIs and Sharia-compliant MFIs

<table>
<thead>
<tr>
<th></th>
<th>Conventional MFIs</th>
<th>Islamic MFIs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sources of Funds</td>
<td>Foreign donors, multilateral and national agencies, government, central banks, savings of clients</td>
<td>Religious institutions, Islamic charitable sources, saving of clients, foreign donors, national agencies, private sector</td>
</tr>
<tr>
<td>Mode of financing</td>
<td>Interest-based</td>
<td>Non-interest bearing financial instruments</td>
</tr>
<tr>
<td>Financing the poorest</td>
<td>The extreme poor are usually left out of the financing model</td>
<td>The extreme poor are integrated in the financing model by integrating the Zakah (act of giving) principles in the model</td>
</tr>
<tr>
<td>Funds transfer</td>
<td>Cash</td>
<td>Goods</td>
</tr>
<tr>
<td>Deductions at inception of contract</td>
<td>Percentage of funds deducted from principle</td>
<td>No deductions from principle</td>
</tr>
<tr>
<td>Methods of dealing with defaults</td>
<td>Group/center pressure</td>
<td>Group/spouse guarantee, and Islamic ethics</td>
</tr>
<tr>
<td>Social development program</td>
<td>Secular, ethical and social development</td>
<td>Religious which includes behavior, ethics, and social values</td>
</tr>
</tbody>
</table>


With nearly 87 percent of population in Bangladesh practicing Islam, Sharia-compliant financial services have the potential to reach out to a significant part of the country’s excluded population. Set up in 1983, the Islami Bank Bangladesh Limited (IBBL) was the first such initiative in the country. IBBL’s ‘Rural Development Scheme’ was launched with the objective to create employment opportunities (by providing small and micro investments) to the poor, and to alleviate poverty through income generating activities by adopting Islamic microfinance products through a community development approach. Subsequently, IBBL expanded its portfolio to offer Sharia-compliant microfinance products as well. As of 2012, the Rural Development Scheme has 0.6 million beneficiaries across 61 districts of Bangladesh.

References: Scaling up Islamic Microfinance in Bangladesh through the Private Sector: Experience of Islami Bank Bangladesh Limited (IBBL), UNDP

Mid-1990s onwards to 2008: an era of rapid growth and expansion

With the gradual expansion of microcredit services across geographical areas and demographic groups in the early 1990s, it became evident that poor households required a wider range of financial services to meet their life-cycle needs. Thus, the mid-1990s saw the rise of a range of second-generation innovations in the delivery of financial services that focused on the needs of the vulnerable and ultra-poor, that were not adequately met by the existing models. To overcome these limitations, the new approaches to financial services laid greater emphasis on savings as a tool for risk mitigation, on individual rather than group-based lending models and greater flexibility in terms of loan size, repayment schedules and access to savings.

This period also saw a surge in the international recognition and encouragement of Bangladesh’s microfinance institutions and NGOs, provided large-scale visibility to their initiatives, and coincided with global initiatives such as the United Nations Year of Microcredit (2005). This period also marked a new chapter in the policy and regulatory framework of microfinance in Bangladesh, with the establishment of an independent authority to oversee all microcredit providers (except Grameen Bank) in 2006 - the Microcredit Regulatory Authority. Prior to the establishment of the Authority, microfinance activities in Bangladesh were carried out as per conventional laws such as the Banking Companies Ordinance 1962 and the Co-operative Societies Ordinance, 1984. PKSF also functioned as a quasi-regulatory authority that set criteria and conditions for MFIs in getting access to its financial resources, along with non-prudential guidelines for partner organizations.

While international donors and PKSF had played a significant role in fueling growth until now, this period saw large MFIs explore new sources of funding, and were gradually able to service their requirements through deposit mobilization and commercial borrowings.

Scaling up of Microfinance in Bangladesh: Enabling Factors

Not only is the growth of microfinance in Bangladesh an inspiring tale of determination and innovation, but it offers important policy lessons and insights to other countries of the region. A World Bank case study (Zaman, 2004) identified the following enabling factors that contributed to the rapid expansion of microfinance in Bangladesh since its inception:

- **Institution Building**: The vision and persistence of leaders of the NGO/MFI movement are key factors behind the success of the microfinance industry in Bangladesh. Leadership skills were instrumental at initial stages in persuading a skeptical public that providing credit to the poor could become a viable and replicable proposition.

- **Role of International Donors**: External resources played an important part in the growth in outreach and institutional strengthening of the initial stages of the microfinance industry.

- **Favorable Policy Environment**: The enabling environment that existed in Bangladesh at the time greatly aided the early experimentation and later scaling-up of the microfinance industry, by taking a balanced approach to regulation.

- **Establishment of the Palli Karma Sahayak Foundation as an apex financing body**: PKSF played an instrumental role in contributing to the sharp increase of access to microcredit that took place in the 1990s by expanding the capital base for MFIs to onlend to the poor.
Another key development during this period was the growing concerns regarding the increasing competition among major MFIs in the market, the possibilities of multiple lending to borrowers and market saturation. As observed in a 2013 CGAP study (Chen & Rutherford), after a rapid annual growth of 15-28 percent in active borrowers from 2004 to 2007, there was a slowdown in the industry. The study also captures client perspectives on microcredit through household interviews in rural Bangladesh. While its findings are not representative of Bangladesh due to a small sample size, a number of striking themes emerged from the interviews. For instance, many households reported that they had reduced the number of MFI accounts and/or loans they held. MFI staff reported that their members had become more judicious in the uptake and usage of loans. Respondents also expressed the desire to save more rather than borrow, and also described the stress associated with making loan repayments. However, the industry has rallied from these concerns since then, and has showed strong resilience in the wake of the global economic slowdown and a devastating cyclone in 2007.

Today microfinance institutions continue to play an instrumental role in promoting access to credit, especially in rural areas. As of June 2014, there are 697 licensed NGO-MFIs in Bangladesh, with a client base of 25 million, which includes 20 million borrowers. As per the Rural Credit Survey of Bangladesh 2014, 67.55 percent institutional loans are disbursed by NGOs whereas 16.99 percent by banks, 2.95 percent by Cooperative Society/Samity, 1.40 percent by Government Departments and 11.12 percent of loans requirements are met by Non-Institutional/Personal Sources (Table 2).

Emerging trends: from microfinance to financial inclusion
In the years following the slowdown in uptake of traditional microcredit products in Bangladesh, leading financial service providers such as BRAC and Grameen Bank have begun experimenting with innovative product refinements such as flexible loan repayment schedules and top-up loans. Financial service providers recognize the importance of providing a basket of financial services such as savings, investments, insurance, and so on.

Table 2: Findings from Rural Credit Survey of Bangladesh 2014

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Number/Amount</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distribution of Loans by Disbursing Source</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank</td>
<td>13,291,367</td>
<td>100.00</td>
</tr>
<tr>
<td>- Nationalized Bank</td>
<td>2,258,352</td>
<td>16.99</td>
</tr>
<tr>
<td>- Non-Government Bank</td>
<td>788,147</td>
<td>5.93</td>
</tr>
<tr>
<td>- Specialized Bank</td>
<td>925,568</td>
<td>6.96</td>
</tr>
<tr>
<td>NGOs</td>
<td>544,637</td>
<td>4.10</td>
</tr>
<tr>
<td>NGOs</td>
<td>8,977,684</td>
<td>67.55</td>
</tr>
<tr>
<td>Cooperative Society/Samity</td>
<td>391,764</td>
<td>2.95</td>
</tr>
<tr>
<td>Government Departments</td>
<td>185,111</td>
<td>1.40</td>
</tr>
<tr>
<td>- Rural Development Board</td>
<td>141,183</td>
<td>1.06</td>
</tr>
<tr>
<td>- Department of Youth Development</td>
<td>17,982</td>
<td>0.14</td>
</tr>
<tr>
<td>- Department of Women Affairs</td>
<td>4,761</td>
<td>0.04</td>
</tr>
<tr>
<td>- Department of Social Services</td>
<td>21,185</td>
<td>0.16</td>
</tr>
<tr>
<td>Non-Institutional/Personal Sources</td>
<td>1,478,457</td>
<td>11.12</td>
</tr>
<tr>
<td>- Mahajans</td>
<td>456,980</td>
<td>3.44</td>
</tr>
<tr>
<td>- Friends/Relatives</td>
<td>530,648</td>
<td>3.99</td>
</tr>
<tr>
<td>- Dadan Businessman</td>
<td>317,913</td>
<td>2.39</td>
</tr>
<tr>
<td>- Others</td>
<td>172,916</td>
<td>1.30</td>
</tr>
</tbody>
</table>

Source: Report on Rural Credit Survey 2014, Bangladesh Bureau of Statistics (BBS)

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4 A Microcredit Crisis Averted: The Case of Bangladesh, No. 87 July 2013 Greg Chen and Stuart Rutherford, Focus Notes, CGAP
insurance and credit to clients that can meet their various life-cycle needs and aspirations. While the financial inclusion model has been credit led so far, with a component of involuntary savings, there is increasing emphasis on offering clients more flexible savings products. Member deposits have historically been collected in Bangladesh as a mandatory condition for receiving a microfinance loan. However, in recent times microfinance institutions have begun offering flexible, individual deposit services to their members.

In the past, the high cost of building and operating traditional bank branches has been a major obstacle for reaching poor customers, especially in rural areas. Brick-and-mortar branches are expensive for banks to maintain in far-flung communities, while traveling to urban areas is costly for many rural customers. The emergence of digital financial services has transformed the financial services landscape in countries of Sub-Saharan Africa and South Asia. Bangladesh has been a forerunner among other South Asian countries in embracing digital financial services, and the rapid growth and take-up of Mobile Financial Services (MFS) in the last five years is arguably one of the most promising trends.

With at least 10 service providers already offering services on the market, Bangladesh accounts for more than eight percent of the total registered mobile money accounts globally⁶. As of February 2015, there are over 25 million registered mobile finance clients in Bangladesh. A snapshot of key mobile financial services indicators is presented in the table below. Prominent players in this segment include BRAC Bank Limited’s bKash, Dutch-Bangla Bank Limited’s DBBL Mobile Banking and Islami Bank Bangladesh Limited’s mcash. The focus of these key players has been on expanding their outreach through utilization of existing resources (i.e. ATMs, branch offices) and the acquisition of agents across the country. The main target population of these providers has been the unbanked and underbanked sections of society. The growth of the market has largely benefited from domestic remittances. The most popular transaction types are cash-in (42 percent of total transactions), cash-out (37 percent) and person to person (P2P) transactions (19 percent)⁸.

