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Can Commercially-oriented Microfinance Help Meet the Millennium Development Goals? Evidence from Pakistan

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Summary. — The current emphasis in the microfinance industry is a shift from donor-funded to commercially sustainable operations. This article evaluates the impact of access to microloans from the Khushhali Bank—Pakistan's first and largest microfinance bank which operates on commercial principles. Using primary data from a detailed household survey of nearly 3,000 borrower and non-borrower households, a difference in difference approach is used to test for the impact of access to loans. Once the results are disaggregated between rural and urban areas there is a positive impact in rural areas on food expenditure and on some social indicators such as the health of children and female empowerment. These impacts are observed even in very poor households. These findings suggest that commercially-oriented microfinance and the millennium development goals are not incompatible, given a supportive environment.
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Key words — Asia, Pakistan, microfinance, poverty, impact, empowerment, Millennium Development Goals

1. INTRODUCTION

The Millennium Development Goals (MDGs) reflect ambitious development targets encompassing not only monetary measures of poverty, but also more comprehensive measures of development that quantify development in areas such as education, gender equality, and health. [1] By providing small scale financial services to those on low incomes, microfinance is seen by many as one of the most significant of the instruments to support these targets. Representing this hope, the United Nations declared 2005 the International Year of Microcredit with the goal of "Building Inclusive Financial Sectors to Achieve the Millennium Development Goals" (International Year of Microcredit, n.d.).

None the less, within the microfinance industry it is recognized that microfinance institutions (MFIs) that rely on aid funding will be subject to the vagaries of aid budgets and will never be able to expand to the scale that will make a major change in poverty and in related social indicators at a national level. The response has been to shift the focus of MFI activity from donor-driven schemes that channel subsidized credit to borrowers to commercially-oriented operations charging interest rates that cover full costs and are thus financially self-reliant. This "commercialization of microfinance" has prompted considerable debate as to how far it is compatible with the original poverty reduction mission of MFIs (Montgomery & Weiss, 2005). One commentator has gone so far as to refer to "a battle for the soul of microfinance" (Harford, 2008). This question cannot be answered *a priori* and empirical evidence is needed to clarify the extent to which there is indeed a trade-off between financial sustainability and achievement of the MDGs and related poverty targets. The trade-off can be examined in various ways. For example, one approach assesses the impact on borrowers of interest rate increases that accompany the shift to a commercially-oriented microfinance sector (Dehejia *et al.*, 2008; Karlan & Zinman, 2008). Another examines a large sample of MFIs covering a variety of institutional forms and lending methodologies to see how far any dilution of poverty focus (as proxied by loan size) can be associated with the MFI's lending methodology, size, or age. The authors conclude that for larger and older MFIs the results are consistent with the view that "as institutions mature and grow they focus increasingly on clients that can absorb larger loans" (Cull et al., 2007, p. 131). This is not necessarily "mission drift" since more poor borrowers could still be served under a commercial model, but it is a warning that even NGO MFIs may not be focusing primarily on the very poor any more. Conducting detailed and rigorous impact studies is difficult and as one review paper has commented: "thirty years into the microfinance movement we have little solid evidence that it improves the lives of clients in a measurable way" (Roodman & Murdoch, 2009, pp. 3–4).

This paper contributes to this debate by focusing on a case-study of a relatively new commercially-oriented microfinance bank. It reports the analysis of survey data collected in Pakistan in 2005 relating to the lending activity of the Khushhali Bank, the first licensed microfinance bank in the country and the one designed to operate on commercial lines but with a social mission consistent with the MDGs, which in turn form the center-piece of the government's poverty reduction strategy (Government of Pakistan, 2003). The paper is distinct in

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a number of ways: it is based on a large national survey of 2881 households, which is a far larger sample than is normal for this type of study; it focuses on a country in which the microfinance sector is relatively new and where little rigorous work has been conducted on the impact of microfinance; it applies a rigorous control group approach that addresses the main sources of bias; and it uses a wide range of outcome measures to capture the impact of lending on alternative dimensions of welfare.