In spite of this expansion in MFS in the last five years, service providers are still to tap into the full potential of mobile financial services in Bangladesh. The USAID study on mobile financial services notes that there is a need to increase the awareness of MFS among key players—both service providers and potential clients. There is also a need to consider the gender differences in access to mobile phones and financial services. For instance, only 18 percent of digital finance users in Bangladesh are women⁹. Some providers have recognized this digital divide as well as opportunity and are offering tailor-made

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⁷ http://www.bangladesh-bank.org/fnansys/paymentsys/mfsdata.php
⁸ http://www.cgap.org/blog/digital-finance-bangladesh-where-are-all-women

<table>
<thead>
<tr>
<th>Key MFS Indicators</th>
<th>Number of Agents</th>
<th>Number of Registered Clients</th>
<th>Number of Transactions</th>
<th>Transaction Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 2013</td>
<td>0.060</td>
<td>5.00</td>
<td>10</td>
<td>$301</td>
</tr>
<tr>
<td>December 2013</td>
<td>0.189</td>
<td>13.18</td>
<td>31.36</td>
<td>$862</td>
</tr>
<tr>
<td>June 2014</td>
<td>0.414</td>
<td>16.7</td>
<td>44.01</td>
<td>$1,110</td>
</tr>
<tr>
<td>December 2014</td>
<td>0.541</td>
<td>25.2</td>
<td>74.47</td>
<td>$1,361</td>
</tr>
<tr>
<td>February 2015</td>
<td>0.543</td>
<td>25.87</td>
<td>76.99</td>
<td>$1,423</td>
</tr>
</tbody>
</table>

Numbers in millions *Value in USD
solutions targeted towards women. For instance, The Asia Foundation has launched a new program with Telco partner Banglalink and UCash that will help women entrepreneurs utilize digital financial services and reach new markets through e-commerce.

Way forward
The landscape of financial services in Bangladesh has undergone a considerable transformation in the last four decades, from the origins of microfinance in the 1970s, to the present day mobile financial services revolution. In spite of these rapid strides, Bangladesh is still a long way from attaining universal financial access - less than one-third of adults have an account at a financial institution (Global Findex 2014). The statistics for savings and borrowings from formal financial institutions tell a similar story.

While these numbers may seem discouraging, they also represent a massive opportunity for financial services providers in Bangladesh to achieve scale, by catering to a client segment that has largely been ignored by the mainstream financial sector. This requires concerted efforts by all stakeholders in understanding the diverse needs of demographics such as vulnerable communities, small entrepreneurs and women. Bangladesh is no stranger to natural calamities such as cyclones and floods, and periods of duress such as *monga*\(^{10}\), which have serious implications for poor and vulnerable communities, as well as the operations of financial institutions working with them. Such a calibrated approach will go a long way in alleviating barriers on the demand as well as supply-side, and aligning the services of financial institutions with client requirements. Moreover, with the global paradigm shift from microfinance to responsible finance, policymakers and industry leaders need to pave the way for responsible finance practices that balance growth with client interests and thus promote trust in financial institutions.

Today, financial inclusion is widely acknowledged as a means to improve the lives of the poor and vulnerable. However, a sustainable impact on their lives requires more than financial access- a combination of handholding support, market linkages, capacity building initiatives and livelihood opportunities that address the root of the problem of poverty and deprivation in Bangladesh.

\(^{10}\) Monga refers to a cyclical phenomenon of unemployment and food insecurity that is linked with the planting and harvest of paddy in Bangladesh.
India is the seventh-largest country in the world by area, the second-most populous country with over 1.2 billion people, and the largest democracy in the world. India is the third largest economy in terms of Purchasing Power Parity (PPP) as of April 2014 and has a significant share in world GDP\(^1\). The International Monetary Fund (IMF) reported, India is the 12\(^{th}\) largest economy in terms of absolute unadjusted dollars. The country has an impressive GDP growth record, with an annual average of 6.04 percent from 1951 until 2015\(^2\).

In India, the informal sector accounts for 93 percent of total employment including agriculture and 82.4 percent of employment in non-agricultural economic activities\(^3\). The figures for informal employment are likely to be even larger because enterprises identified as “employer’s households”, which account for employment like the provision of domestic services, are excluded from the definition of the informal sector. The informal character of these economic activities structurally excludes communities and households engaged in them from the formal economy. India’s inclusive growth\(^4\) strategy for economic development aims at making products and services, including financial services, available to those who for various reasons stand excluded. Financial inclusion is considered important as it provides an avenue to the poor for bringing their savings into the formal financial system, an avenue to remit money to their families in villages besides weaning them away from the clutches of the usurious money lenders.

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3. Ramesh Kolli, Measuring the Informal Economy: Case Study of India, 2011
At the same time, informal entrepreneurs do not form a monolithic group. There is a pyramid at the bottom of the pyramid, at the bottom of which are located the ultra-poor who face distinct challenges. At the top are flourishing micro entrepreneurs who either have service-based or manufacturing enterprises, have aspirations to grow, but poor access to the right kind of financial services. For one, these different categories need a new typology (pre-, nano-, micro-, tiny, for instance) to describe them. Secondly, and more importantly, the needs of each of these categories are vastly different. At the pre-enterprise level, for instance, there is fungibility between personal and economic finances. At some point in the evolution the separation may happen. The threshold of formalization follows, where an enterprise starts acquiring signals of formalization (PAN card, IT returns, chartered accountant). However, more than 90 percent of the enterprises in India are below the threshold of formalization and are spread across the multiple layers of enterprises. Their demands are bypassed by the mainstream players with stringent and inflexible norms of what is ‘bankable’.

Efficient targeting of the population is the key in achieving the goal of financial inclusion; the purpose of financial inclusion policies in India has been to make affordable saving, investment and insurance options available to the poor and the vulnerable. Not surprisingly, the most underserved are those in greatest need of financial services — the bottom 40 percent. The National Council of Applied Economic Research (NCAER) National Survey of Household Income and Expenditure (NSHIE) 2011-12 survey indicates that on average, less than 30 percent of those in the bottom-most quintile have a bank account, and about 50 percent of households falling in the second quintile have bank accounts as against the national average of 60 percent. It is also seen that lack of financial access is the highest among casual wage laborers.

The NSHIE survey indicates that casual wage labor comprise 38 percent of all households at the all-India level but only about percent of them have a bank account. Moreover a large fraction of these accounts are only used to withdraw payments for work done under the Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA). In these cases while having a bank account does decrease corruption and promotes transactional efficiency, it does not mean affordable credit from formal sources for the rural poor who continue to rely on informal sources of finance at high interest rates for their credit needs. In fact, the Sarangi Committee report of the Task Force (2010) on ‘Credit Related Issues of Farmers’ notes that small and marginal farmers who own more than 80 percent of agricultural holdings, are “disturbingly” becoming more indebted to the moneylenders. As per this report, farm households not accessing credit from formal sources as a proportion to total farm households are more at 95.91 percent, 81.26 percent and 77.59 percent in the north-eastern, eastern and central regions, respectively. These numbers are staggering, and go to show that even if on average 54 percent of rural households have a bank account as per the 2011 Census, the actual purpose of more inclusive access is not translating to affordable credit for the poor who really need such services.

Early efforts towards financial inclusion

From India’s independence in 1947 till the 1960’s the banking sector in India was largely privately owned and operated. However, during this period, there was a growing recognition of the importance of banking services as an important tool to facilitate the development of the economy. This momentum paved the way for the historic bank nationalization program in India in 1969, wherein 14 of the largest commercial banks were nationalized. The primary objective of bank nationalization was to align

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6 This part is drawn from Indira Iyer, Financial Inclusion Need for Differentiation between Access and Use in EPW, February 14, 2015 vol l no 7, Page 20
7 Inclusive Finance India Summit brochure, Access Assist 2015
the flow of credit with policy priorities such as five-year plans, and improve the flow of credit to sectors such as agriculture.

The period from 1970s to early 1980s has seen a massive expansion and introduction of specialized banks to address the issues of exclusion and specific needs of certain segments of population. The major initiatives in this regard include priority sector lending, lead bank schemes, introduction of bankers committee, setting up of regional rural banks, and a targeted branch expansion policy, to name a few. The establishment of a National Bank for Agriculture and Rural Development (NABARD) in July 1982 and a Small Industries Development Bank of India (SIDBI) in April 1990 are two major landmark initiatives towards addressing the financial needs of financially excluded and underserved segments of population.

Together these initiatives have helped the Indian banking industry achieve remarkable scale and outreach, given the large extent of the country. Today, a little over one lakh bank branches are engaged in providing financial services in India (March, 2013). In spite of this growth in branch networks, regional disparities in access to financial services persist. Only 37 percent of bank branches are based in rural India, which is home to nearly 69 percent of the Indian population (Census, 2011). While access to banking services across the country has improved from 35.5 percent, when population was availing banking services in 2001 to 58.7 percent in 2011, average population per branch is still high with 12,100 per branch as of March 2013.

Financial services, specifically access to timely and affordable credit is a critical input for economic development. Its timely availability in the right quantity and at an affordable cost goes a long way in contributing to the well-being of the people, especially those belonging to the lower rungs of society. Acknowledging these needs, India’s private and community development sector based institutions have been playing a crucial role in promoting inclusive finance in the country in the last three to four decades.

A community based approach to financial services, rooted in the mutual cooperation and trust within rural and urban communities, has been one of the most defining characteristic of India’s journey towards financial inclusion. India’s tryst with innovative, community-based financial service models can be traced back to the origins of the Swashrayi Mahila Sewa Sahakari Bank (SEWA) in 1970s - a leading example of a ‘women owned and managed’ Cooperative Bank. Set up in 1974 as an urban cooperative bank, SEWA is the first and largest cooperative of its kind in India. Led by its founder Ms. Ela Bhatt, the banks’ policies are formulated by the self-employed women members as shareholders and their own elected Board of women workers.

Women have played a pivotal role in India’s financial inclusion story from the outset, and the trend continues today. Another significant approach to financial inclusion to emerge during the 1980s was the Self-Help Group (SHG) model, comprising of a group of 10-20 women who came together to promote saving habits among themselves. The much-acclaimed approach owes its origins to experiments in villages of rural India by the Mysore Resettlement and Development Agency (MYRADA), backed by NABARD. The initial success of these pilots prompted NABARD to study the functioning of microfinance SHGs and explore avenues for collaboration with the formal banking system, in association with Asia Pacific Rural and Agricultural Credit Association’ (APRACA). Both these research projects threw up encouraging possibilities and NABARD initiated a pilot project called SHG-bank linkage project (Satish 2005, NABARD 1991). The 1990s saw the expansion of the SHG model at a national scale, in partnership with...
non-government organizations across the country. The program became widely accepted and was promoted by states and various institutions, with vital support from the banking industry in offering savings and credit services linkages to these women’s groups.

The 1990s also saw the emergence of a new model of microfinance in India - popularly known as the NGO-Microfinance Institution Model (NGO-MFI). This model owes its origins to the relentless efforts of NGOs working on livelihood programs for poor and vulnerable communities. Recognizing the limitations of the mainstream banking system in catering to the needs of marginalized households and enterprises, NGOs explored the bank financing channel by linking with development organizations and SHGs. These organizations saw the potential of bank linkage or intermediation as an important development strategy. Thus, the foundation for several of India’s prominent microfinance and community development finance institutions such as BASIX, Share, Spandana, SKS, Grameen Koota, Rashtriya Gramin Vikas Nidhi (RGVN), Adhikar and Village Welfare Society (VWS), PRADAN, and Nav Bharat Jagriti Kendra was laid down during this period. It is this movement that set the tone for MFIs becoming intermediaries between publicly sector development finance institutions and community groups or individual borrowers. The NGO-MFI model in India has been extensively supported by the Small Industries Development Bank of India (SIDBI) and onlending institutions such as the Friends of Women’s World Banking.

Today, both the SHG-Bank linkage program model and the MFI model are rapidly expanding as a result of the joint efforts of the industry and an enabling policy environment.

Another important player in the financial inclusion space is the Non-Banking Financial Company-Microfinance Institution (NBFC-MFI). An NBFC-MFI is a for-profit entity that has achieved commendable success in terms of expansion in microfinance portfolio and client outreach in India. The participation of 68.43 million clients from low-income households (from rural and urban areas) and unregulated segments, primarily small/micro-enterprises in microfinance program/s, clearly portrays the role that NBFC-MFIs play in the ‘financial inclusion’ drive in India. In addition, the total loan outstanding of Rs. 249.69 billion as of March 2014\(^1\) draws attention of the apex bodies (specifically Government of India - GoI and Reserve Bank of India - RBI) toward the microfinance business model.

It is also important to note that financial inclusion has thus become an integral part of the Government and the RBI’s strategies, policies and schemes that intend to uplift the wellbeing of the underprivileged at a larger scale thus aligning with the G20’s principles\(^2\). The recent acknowledgment of MFIs operating under Non-Banking Financial Company Act as a sub-category ‘NBFC-MFI’ reflects the prominence of this institutional model of financial inclusion in the country. In their pursuit of a sustainable model of microfinance business, NBFC-MFIs have undergone various phases of evolution, with period of stress such as post the 2010 microfinance crisis that originated in Andhra Pradesh\(^3\); subsequently, the RBI acknowledged NBFC-MFIs as a sub-category of Non-Banking Finance Company and RBI’s directives which provided a well-defined structure and framework for microfinance business came forth. Recent policy and regulatory developments in India not only influence the NBFC-MFI business model but also greatly influence a wide range of MFIs’ business, operating as non-profit (NGO-MFIs) and mutually aided societies (cooperatives). Additionally, the introduction of Small Finance Bank and Payment Bank, the inclusion of NBFC-MFIs under the Business Correspondence model, and the recent launch of the MUDRA bank are momentous policy and regulatory developments. They will have a huge impact on financial inclusion and might change the landscape of the microfinance sector in future.

\(^{11}\) Nair | Tankha, Inclusive Finance India Report 2014

\(^{12}\) http://www.afi-global.org/sites/default/files/afi%20g20%20principles.pdf

\(^{13}\) http://governancexborders.com/category/andhra-pradesh-microfinance-crisis/
1990s onwards: major policy initiatives
A wide range of financial inclusion initiatives and experiments has been carried out under diverse legal frameworks, along with varied approaches, in India over the last three decades. In 1998, NABARD appointed a ‘Task Force’ under the Chairmanship of Shri Y.C Nanda, (then Managing Director, NABARD) with an intent to formulate a suitable national policy framework that will facilitate an orderly development of the microfinance sector. The idea of the need for self-regulation by the industry was strongly recommended by this Task Force. Further, the Task Force also advocated for establishment of ‘Self-Regulatory Organization/s (SROs).’ Despite the concept of self-regulation having been discussed and recommended by the Task Force in late 1990s, it was only implemented by the microfinance sector as Code of Conduct, post 2006 - when the first signs of stress began to emerge in the industry.

The industry association, Sa-Dhan, developed a ‘Voluntary Mutual Code of Conduct and the Fair Practices Code’ in consolidation with key stakeholders including its member MFIs, and facilitated the implementation of this code among its members14. Apart from the introduction of a Code of Conduct, the sector has also collectively drafted the ‘Microfinance Sector (Development and Regulation) Bill in 2007. The 2007 draft bill was not passed, and the bill was once again re-drafted in 2012 in response to the crisis in 201015. However, the 2012 draft bill also faced the same fate as its predecessor, following which the sector collectively moved ahead and brought the revised self-regulatory norms under the leadership of MFIN, the industry association. An ‘industry level unified code of conduct and regulatory framework for MFIs, especially for NBFC-MFIs’ was also introduced. Subsequently, the RBI introduced the concept of a ‘Self-Regulatory Organization (SRO)’ and thus the Microfinance Institutions Network (MFIN) was formally appointed by RBI as an SRO in June 18, 201416 and Sa-Dhan was also awarded SRO17 status in February 2015.

Over the years, the Government of India and Reserve Bank of India have been constantly engaged in mapping the issues of financial exclusion at different phases and appointed committees to work on modalities of the future direction of financial inclusion in India.

In 2006, the Union Government set up a commission headed by the eminent economist Dr. C. Rangarajan and in 2008, a committee was setup under the chairmanship of Dr. Raghuram Rajan, to further guide the future of the financial inclusion. As a result of this constant engagement between the apex policymaking and regulatory agencies, a wide range of initiatives have been introduced to address the issues of financial exclusion in India18. Some of these include - introduction of basic banking services with No- Frills Accounts, credit card for farmers ‘Kisan Credit cards’; the agent model of banking is also in 2005-06, as a result of recommendations by a committee under the leadership of Dr. H.R Khan, wherein banks are allowed to appoint third parties as agents to offer banking services to underprivileged sections on their behalf. Other innovative technology-based delivery models include mobile banking, kiosk/ATM based banking, branchless banking and Aadhaar enabled payment services.

Recent policy reforms and large scale initiatives towards greater financial inclusion
In the last two years, the financial inclusion initiative in India has been experiencing a landslide development in terms of policy reforms and financial inclusion schemes that aim to minimize the issues of exclusion in country. In 2014, the Government of India introduced the concept

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17 [http://www.livemint.com/Money/PcpbZpYM9ZNCgOklw96gfN/SaDhan-gets-selfregulatory-organization-status-after-MFIN.html](http://www.livemint.com/Money/PcpbZpYM9ZNCgOklw96gfN/SaDhan-gets-selfregulatory-organization-status-after-MFIN.html)
18 SonuGarg, Dr. and Parul Agarwal, Financial Inclusion in India – a Review of Initiatives and Achievements, 2014
of ‘Jan Dhan se Jan Suraksha,’ through multiple savings, insurance and pension schemes\textsuperscript{19}. In a single day, the Pradhan Mantri Jan Dhan Yojana (PMJDY) was able to open a staggering 1.5 crore saving bank accounts signaling accelerated efforts by the Government to make financial inclusion a key goal to change lives, reduce risks, and make a broader section of the population a part of the growth process. According to Reserve Bank of India (RBI) data, as at the end of March 2014, Indian commercial and rural banks had 243 million Basic Savings Bank Deposit accounts (BSBD) – 126 million through bank branches and the rest through business correspondents\textsuperscript{20}. In just over five months, the scheme extended banking to almost every single household in the country – with the new accounts adding up to nearly 116 million; the Government claims 209 million of the country’s 210 million households are now covered by banking, especially, under the PMJDY. The accounts opened, and cumulative deposits across the accounts totalled to Rs. 9,188 crore. The share of women account holders was about 51 percent and 60 percent of the accounts were in rural areas\textsuperscript{21}.

In another similar initiative of offering card services i.e. Rupay cards; 10 crore beneficiaries are already covered by March 2016, who will get a benefit of personal accidental insurance of Rs. 1 lakh under the Yojana. In addition, a life insurance cover of Rs. 30,000 is also being provided to eligible beneficiaries\textsuperscript{22}.

However, if the purpose of opening a bank account is to use financial services and save and invest, then the performance is dismal. Recent past studies shows a dreary result of such achievements when it comes to the use of such accounts. According to the World Bank’s Global Financial Development Report (2014) only 11 percent of those who had a bank account had savings and only eight percent took loans. Equally alarming are the number of bank accounts that are opened and lie dormant. The Reserve Bank of India (RBI) 2011–12 Annual Report also indicates and official data released by the Government shows that almost 75 percent of savings accounts lie dormant\textsuperscript{23}.

While the Government of India has progressively initiated addressing the issues of exclusion through its schemes and programs simultaneously, Government and Reserve Bank of India have also introduced breakthrough policy reforms by introducing specialized institutional models to address the exclusion issues of specific nature. In the 2015 budget, the Government of India proposes to create a ‘Micro Units Development Refinance Agency (MUDRA) Bank,’ with a corpus of Rs. 20,000 crore, and credit guarantee corpus of Rs. 3,000 crore. The objective is defined for the MUDRA Bank to ‘fund the un-funded;’ specifically address the issues of exclusion the small business units face in India. As per the NSSO survey 2013, there are 5.77 crore small business units, mostly individual proprietorship (62 percent owned by SC/ST/OBC), and a mere four percent of them get institutional finances\textsuperscript{24}. Government also clearly ropes-in the microfinance sector across the institutional and operational models to pursue this objective as a key delivery channel at the grass-roots level under the MUDRA.