2. KHUSHHALI BANK OPERATIONS

Microfinance remains relatively little developed in Pakistan, although there has been a rapid growth since 2000 starting from a low base. As of March 2008 there were estimated to be around 1.6 million active borrowers with an average loan size of Rs. 11,000 (less than $150) as compared with Rs. 460,000 in the banking sector as a whole. However, the potential market for microcredit is likely to be much larger than this and the microfinance strategy of the State Bank of Pakistan targeted a total of 3 million borrowers by 2010. [2]

The Khushhali bank was founded in 2000 as the first initiative of the Microfinance Development Program sponsored by the Asian Development Bank. It was an early version of a commercially-oriented microfinance intervention with its share capital drawn from 16 commercial banks. While operating alongside more conventional aid funded MFIs, it has become the largest provider of microfinance in Pakistan, now providing a range of loan products to over 360,000 active borrowers (nearly 25% of the national total), while focusing on the core objective of operational self-sufficiency. It is not a perfect case-study of a commercially-oriented microfinance bank since although its objectives are commercial it has not yet achieved full financial self-sufficiency. Even though its Annual Report for 2007 reports a profit before tax of Rs. 156 million and a return on equity of 5%, these calculations do not net out the effect of the substantial interest rate subsidy from the Asian Development Bank and independent estimates suggest that the operational self-sufficiency ratio is no more than 80%. [3] The most recent Annual Report for 2008 reports a profit after tax of Rs. 103 million but again this fails to remove the effect of any financial subsidy. Hence what we are examining is the impact of the lending of a bank that is aiming for financial viability but which is not yet operating on fully commercial lines.

As part of its social mission Khushhali targets clients who are "poor" and "very poor," but not those who are "destitute" (living off charity, or *zakat*) or "non-poor," who receive enough income to pay income tax. In the sample drawn for this study in 2005, more than 70% of the clients were below the official poverty line of the Government of Pakistan and 20% were at less than half of the caloric consumption of those defined as poor. [4] When data for this study were collected in 2005, the bulk of clients (60%) were in rural areas and roughly one-third were women, although according to the bank's more recent Annual Reports both of those ratios have declined as the bank has expanded in the past few years.

At the time of the survey the bank offered eligible clients uncollateralized micro-loans of Rs. 3,000–Rs. 30,000. [5] The first loan would be between Rs. 3,000–10,000 and loan sizes increase 20% with each cycle to a maximum of Rs. 30,000. The terms of the microloan vary between 3 and 12 months, to be repaid with interest on declining balances in equal monthly installments or in one bullet payment, depending on the purpose of the loan. Loans were offered for investments in arable agriculture, in livestock, or in micro-enterprises to establish a new business or to purchase assets or working capital for an existing business, but not for consumption. At the time of the survey in 2005 the interest rate was 20% and the average loan per borrower was $142. This was higher than that charged by other microfinance institutions and well above the average lending rate of 11% reported in the IMF International Financial Statistics, however it is well below earlier estimates of the cost of borrowing from informal credit sources (Arif, 1999).

Although the bank has introduced an individual scoring report to screen and classify clients according to the above eligibility criteria, it uses a group lending methodology under which clients form groups called community organizations that can be male, female, or mixed gender groups of between 3 and 25 members (usually 3–5 members in urban areas and 10–25 in rural) who provide personal guarantees to each other. Loans are made directly to individuals in the group, but if any one member of the group defaults then all members of that group become ineligible for loans.

3. RESEARCH METHODOLOGY

The first question to be addressed in conducting any impact evaluation is: how to measure impact? Most microfinance programs are designed to encourage borrowers to invest their loans in their farms or microenterprises. The hope is that these investments will lead to higher profits, which will in turn lead to higher household income, which will gradually lift client households out of poverty. Microfinance may also affect non-income measures of household welfare such as health, education, or empowerment. Note that the effects of microfinance on these broader measures of welfare may not be expected to be all positive. On the one-hand, households with more profitable family farms or microenterprises may be able to afford textbooks for their school age children, or hire workers to help with duties previously required for family members. On the other hand, the extra time required for household members in running a newly-profitable family farm or microenterprise may also lead to lower enrollment rates for school age children who are encouraged to skip school or drop out all-together in order to contribute to the business.

In this study, we used the Khushhali Bank mandate of

> *"…providing micro-finance services to poor persons, particularly poor women for mitigating poverty and promoting social welfare and economic justice through community building and social mobilization with the ultimate objective of poverty alleviation" (Status and Nature of Business, from Khushhali Bank Annual Report 2004)*

as a guide in designing our study. Thus, we looked at what might be called traditional, or at least, direct, impacts of microfinance on household business profits as well as broader measures of household welfare such as health, education, female empowerment, and finally, poverty, as measured by food and non-food consumption-expenditure.

Table 1 reports the summary statistics for the measures of household welfare used in this study. Business profits for the different types of activities supported by Khushhali Bank loans—agriculture and livestock farming as well as microenterprise—are measured by reported profits and sales. Consumption-expenditure, the basis for measuring official poverty statistics in Pakistan, measured as food expenditures, non-food expenditures, medical expenditures and educational expenditures per child, indicates income effects of participation in the microfinance program. Non-income measures of household welfare are also included: the probability that children are in school, absenteeism from school, the probability of

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