In another massive initiative, on November 27, 2014 the Reserve Bank of India introduced ‘Small Finance Bank\textsuperscript{25} and Payment Bank\textsuperscript{26}. Ten institutions are approved in principle to Small Finance Bank license, out of which eight are NBFC-MFIs and 11 institutions, primarily Mobile Network Operators (MNOs), are approved in principle to the licenses of Payment Bank in India. At the same time, the

\textsuperscript{20} http://www.thehindu.com/news/national/1150-cr-bank-accounts-opened-under-jan-dhan-yojana/article6806138.ece
\textsuperscript{22} Indira Iyer, Financial Inclusion Need for Differentiation between Access and Use in EPW, February 14, 2015 vol l no 7, Page 19
\textsuperscript{23} http://pib.nic.in/newsite/PrintRelease.aspx?relid=116209
\textsuperscript{24} https://rbi.org.in/scripts/bs_viewcontent.aspx?id=2901
prime thrust has been on digitization of financial inclusion drive across the models. While these developments are most promising and have the potential to accelerate the financial inclusion and are able to meet the need of the last mile, there is a clear road map that needs to be drawn to guide these developments to meet it objective.

What does the future hold for financial inclusion in India?

Financial inclusion initiatives in India have arrived at a very critical stage. On one hand, a wide spectrum of supply side players are gearing up, at the same time, new hybrid models and technology led financial services space are driving innovations to crack the last mile riddle. Models like business correspondent and MFIs are converging; similarly 10 in-principle licensed NBFC/NBFC MFIs are expected to launch themselves into Small Finance Banks (SFBs), thus bringing in a whole new suite of customer centered products for unbanked and underbanked segment. Similarly Payments Banks and their potential synergies with NBFC-MFIs and other delivery channels on lending side open a whole new arena for payments led wholesome banking in India.

All this is taking place in addition to the Government of India’s efforts in deepening and widening financial inclusion infrastructure in India through schemes like Jan Dhan - Aadhaar (Unique Identity Details) and Mobile (JAM), Micro Units Development and Refinance Agency (MUDRA), and National Payments Corporation of India Ltd. These are the rails of payments led financial inclusion in India, and for MFIs in India, which have network efficiencies in the remotest corners of the country and an impeccable understanding and proximity to last mile customers, new avenues for strategic business growth are plentiful. However, with the evolving ecosystem, financial inclusion will be based on the ability of supply side players to partner with each other and leverage each other’s strengths; as India is such a vast and diverse country, it is unlikely that any single player could deliver on standalone basis. In this emerging context relevance and strength of Indian MFIs lies in their proven business model, deep penetration and client proximity which offers them an edge over many other market participants. Another key aspect that needs to be carefully incorporated into the entire drive of the financial inclusion is the idea of responsible finance. Making the supply side more sensible and responsible in offering suitable product requires innovation and testing of ideas and products on a regular basis. While massive investment and effort has gone into addressing the financial education needs of the clients, still financial capability of the demand side to participate in these developments has to be the priority of the industry and should pursue in a continual approach. In the digitization of the financial inclusion it should also be the prime focus to protect the underprivileged from unforeseen risks and the privacy of the identity should be maintained at the highest level.

The recent initiatives are encouraging and their future success lie on how well the sector will be able to consolidate the achievement, acknowledge the strength among them and initiate new partnership and collaboration to address the issues of exclusion in country.
Nepal is at a crucial stage in its development history. Since the end of the civil war in 2006, Nepal has come a long-way, and made rapid strides in promoting political stability and economic development in the country. Since 2013, a democratically elected government has been instated, and the country is now governed by the 'Constitution of Nepal' that came into effect on September, 2015, replacing the Interim Constitution of 2007. The State of Nepal has gone through various phases of transition in the last two to three decades, from a monarchy to a republic; from a state of authoritarianism to democracy; and finally from a centralized state to devolution of autonomy at the regional and local levels. These are landmark developments that are paving the way for inclusive growth in Nepal and ensuring a smooth transition of the country into a new phase of development, by laying the struggles of the previous two-three decades to rest.

Nepal has made commendable strides in poverty reduction between 1996 and 2011, with a fall in poverty incidence from nearly 42 percent to 25.2 percent during this period\(^1\). Despite the remarkable decline in overall poverty level, poverty in rural Nepal, which is home to 80 percent of the country’s population, is still significantly higher than urban Nepal. Moreover, the incidence of poverty in the

mid-western and far-western mountainous regions of the country, where the terrain is rugged, rainfall is low and the poor-quality soil is difficult to farm, is nearly 50 percent. Agriculture is the major contributor to Nepal’s economy, with a share of 36 percent in national GDP and 66 percent in employment. Therefore, the development of agriculture sector is essential for the development of national economy.

Improved access to rural finance and the growth of microfinance institutions, combined with an increase in remittances has had a significant impact on the reduction of poverty in Nepal. Along with an increase in the number of financial institutions in Nepal, the Central Bank’s interventions such as special interest rates have encouraged financial institutions to expand their branch networks. As of mid-2011, there are 1,245 bank branches in Nepal, an increase of 45 percent from 2008. Moreover, the World Bank’s Global Findex 2014 reveals that 34 percent of adults in Nepal have a formal account, and 16 percent of adults have formal savings. Thus, Nepal performs better than other countries of the South Asian region in this regard.

Policy interventions by the Nepal Government to make financial services available to excluded populations have been encouraging. The Government along with the Central Bank recognizes that “unrestrained access to public goods and services is considered to be the sine qua non of an open and efficient society and since financial services possess basic features of the public good, it is essential that availability of financial services to the entire population without discrimination is the prime objective of any public policy.”

Over the last decade, development indicators have shown encouraging results. Nepal has seen its aggregate human development indicators improve and per capita incomes increase, and there are signs that such improvements are positively affecting levels of social cohesion and citizen empowerment throughout the country. For example, recent survey evidence suggests that: socio-political participation is increasingly not determined by ethnic and caste status; that inclusion in civil society and political activities is widespread among all segments of the population; and that levels of citizen trust in political and public institutions are primarily influenced by the performance of those institutions rather than by social characteristics of individuals, such as ethnic identity or political affiliation (Askvik et al., 2011).

Nara viewed that based on the state of development as well as environment, people, economy, customs, culture and access, Nepal can be divided into four almost parallel regions viz. mountains, inaccessible hills, accessible hills and Tarai. He viewed that there exist great variations across geographic regions with Tarai the most potential and mountains the least. Tarai and accessible hills have comparative advantage due to dense population, good transport network, high quality and existence of high per capita high quality cultivated land. Limited infrastructure and market access, remoteness, sparse population, climatic conditions, less arable land and limited but specialized economic potentialities further alienates the remote areas. He further pointed out that demand for financial inclusion and microfinance is higher in these areas than in Tarai and accessible hills due to poverty and deprivation.

A brief history of the journey of financial inclusion in Nepal

Nepal has a long banking history with the first bank ‘The Nepal Bank Limited’ established in the 1930s. The late 1950s and 1960s saw the emergence of specialized banks

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2 Enabling Poor Rural People to Overcome Poverty in Nepal, IFAD
3 Government of Nepal website
4 Financial Inclusion: State of the Art in Nepal, Nara Hari Dhakal
5 Livelihoods, basic services and social protection in Nepal; Bishnu Raj Upreti, Sony KC, Richard Mallett and Babken Babajanian, with Kailash Pyakuryal, Safal Ghimire, Anita Ghimire and Sagar Raj Sharma August 2012; - Researching livelihoods and services affected by conflict - Working Paper 7, Secure Livelihoods Research Consortium
6 Towards Expanding the Frontier of Microfinance services in Nepal - Nara Hari Dhakal, 2007
and commercial banks established with the objective of promoting industry, trade and other commercial activities in the country. The Agricultural Development Bank was setup in 1967 (originally a cooperative bank) to finance agri-based loans and agri-business. The banking industry saw large-scale expansion in the late 1970s and 1980s; banks and financial institutions witnessed tremendous growth in volume and complexity and made significant improvements in all the areas relating to financial viability, profitability and competitiveness, as well. However, the outreach of banks remained concentrated to certain segments of the population. Large sections of the population, especially the underprivileged and rural sections, remained out of the ambit of banking services in the country, resulting in widespread significant financial exclusion.

At the same time, it is important to acknowledge the scale of challenges faced by policymakers and regulators in promoting financial access in the country. Nepal is renowned for its diverse terrain, with lowland jungles to hilly and mountainous regions, where physical infrastructure is still weak. Many households, especially in hill and mountain regions, lack access to financial services, and thus walk hours to reach a bank branch. For banks, thriving in rural areas with limited infrastructure has proven difficult and costly. As a result, growth of financial services has largely been an urban phenomenon.

Efforts to promote financial inclusion in the Nepalese financial sector have been an outcome of the strategies implemented by the Government of Nepal (GON), bilateral and multilateral development partners, and the private sector. The Sixth Plan (1980-81 – 1984-85) of the Nepal Government first acknowledged the issues of exclusion, and recognized the necessity of microfinance in addressing the issues of exclusion and poverty. Subsequently, both the government and non-governmental sectors developed and implemented a number of schemes and programs to ensure access to formal credit to the poor; particularly to poor women. The microfinance sector gained momentum during the 1990s, which saw the rise of a number of microfinance service providers, entry of local NGOs and Microfinance Development Banks (MDBs) in the market. Nepal Rastra Bank, the Central Bank of Nepal played a crucial role by emphasizing towards promoting inclusive financial sector development during this period as well.

**Outreach and regional disparity**

The Nepal Government’s provision for deprived sector lending requirements for banks and financial institutions is the key driving factor in promoting microfinance in the country. In addition, the annual monetary policy, Microfinance Policy 2008, Bank and Finance Institutions Act 2006, Act for NGOs involved in Financial Intermediation 1999 and Co-operative Act 1992 are key policies and regulations that provide the macro framework for microfinance activities in the country. A wide range of institutions including Commercial Banks (CBs) Development Banks (DBs), Finance Companies (FCs), Microfinance Development Banks (MDBs), Financial Intermediary NGOs (FI-NGOs) and financial cooperatives engage in promoting financial inclusion within the above policies and provisions.

As of mid-July 2013, there has been considerable progress in the branch network, with commercial banks having reached 1,486 branches, development banks 764, finance companies 242 and micro-finance development banks 646 and average active clients per branch stand at 8,443. Nevertheless, there are very striking regional disparities in coverage of microfinance in Nepal. While the Tarai (plain land) and accessible hill areas have a high population density and provide a better opportunity for financial institutions to do business, the hilly and deprived areas need financial services the most, under these schemes and institutional arrangements. Despite government efforts, the imbalance continues to persist. Table 1 below reemphasizes the skewed reach of banks and financial institutions in Nepal.

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8 The Status of Financial Inclusion in Nepal, Bharat Ram Dhungana (Nepal) and Dr. Prashant Kumar (India) 2015
9 The Status of Financial Inclusion in Nepal, Bharat Ram Dhungana (Nepal) and Dr. Prashant Kumar (India) 2015

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Pathways to Financial Inclusion in South Asia: The role of Microfinance
The number of branches in central development region is very high (45 percent) as compared to other development regions. The far western development region has the lowest number of branches (4.9 percent) of banks and financial institutions whereas mid-western development region has 8.8 percent. Similarly, the population per branch in western development region is lower (6,795) whereas this proportion in far western development region is very high (16,575). The data shows that financial inclusion led by banks and financial institutions in western development region is better. But in the case of far western and mid-western development region, the presence of financial inclusion is very poor. Due to complex geographical location and lack of basic infrastructure, there is limited number of banks and financial institutions in the region. The government and regulatory authority should give adequate attention in providing better financial service infrastructure to enable financial inclusion in these geographical regions. Nara (2011) estimated Nepal market for financial inclusion at 5.684 million people living both in accessible and inaccessible areas. Apart from the people living below poverty line, those residing at the border line are too need access to financial (micro) services.

**Regulation facilitated the practice of microfinance**

Nepal was one of the first countries in South Asia to introduce specific regulations for the microfinance sector: the Development Banks Act, 1996 and the Financial Intermediary Societies Act (FISA), 1998 were both aimed at stimulating the growth of financial services in the rural, mostly unbanked areas of the country. In addition, the Financial Intermediaries Act that enable and legalized ‘Non Profit Organizations (NGOs) to operate as microfinance service providers in the country. Two of the well-known FI-NGOs, Nirdhan, and the Centre for Self-Help Development (CSD) got registered under the Financial Intermediaries Act at the initial days; later 47 NGOs got license to operate as FI-NGOs under the same act.

It was FISA that introduced the concept of a “limited banking license” as a way to legitimize the ongoing financial services activities of NGOs registered as societies and of cooperatives. The main attraction of the limited banking license for cooperatives was the stamp of legitimacy conferred by Central bank supervision. At the same time, the stamp did not initially benefit either NGOs or cooperatives since these institutions were not particularly successful at raising voluntary deposits from members, let alone from the general public. It is partly for this reason that the number of cooperatives licensed under the act has declined, from 35 during 1999 and 2000 to just 16 in July 2011. Overall, the regulatory framework put in place by the Central Bank has been quite liberal with limited capital requirements and low liquidity norms and no cap on

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**Table 1: Region-wise Financial Inclusion Led by Banks and Financial Institutions**

<table>
<thead>
<tr>
<th>S. N.</th>
<th>Dev. Region</th>
<th>Branches No.</th>
<th>Total Population No.</th>
<th>Population per Branch</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Eastern</td>
<td>570</td>
<td>5,811,555</td>
<td>10,196</td>
</tr>
<tr>
<td>2</td>
<td>Central</td>
<td>1,411</td>
<td>9,656,985</td>
<td>6,888</td>
</tr>
<tr>
<td>3</td>
<td>Western</td>
<td>725</td>
<td>4,926,765</td>
<td>6,795</td>
</tr>
<tr>
<td>4</td>
<td>Mid Western</td>
<td>278</td>
<td>3,546,682</td>
<td>12,758</td>
</tr>
<tr>
<td>5</td>
<td>Far Western</td>
<td>154</td>
<td>2,552,517</td>
<td>16,575</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>3,138</td>
<td>26,494,504</td>
<td>8,443</td>
</tr>
</tbody>
</table>

*Source: Banking and Financial Statistics, NRB, Mid July 2013.*

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10 State of Microfinance in Nepal- Prepared for Institute of Microfinance (InM), As part of the project on State of Microfinance in SAARC Countries

By Shankar Man Shrestha, 2009 Towards Expanding the Frontier of Microfinance
interest rates. However, political pressure on MFI interest rates still prevails.

In 2004, the Government introduced the Banks and Financial Institutions Ordinance, which was converted into an Act in 2006. It has a provision of licensing microfinance banks under the class ‘D’ banks. As a result, 13 microfinance banks have been issued license by the Nepal Rastra Bank till date. In order to make available small wholesale funds to cooperatives and NGOs serving to low income section of the population, the Government had created a fund called Rural Self-Reliant Fund in 1991 with NPR 20 million. The Government with the assistance from Asian Development Bank and Nepal Rastra Bank also established the Rural Microfinance Development Centre Limited (RMDC) in 1998, to provide larger wholesale loans to MFIs through implementation of the ADB assisted Rural Microfinance Project (RMP).

The introduction of RMDC attracted several MFIs into the microfinance market; this development assisted in increasing the coverage and growth of microfinance institutions operation in country. In 2001, the Government had also instituted another wholesaler, the Sana Kisan Bikas Bank Limited (SKBBL) to provide wholesale funds to the Small Farmers Cooperative Limited (SFCL) to address the finance needs of small and marginal farmer community. Apart from these landmark policy reforms, Government has also been promoting self-help groups under its several rural and community development projects of the government and donors to provide small credit to the self-help group members through grants for seed funds.

Historically, the NGO legal form dominated the microfinance landscape in Nepal. However, the policy reforms encourage a large section of NGOs to transform to Microfinance Development Banks (MFDBs). Since last ten years, there is also a significant trend of commercialization of the sector. The decline in numbers of licensed FINGOs – from 45 in 2007 to 38 in 2011 is largely explaining the growing tendency of FINGOs transforming into banks.

In 2009 when the country experienced a political instability, MCRIL’s Nepal microfinance index, known as CRILEX report, shows the issues of over indebtedness has also reported in the microfinance sector, fostered a sense of crisis in the industry. While microfinance in Nepal has grown steadily at 25 percent to 40 percent per annum for last 8 years from 2003 to 2011; the overall stake of the microfinance sector in the Nepal’s financial system is just about 2.2 percent in 2011, which was just 1.9 percent in 2005.

Microcredit to microfinance in Nepal

The regulatory reforms in late 1990s in Nepal allowed MFIs to mobilize thrift deposits formally from their members and record as part of their balance sheets wherever these were legally permitted. Most MFIs in the country (all 56 partner MFIs of Rural Microfinance Development Centre Ltd. (RMDC), for instance) are able to offer deposit services. Initially, though, due to the lack of public confidence (in FINGOs, in particular) not all MFIs were able to take full advantage of this. However, as with MFIs in other countries, public confidence has improved with the longevity of the

Figure 1: Sources of funds for microfinance operations

(Source: Micro-Credit Ratings International Limited Report, 2012)

institutions and the savings orientation of MFIs in Nepal has improved considerably over the years. Cost efficiency has held steady over the years. In 2011, 34.7 percent of the on lending requirement was served by client saving.

The cost incurred by Nepali MFIs in servicing loan accounts is very low in comparison with the global benchmark of $85 global average on the MIX. Even when compared with other Asian MFIs, the cost per borrower in Nepal (Rs. 1, 614 for all MFIs, $22) amounts to just 36 percent of the East Asian median of $61 and is also substantially lower than the MIX median for low end MFIs internationally ($64).

Thus, today a diverse range of financial delivery models are being adopted by financial institutions in Nepal in offering financial inclusion services. Lending modalities such as individual lending, Grameen, solidarity group lending, village banks, village savings and loan schemes, cooperatives and self-reliance group are common. However, the Grameen model is most the common in lending methodology among financial service providers.

Outreach performance of microfinance industry

The outreach performance of the Nepalese microfinance industry shows that ‘D class’ MFIs have 76.7 percent district coverage to target district ratio. The outreach performance in terms of number of branches, members, borrowers, and savers of private MFIs is significantly high as compared to the Government MFIs and wholesale lending MFIs. Although district coverage of MFIs is high (76.7 percent), its services have not been extended in remote rural areas. The microfinance services are basically confined in the surrounding areas of district headquarters, city, and towns where road and basic amenities are available. The inclusive financial system should be developed in the nation that will help in expanding formal financial services to the marginalized and poor people. The outreach performance of microfinance Industry for the year January, 2014 has been presented in Table 2.

Changing landscape of financial inclusion

In the last three to four years, digital financial services have generated considerable interest in Nepal, as a result of the efforts of financial institutions, technology providers, Telcos and international agencies such as USAID. Since then, Nepal’s Central Bank has issued mobile banking regulations and announced its willingness to revisit and improve them as banks and regulators gain more experience with mobile financial services. Since

Table 2: Outreach Performance of Micro-finance Industry in Nepal

<table>
<thead>
<tr>
<th>Indicators</th>
<th>GMFiS</th>
<th>PMFiS</th>
<th>WLMFiS</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>No.</td>
<td>%</td>
<td>No.</td>
<td>%</td>
<td>No.</td>
</tr>
<tr>
<td>District coverage to target district</td>
<td>80.0</td>
<td>60.0</td>
<td>90.0</td>
<td>76.7</td>
</tr>
<tr>
<td>No. of branches</td>
<td>170</td>
<td>1.3</td>
<td>10</td>
<td>1.3</td>
</tr>
<tr>
<td>No. of members</td>
<td>190,089</td>
<td>13.4</td>
<td>890,715</td>
<td>63.0</td>
</tr>
<tr>
<td>No. of borrowers</td>
<td>136,941</td>
<td>13.3</td>
<td>678,691</td>
<td>65.9</td>
</tr>
<tr>
<td>No. of savers</td>
<td>150,902</td>
<td>13.7</td>
<td>947,736</td>
<td>86.3</td>
</tr>
</tbody>
</table>


12 The Status of Financial Inclusion in Nepal, Bharat Ram Dhungana (Nepal) and Dr. Prashant Kumar(India)2015
USAID NEAT has partnered with Mega Bank, a Nepali commercial bank, to support the establishment of branchless banking outlets, and with Laxmi Bank, another Nepali commercial bank, to support the rollout of mobile banking—its Mobile Khatta service—using a shared technology platform. Over 300 mobile financial services agents in 16 districts are operational in Nepal today. Banks report that transactions conducted through a mobile agent cost less than 1/20th of those conducted through a bank branch. And reducing the outreach cost is critical to getting financial services to the large rural, unbanked population. Today, a number of institutions are refining their strategies, products and pricing to ensure the success and growth of these innovative services.

Nepal is a tough terrain for financial services delivery and thus alternative channels such as agent networks, ATMs, ultra-small branches, kiosks and credit service centers can play a crucial role in improving accessibility for a large number of customers. However, while alternative delivery channels surely are the way forward for Nepal and the South Asian region as a whole, there is a need to address a number of barriers on the demand and supply, such as the adoption of technology by low-income households and weak infrastructure in rural and remote areas. Moreover, in order to achieve the goal of universalizing financial inclusion in Nepal, policymakers and regulators will need to focus on improving financial literacy and awareness of formal financial services.

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Situated in the north-western portion of the South Asian subcontinent, Pakistan has a rich economic history that dates back to one of the earliest known human civilizations— the Indus Valley Civilization. Pakistan is the sixth most populous country in the world with an estimated population of 185 million\(^1\), which is spread across its diverse blend of landscapes from the SWAT valley in the north to Sindh in the south.

As a result of concerted efforts by policymakers and international development agencies, and strong economic growth in the last decade, Pakistan has taken positive strides to alleviate core development challenges during this period. The proportion of population living below poverty line has come down from 34.5 percent in 2001 to 22.3 percent in 2005\(^2\). Moreover, between 1980 and 2014, Pakistan’s Human Development Index value has increased from 0.353 to 0.538, a commendable increase of 52.5 percent. However, sustainable development and poverty alleviation continue to remain a challenging policy issue, exacerbated by the adverse impacts of frequent natural disasters such as floods and earthquakes and security concerns.

It is widely acknowledged that a well-developed financial system can play a key role in catalyzing the development process of a country. Financial deepening has been associated with higher economic growth and a faster growth of the income of the poor than average GDP per capita, thus leading to a reduction in inequalities. Beginning with the process of bank nationalization in the 1970s, Pakistan has made significant efforts to strengthen its

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\(^1\) http://data.worldbank.org/country/pakistan

\(^2\) http://data.worldbank.org/country/pakistan
banking and financial system. In the last four decades, several new financial institutions and delivery models have emerged to expand the access of financial services to underserved sections of society. The story of the rise of community-based finance programs in Pakistan resembles that of other countries in the South Asian region - the indispensable role of non-governmental organizations in mobilizing communities and promoting financial inclusion.

**Journey of microfinance**

The origins of microfinance in Pakistan can be traced back to a string of socially innovative community development programs, the ‘Orangi Pilot Project’ in Karachi in the early 1980s. Pioneered by Dr. Akhtar Hameed Khan, the program involved local residents solving their sanitation, housing and health challenges by raising local resources at low costs, and minimizing reliance on external support. In 1988, the Orangi Charitable Trust was set up which focused on providing microcredit, financial services- from setting up cooperatives of small producers, and providing microcredit to small entrepreneurs in Orangi in the late 1980s, and supporting other NGOs and Community-Based Organizations (CBOs) in both urban and rural areas in Pakistan in promoting microcredit in their areas of operation in the 1990s. Another significant development during this period was the launch of Aga Khan Foundation’s (AKF) Rural Support Program in northern areas of Pakistan in 1983. The focus of AKF’s rural support program was to promote access to necessary financial and technical resources at the community level. A defining feature of these early programs in Pakistan was their philanthropic character. Figure 1 provides a brief history of the evolution of the microfinance sector in Pakistan.

The 1990s saw the rise of a number of NGOs and institutions set up with the exclusive purpose of offering microfinance services. Established in 1991, Pakistan’s National Rural Support Program (NRSP) also provided

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3 The evolution of the microcredit programme of the OPP’s Orangi Charitable Trust, Karachi, Arif Hassan and Mansoor Raza, 2011
a considerable push to poverty alleviation programs with an emphasis on promoting linkages with affordable financial services and income-generating activities for the rural poor. In 1996, the United Nations Development Programme set up an action-research project, the ‘Urban Poverty Alleviation Programme’ with a goal was to develop an indigenous model of poverty alleviation through providing financial services to poor women. Following its initial success and financial viability, the program was incorporated into the NRSP. This period also saw the entry of specialized financial institutions such as the Network Leasing Corporation (NLCL) and Orix Leasing Pakistan limited into the microfinance industry. At the same time, there was increasing global interest in microfinance as a tool for poverty alleviation.

The dawn of the 21st century paved the way for landmark policy and regulatory developments in Pakistan’s microfinance sector, and laid the foundation for a period of steady growth in outreach and operations. The Government of Pakistan introduced the Microfinance Institutions Ordinance in 2001 and since then, several major initiatives have been taken towards promoting the microfinance sector. Widely recognized as a progressive and facilitative framework, its passage has, to date, resulted in the establishment of eight privately-owned and operated Microfinance Banks (MFBs) with a singular focus on the provision of microfinance services. The MFI Ordinance was supplemented with a set of Prudential Regulations (PRs). The PRs laid out a comprehensive set of criteria to establish MFBs and carry on operations. Several iterations of the PRs have been issued over the years to keep pace with the industry’s changing landscape.

A landmark initiative during this period was the formation of the Pakistan Microfinance Network (PMN) – a representative body of microfinance institutions that promotes microfinance in the country. The PMN traces its beginnings to 1997 when a group of microfinance practitioners laid its foundations as an informal platform for coordination, exchange of ideas and peer learning. In 2001, PMN successfully become a separate legal entity and since then the Network has grown significantly.

Another significant policy development in 2000 was the establishment of a wholesale window of finance for NGO-MFIs - the Pakistan Poverty Alleviation Fund. The primary objective of the Fund was to promote and empower pro-poor institutions that serve populations at the bottom of the pyramid, by providing on-lending funds and grant support to them.

Together, these policy and regulatory developments gave a significant boost to microfinance operations in Pakistan. Pakistan’s microfinance sector expanded outreach at an average annual rate of 49.6 percent during 2000-2007. By 2008, outreach stood at 1.7 million active borrowers. Moreover, the industry showed signs of growing maturity as reflected in the expansion of financial services across geographies and market segments, improved client responsiveness, and lowering of transaction costs.

However, as with the rapid growth of microfinance in Bangladesh in the early 21st century, the first signs of stress, over-indebtedness and possible mass default began to emerge in Pakistan around this time. The predominant view in existing literature is that this phase of expansion was accompanied by weak internal controls and risk management systems. Moreover, lending concentration and multiple borrowing, and a loss of MFI credit discipline also contributed to the problem.

To stimulate growth of the sector on a sustainable basis, the State Bank of Pakistan spearheaded the formulation of a National Microfinance Strategy in 2007, which paved the way for enabling regulations to support alternate delivery channels such as branchless banking, setting up of funding mechanisms. Historically, a major reason for low access to financial services in Pakistan has been the high cost and time implications in accessing bank branches by people.

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4 http://nrsp.org.pk/urban-poverty-alleviation-programme.html
living in rural and remote areas. Moreover, women in these areas face additional challenges due to constraints on their mobility largely for multiple reasons. Hence, the advent of branchless banking in 2008 has given financial inclusion efforts a significant boost. As a result of the Central Bank’s progressive stance in promoting banking innovations, today Pakistan is one of the fastest developing markets for branchless banking in the world, and leads the South Asian region in this regard.

In 2008, another innovative model of microfinance that emerged was the partnership between First Micro Finance Bank and Pakistan Post (FMFB), to scale up microfinance services in rural and urban areas of the country. It provided FMFB with an opportunity to serve financially excluded sections of society, by leveraging Pakistan Post’s extensive outreach networks. Another key development during this period was the Central Bank’s move to allow Microfinance Banks to open kiosks at third party premises. Together, these innovative approaches laid the foundation for the promotion of financial inclusion in Pakistan and also provided impetus to the industry which was undergoing a slowdown at this point. Moreover, the slowdown in credit growth provided service providers with room to develop support infrastructure and risk-management systems, as well as diversify their product offerings.

Since 2000, microfinance in Pakistan has come a long way and is now considered as one of the key pillars of economic development and poverty alleviation. The State Bank of Pakistan has followed an innovative and liberal approach towards continuous improvement in its regulatory framework for microfinance and today, Pakistan’s regulatory environment for microfinance is ranked among the best in the world.

As a result, a diverse range of institutions have emerged that serve the needs of financially excluded and vulnerable sections of society. These can broadly be classified into Microfinance Banks (MFB) and Commercial Banks involved should help in achieving more transparency in microfinance, falling under the regulatory ambit of the State Bank of Pakistan; leasing companies involved in micro-leasing regulated by the Securities Exchange; and Rural Support Programmes (RSP), Microfinance Institutions (MFI), and Cooperatives. The prominent among these are MFBs, MFIs and RSPs. (Table 1)

While the progress of financial inclusion in Pakistan has been commendable thus far, the growth in access has not always been even. Women are still largely excluded from the formal financial system. Only 4.8 percent of adult women have a formal account. Constraints on mobility and social interaction restrict women’s access to financial services. While the advent of digital financial services may be able to alleviate some of these barriers, there is a 42 percent gender gap in the ownership of mobile phones in Pakistan. Thus, addressing these imbalances requires careful attention to not only the life-cycle needs of women, but also their gendered experiences with respect to social interactions and mobility.

### Mitigating risks

While the microfinance sector in Pakistan continues to expand, mature and manage institutional and operational risks, there is a growing recognition of the need to engage with external risks and changing global environments. The

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7 National Financial Inclusion Strategy, Pakistan, 2015
Center for the Study of Financial Innovation’s 2014 *Banana Skins* Report reveals macroeconomic trends and security as the topmost concerns for stakeholders in the microfinance industry (Table 2). While political interference emerges as the biggest risk in the South Asian region, the global microfinance sector faces risks of over-indebtedness. Thus, for the microfinance sector in Pakistan to stay on its current growth trajectory and play a key role in financial inclusion ahead, it is important for policymakers and regulators to pay heed to these concerns.

**Table 1: Microfinance Peer Groups in Pakistan**

<table>
<thead>
<tr>
<th>Microfinance Institution (MFI):</th>
</tr>
</thead>
<tbody>
<tr>
<td>A non-bank, non-government organization (NGO) providing microfinance service. Organizations in this group are registered under a variety of regulations including the Societies Act, the Trust Act, and the Companies Ordinance. The MFI peer group includes local and multinational NGOs such as BRAC-Pakistan and ASA-Pakistan.</td>
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</tbody>
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<thead>
<tr>
<th>Microfinance Bank (MFB):</th>
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<tbody>
<tr>
<td>A commercial bank licensed and prudentially regulated by the central bank of Pakistan to exclusively service the microfinance market. The first MFB was established in 2000 under a presidential decree. Since then, seven MFBs have been licensed under the Microfinance Institutions Ordinance, 2001. MFBs are legally empowered to accept and intermediate deposits from the public.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Rural Support Programme (RSP):</th>
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<tbody>
<tr>
<td>Also an NGO registered as a non-profit section 42 company under the Companies Ordinance. An RSP is differentiated from the MFI peer group based on the purely rural focus of its credit operations. As a group, the RSPs are registered with and supervised by the Securities and Exchange Commission of Pakistan (SECP).</td>
</tr>
</tbody>
</table>

*Source: Pakistan Microfinance Review, 2009*

**Table 2: Regional and Global Comparison of Top Ten Risks**

<table>
<thead>
<tr>
<th>Top Ten Risks to the Microfinance Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Pakistan</strong></td>
</tr>
<tr>
<td>1 Macro-Economic Trends</td>
</tr>
<tr>
<td>2 Security</td>
</tr>
<tr>
<td>3 Profitability</td>
</tr>
<tr>
<td>4 Credit Risk</td>
</tr>
<tr>
<td>5 Inappropriate Regulation</td>
</tr>
<tr>
<td>6 Competition</td>
</tr>
<tr>
<td>7 Political Interference</td>
</tr>
<tr>
<td>8 Interest Rates</td>
</tr>
<tr>
<td>9 Managing Technology</td>
</tr>
<tr>
<td>10 Natural Disasters</td>
</tr>
<tr>
<td>*<em>South Asia</em></td>
</tr>
<tr>
<td>1 Political Interference</td>
</tr>
<tr>
<td>2 Over indebtedness</td>
</tr>
<tr>
<td>3 Client relationships</td>
</tr>
<tr>
<td>4 Regulation</td>
</tr>
<tr>
<td>5 Risk management</td>
</tr>
<tr>
<td>6 Funding</td>
</tr>
<tr>
<td>7 Competition</td>
</tr>
<tr>
<td>8 Competition</td>
</tr>
<tr>
<td>9 Credit risk</td>
</tr>
<tr>
<td>10 Management</td>
</tr>
<tr>
<td>*<em>Global</em></td>
</tr>
<tr>
<td>1 Over indebtedness</td>
</tr>
<tr>
<td>2 Credit Risk</td>
</tr>
<tr>
<td>3 Competition</td>
</tr>
<tr>
<td>4 Governance</td>
</tr>
<tr>
<td>5 Risk management</td>
</tr>
<tr>
<td>6 Strategy</td>
</tr>
<tr>
<td>7 Competition</td>
</tr>
<tr>
<td>8 Management</td>
</tr>
<tr>
<td>9 Regulation</td>
</tr>
<tr>
<td>10 Staffing</td>
</tr>
</tbody>
</table>

*Microfinance Banana Skins* 2014
From inclusive finance to responsible finance

Pakistan was an early adopter in the development of credit reporting systems, with the State Bank of Pakistan establishing a Credit Information Bureau (CIB) in 1992. In 2003, while the system was made electronic, only loans beyond Rs. 500,000 rupees were due to be reported into the system. Thus, information on microcredit loans was not captured in this system. Concerns regarding the health of the microfinance industry during 2007-09, have prompted a series of consumer protection initiatives by the industry association PMN. In response, PMN launched a consumer protection initiative that aims to improve practices through a voluntary code of conduct and related measures. The code of conduct offers PMN’s members—which include regulated microfinance banks as well as unregulated MFIs—a common client protection vision and guidance to improve practices.

In a bid to promote further transparency and accountability in the industry, and ensure adherence to client protection, the Microfinance-Credit Information Bureau (MF-CIB) was launched in Pakistan in June 2012. Over the past three years, the MF-CIB has been gradually integrated into the ecosystem of the sector and is expected to play an important role in improving transparency, as well as promoting financial inclusion in the country.

Universalizing financial inclusion by 2020

In line with the World Bank’s vision of achieving Universal Financial Access by 2020, Pakistan has developed a comprehensive National Financial Inclusion Strategy (NFIS) for 2015-2020, which serves as a roadmap and call to action for key stakeholders in the country. The strategy is a testament to the country’s commitment to financial inclusion efforts and serves as a guide to promote

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**Figure 3: The Enabling Environment for Financial Inclusion: Findings from Global Microscope 2015**

<table>
<thead>
<tr>
<th>Rank/55</th>
<th>Score/100</th>
<th>A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>Peru</td>
<td>90</td>
</tr>
<tr>
<td>2</td>
<td>Colombia</td>
<td>86</td>
</tr>
<tr>
<td>3</td>
<td>Philippines</td>
<td>81</td>
</tr>
<tr>
<td>4</td>
<td>India</td>
<td>71</td>
</tr>
<tr>
<td>5</td>
<td>Pakistan</td>
<td>64</td>
</tr>
</tbody>
</table>

While financial inclusion in Pakistan remains low, recent trends suggest that the country is making concerted efforts in the right direction. Pakistan was placed fifth in the Global Microscope 2015’s list of enabling environments for financial inclusion, up six points from its 2014 score. This reflects an energetic, sustained effort by the government to strengthen the financial inclusion landscape of the nation. This includes a well-documented National Strategy for Financial Inclusion, which serves as a roadmap for all stakeholders.

*The Economist Intelligence Unit’s Global Microscope Report assesses the regulatory environment for financial inclusion across 12 indicators and 55 countries.

Source: Global Microscope 2015: The enabling environment for financial inclusion, Economist Intelligence Unit

financial inclusion over the next five years\textsuperscript{9}. The NFIS reiterates the need to put in place key enablers such as public and private sector commitment, an enabling legal and regulatory environment and digital infrastructure that can promote universal access to formal financial services. On the implementation side of the strategy, the Government has simplified basic account opening with the ‘Asaan’ Account initiative; the Credit Bureau Act has been passed by the National Assembly, which will improve the regulatory framework, preserve consumer protection and increase the depth of available credit information; and the Government has joined the global Better than Cash Alliance Initiative (BTCA), which signals its commitment to the digitization of payment processes.

Despite the concerted efforts of the Pakistan Government and other key stakeholders, Pakistan continues to face a number of barriers in universal access to financial services. Only 13 percent of adults in Pakistan have a formal account, as compared to the corresponding figure of 46 percent for South Asia. Five percent of the world’s unbanked population lives in Pakistan. Moreover, there are stark gender imbalances in the access to financial services—less than 5 percent of women are included in the formal financial sector, compared to South Asia’s average of 37 percent. At the same time Pakistan is leading the way in South Asia in digital finance, 6 percent of adults have mobile accounts, compared to South Asia’s average of less than 2.6 percent. (World Bank Findex, 2014)

In such a scenario, the microfinance industry can play a crucial and critical role in promoting inclusive finance at the grassroots level in Pakistan. By working in tandem with other stakeholders and utilizing its synergies with branchless banking and outreach in rural areas, the sector can be a key channel for improving access to financial services across the country in the future as well. By envisioning a National Financial Inclusion Strategy, Pakistan has taken a significant leap towards achieving financial inclusion, and demonstrated its commitment to the realization of this goal. Universalizing financial inclusion by 2020, however, will require a ceaseless commitment to the implementation of the strategy by all stakeholders in the next five years.

\textsuperscript{9} National Financial Inclusion Strategy Pakistan, 2015
Sri Lanka, also known as the pearl, is an island nation south of India. The country has a population of over 21 million. According to the International Monetary Fund, Sri Lanka’s GDP in terms of purchasing power parity is second only to the Maldives in the South Asian region in terms of per capita income. The economic growth in Sri Lanka has been among the fastest in South Asia in recent years. Between 2002 and 2013, average growth is 6.3 percent, with Gross Domestic Product (GDP) per capita rising from US$ 859 in 2000 to US$ 3,256 in 2013. Preliminary indications are that GDP further increased by 7.8 percent in 2014-15. National poverty incidence declined from 26.1 percent in 1990-1991 to 6.7 percent in 2012-2013 driven by improved farm incomes, greater productivity among urban workers, and a lower dependency ratio. Economic prosperity has also been broadly shared. But pockets of poverty persist, especially in the post-conflict regions of the North and East. Safety net spending has fallen sharply as a share of GDP and needs to be better targeted.

In education, Sri Lanka has made impressive gains. The overall literacy rate of Sri Lanka is high at 95.7 percent for age 10 and above. It has lifted primary school enrolment levels to almost 100 percent, and has as many female to male enrolment ratio. Sri Lanka’s public spending on education is modest compared to other middle income countries. It has also achieved excellent results in the area of health, especially in view of its relatively low spending on healthcare, although malnutrition among mothers and children remains high. In 1977 the Sri Lankan economy was opened up, promoting deregulation and entry of private enterprises. The country’s main economic sectors are tourism, tea export, clothing, rice production and other agricultural products. In addition to these economic sectors, overseas employment, especially in the Middle East, contributes substantially in foreign exchange. Women in Sri Lanka have been contributing significantly in economic activities over centuries of history primarily through employment. Due to low productivity and

inadequate incomes in the agricultural sector, women in small farm families have moved from unpaid family labor to other occupations, in particular, to garment factories and employment abroad.

Sri Lanka’s formal financial sector consists of 24 licensed commercial banks and nine licensed specialized banks, with a network of over 6,400 bank branches and other banking outlets and around 2,500 ATMs. Moreover, there are 48 Licensed Finance Companies (LFC) and Specialized Leasing Companies (SLC), with a network of over 1,000 branches taken together. Recent years have seen a notable expansion in the banking sector as well as the LFC and SLC sectors, with a number of branches being opened in provinces other than the Western Province (CBSL 2013).

Microfinance in Sri Lanka

Microfinance services in Sri Lanka have a wide geographical outreach but the extent of outreach of private operators including NGOs and commercial banks in rural areas is rather limited. Although the poor and the poorest groups have been reached by Microfinance Institutions (MFIs), a significant proportion of microfinance clients seems to be from the non-poor groups. It has worked as an instrument of consumption smoothing among almost all income groups. Microfinance has helped middle income households to increase their income levels and assets. It has also helped the very poor to increase their consumption expenditure and has also inculcated savings habits among them. In relation to women, microfinance in Sri Lanka has helped women increase their social status and improve the economic conditions.

History of microfinance in Sri Lanka is rooted in the cooperative movement, which was formalized by cooperatives ordinance in 1911. The microfinance movement in Sri Lanka dates as far back as 1906 with the establishment of Thrift and Credit Co-operative Societies (TCCSs) under the Co-operative Societies Ordinance introduced by the British colonial administration. These were the first credit co-operatives to be established in Sri Lanka. The network of TCCSs was weak and in decline by the late 1970s and therefore were reorganized under a new name of SANASA as member owned societies.

In 1985 the government established 17 Regional Rural Development Banks (RRDBs) in order to reach remote rural areas and smallholders who lacked access to financial services from commercial banks. The RRDBs covered all districts of Sri Lanka with the exception of the North and East. Their success, however, was limited by internal structural weaknesses and excessive geographical fragmentation, which prevented them from reaching a critical mass.

The late 1980s and 1990s also saw the entry of several local and international NGOs into microfinance business. Many of these NGO-MFIs originally combined microfinance activities with other social and community development activities. Apart from NGO-MFIs the Government also forms a key player in the delivery of microfinance services in Sri Lanka. The Government’s Samurdhi Savings and Credit Scheme established in 1996 is presently one of the largest social mobilization programs in Sri Lanka, with over 32,000 village level societies and over 1000 bank branches operating island-wide. Moreover, the Central Bank of Sri Lanka (CBSL) is another key player, which functions as the executing agency of a number of rural credit programs funded by various donor agencies and the Government of Sri Lanka.

Currently, there is a wide range of institutions that are involved in providing microfinance services to low income groups. These include, Cooperative Societies (e.g., TCCSs), hundreds of local and international Non-Governmental Organizations (NGOs), commercial banks (both state-owned and private) and development banks such as the Regional Development Banks (RDBs) and the Sanasa Development Bank (SDB). The tsunami of 2004 led to the channeling of significant amount of foreign aid into the microfinance sector of the country.

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1 Saman Kelegama and Ganga Tilakaratna, Financial Inclusion, Regulation, and Education in Sri Lanka. ADBI 2014
The microfinance sector and the mainstream financial sector, that serve low income segment of customers, have overlapped in Sri Lanka in recent years, serving the financial needs of a broader group of households across a range of income groups. Commercial banks and other formal financial institutions have moved down-market, providing financial services to the lower-income groups, while some MFIs have diversified their services and products, enabling them to attract clients from middle and higher-income groups. This convergence between the two sectors has contributed to a great extent to the high level of financial access and increasing multiple “clientship” (i.e., accessing multiple financial institutions) in Sri Lanka’s financial sector. Furthermore, some MFIs are gradually moving away from their initial objective of poverty alleviation or income generation among the low-income groups, to become more profitable and financially viable institutions. They encourage relatively better-off households (with better repayment capacity) to join them, either by offering relatively larger loans or through special credit schemes targeting higher income groups.

Despite the large number of institutions involved in providing microfinance facilities in Sri Lanka, their impact on reducing poverty or improving household welfare is not very clear. Only a few studies have been undertaken to assess how microfinance has impacted on poverty and living conditions of the households in Sri Lanka. Even these studies, in general, are confined to one or few MFIs/programs, or to limited geographical locations (Colombage, 2004; Shaw, 2004; Gunatilaka and Salih, 1999; Gunatilaka et al., 1997; Hulme and Mosely, 1996). A comprehensive

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**Figure 1a: Adults with an Account at a Formal Financial Institution**

- Sri Lanka
- Bangladesh
- India
- Nepal
- Pakistan
- Afghanistan

0 10 20 30 40 50 60 70 80

% of adults

**Figure 1b: Adults who Borrowed from a Formal Financial Institution**

- Bangladesh
- Sri Lanka
- Nepal
- India
- Afghanistan
- Pakistan

0 5 10 15 20 25

% of adults

study covering participants from a wide range of MFIs and diverse geographical locations has been an important lacuna in evaluating the effectiveness of microfinance in reducing poverty in Sri Lanka.

**Emerging trends: from microfinance to financial inclusion**

The banking and financial sector in the country is strong for financial inclusion and is committed to engage in social responsibility related work as well, or to reach out to vulnerable and disadvantaged groups. According to the World Bank (2012), Sri Lanka has the highest share of adults with formal financial accounts (68 percent) in South Asia, which is much higher than in India, Pakistan, Nepal, and Afghanistan (For more details see Figure 1a and 1b).

A considerable share of households across all income groups has accessed both MFIs and formal financial institutions like commercial banks\(^6\). This is somewhat contrary to the conventional wisdom that low-income groups are excluded from the formal financial sector. As shown in Figure 2, about 64 percent of households access both formal financial institutions like commercial banks and MFIs for their financial needs. In fact, the share of households accessing both types of financial institutions has increased significantly in recent years, from about 38 percent in 2006/07 to 64 percent in 2009/10. Interestingly, a considerable share of households in the lowest-income groups also access commercial banks for their financial needs.

With the growth and expansion of financial institutions in recent decades, accessing multiple financial institutions by households has become a common phenomenon in Sri Lanka’s financial sector in recent years. Tilakaratna (2012) found that the share of households accessing multiple financial institutions for their credit and savings needs had increased to around 84 percent by 2009/10 (from an already high level of 60.2 percent in 2006/07). On average,

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\(^6\) Saman Kelegama and Ganga Tilakaratna, Financial Inclusion, Regulation, and Education in Sri Lanka. ADBI 2014
a household had accessed three financial institutions by 2009/10 for their credit and/or savings needs—a noticeable increase from 1.9 financial institutions in 2006/07.

While access to multiple financial institutions by households suggests a high level of financial inclusion in the country, empirical evidence shows an increase in household debt levels particularly among households that borrow from multiple financial institutions. Tilakaratna and Hulme (2013) found that the average debt-income ratio among the MFI borrowers—an important indicator of borrower indebtedness—had increased from 10.5 percent in 2006/07 to 13 percent in 2009/10, indicating an increase in the level of debt (or indebtedness) at the household level during this period.

A number of factors have contributed to the high level of financial access at the household level in Sri Lanka. A wide network of financial institutions—including both formal and semi-formal financial institutions like banks, leasing and finance companies, co-operative societies, and MFIs—with over 14,000 “access points” and multiple financial institutions operating in many areas of the country, is one of the key factors that have contributed to the high level of financial access at the household level. Availability of a range of financial services and products, such as savings products (ordinary savings, fixed deposits, children’s savings, and special savings products for women, the elderly, etc.), different types of loans (e.g., housing loans, income generation loans, consumption loans), pawning, money transfer facilities, and insurance through financial institutions are other important contributory factors explaining the high level of financial access in Sri Lanka. Relatively good infrastructure facilities and the country’s geographic characteristics, such as its small size and high population density, in conjunction with relatively high literacy and low levels of poverty, have at least indirectly contributed to the high level of financial access at the household level.

Challenges and constraints to financial inclusion in Sri Lanka
Despite the long history of microfinance in Sri Lanka and a proliferation of institutions engaged in microfinance activities, it is only in recent years that questions concerning sustainability, transformation and an inclusive financial system have been given serious consideration by practitioners, policymakers and other stakeholders. The major challenges faced by MFIs in Sri Lanka revolve around lack of regulations in microfinance sector, legal restrictions on MFIs to accept deposits, lack of level playing field, multiple borrowing, and unethical practices in microfinance by some players.

The volatile political situation in the country has also been detrimental to financial inclusion, including a lack of progress on the passage of the Microfinance Bill. Strengthening of the regulatory framework governing the microfinance segment is crucial to improving financial inclusion in Sri Lanka. Lastly there is a lot of scope that exists in improving financial inclusion, particularly related to the cost and quality of financial services provided, client protection and the sustainability of financial institutions.
Way forward

Sri Lanka enjoys a high level of access to financial institutions compared with the other South Asian countries. Its financial sector comprises a wide range of financial institutions (both formal and semi-formal) providing a wide variety of financial services such as loans, savings, pawning, leasing and finance, and remittance and money transfer facilities. Despite the high level of access to financial institutions for loans and savings facilities, the use of insurance services, remittances (through formal channels), ATM facilities, e-payments, and mobile banking, remains low. This is partly due to lack of awareness of these services among people in low-income groups. Technological innovations, such as mobile banking, therefore become crucial in leading to financial inclusion in the country by reducing the transaction costs of reaching out to those in remote areas. The popularity of some mobile financial services like eZ Cash is on the rise. A report published by GSMA (mobile operators association) in 2014 states an increase in the number of eZ Cash users in Sri Lanka. The high rate of financial inclusion is a promising sign towards stronger demands for mobile banking solutions in future. The ability to access money transfer, bill payments and other services through mobile applications would also enable banks to overcome the challenge posed by low ATM and bank branch coverage in a cost efficient way. The growing demand for and competition from eZ Cash will likely encourage Sri Lankan banks to follow the example of their peers in Bangladesh by either partner with existing operator-led MFS services, or by launching their own SMS-based services to respond to current customer needs. The growth in financial services and its mobile applications however require designing financial education programs for creating awareness about financial products and financial planning tools (Carpena et al. 2011). Designing the right regulatory infrastructure and policy mix is also crucial for achieving financial inclusion. This requires finding the right balance between protecting clients and fostering an environment that encourages financial inclusion.