

Bangladesh

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Summary

Microfinance has far greater outreach in Bangladesh than in any other country in this study, with perhaps 80 percent of poor households having access to services. Bangladesh Bank (the central bank) has played only a small and mostly indirect role in the development of microfinance, and has avoided interfering with the activities of microfinance institutions (MFIs).

However, the sheer size of the microfinance sector and increasing deposit mobilization by leading MFIs have inevitably raised questions about the legal and regulatory framework for microfinance. While regulating all MFIs would be impractical, it is widely accepted that the larger ones should be subject to prudential regulation and supervision. The role of the central bank in such regulation is subject to debate, given the difficulties which beset it in regard to the broader financial system. However, there is clearly a role for it to undertake "promotional" activities to enhance the sustainability of the microfinance sector.

Bangladesh Currency Equivalent

Currency Unit – Taka (Tk)
 US\$1 = Tk49.35 (at mid-1999)

Abbreviations

ADB	Asian Development Bank
ASA	Association for Social Advancement
BASIC	Bank of Small Industries and Commerce Bangladesh Ltd
BKB	Bangladesh Krishi Bank
BRAC	Bangladesh Rural Advancement Committee
BRDB	Bangladesh Rural Development Board
CAMEL	capital adequacy, asset quality, management, earnings, liquidity management (set of criteria used for rating banks)
CDF	Credit and Development Forum
GDP	gross domestic product
IBBL	Islami Bank Bangladesh Ltd
IFAD	International Fund for Agricultural Development
IGVGD	Income Generation for the Vulnerable Group Development
MFI	microfinance institution
NBFI	nonbank financial institution
NCB	nationalized commercial bank
NGO	nongovernment organization
PKSF	Palli Karma Sahayak Foundation
RAKUB	Rajshahi Krishi Unnayan Bank
RDRS	Rangpur Dinajpur Rural Service
TharDEP	Thana Resources Development and Employment Project
USAID	United States Agency for International Development

Note

In this report, “\$” refers to US dollars.

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1 Introduction and Background

1.1 Key Demographic and Economic Data

Bangladesh, situated in the delta of the Ganga and Brahmaputra rivers, is one of the most densely populated countries in the world. With a population of 126 million, the relatively small land area translates to a density of 842 persons per square kilometer of total area and as many as 1,450 persons per square kilometer of cultivable land (Bangladesh Bank 1998). Poverty is pervasive. The latest available data from the 1995/96 Household Income and Expenditure Survey indicates that 47.1 percent of the rural people or some 46 million people still live in absolute poverty, unable to afford even the basic dietary requirement of 2,122 calories per day (ADB 1998). Per capita gross domestic product (GDP) in 1997 was estimated at just \$218 in 1987 dollars. The United Nations Development Programme's (UNDP) Human Development Index for Bangladesh was just 0.440 in 1997, resulting in an extremely low international ranking of 150th out of 174 countries. Life expectancy at birth is just 58.1 years and the adult literacy rate for women only 27.4 percent (UNDP 1999).

Almost half of the population (some 47 percent) lives in absolute poverty

Yet, some gains have been achieved. Population growth, though still rapid, is thought to have slowed down to 1.6 percent per annum, and the incidence of poverty is reported to have declined from over 70 percent of the population in the early 1980s to less than 50 percent in the 1990s. The incidence of hardcore poverty in the rural population declined from 36.7 percent in 1983–1984 to 24.6 percent in 1995–1996. Food production has increased at a rate of over 3 percent per annum since the 1980s and the country is said to be on the verge of self-sufficiency, though this is possible only at the present low levels of consumption. Indeed, the decline in poverty is attributed to broad-based economic growth that has occurred through improved agricultural technology, labor-intensive industrialization, and the rapid growth of the service sector in a largely informal economy. Over the past few years, the country has achieved growth of GDP in excess of 5 percent per annum, a degree of macroeconomic stability, and a low inflation rate of about 5 percent per annum (Meyer and Nagarajan 1999).

Structural change in the economy has increased the demand for microfinance services

Over the period 1980–1997, there has been a substantial shift in the structure of the economy. The share of agriculture in value added has declined from as much as 50 percent to just 30 percent, while the share of services has increased from 34 percent to 53 percent and that of industry increased marginally from 16 percent to 17 percent (World Bank 1999). The substantial shift from agriculture to services may be partly attributed to a high rate of rural-urban migration and the relatively easy availability of microfinance to landless poor families for undertaking small trading, repair, and other service sector activities. Despite the high rate of rural-urban migration there has, nevertheless, also been a growth of population and concomitant increase in population density in rural Bangladesh. With increasing pressure of population in rural areas there has, inevitably, been an increase in the reliance of the poor on the service sector of the economy and this, in turn, has contributed to the high demand for microfinance in the country.

In its economic outlook, the country faces a number of major problems. These include a very low savings rate of less than 8 percent of GDP, low levels of efficiency of the public sector, one of the world's highest rates of rural-urban migration, and consequent severe strains on urban housing, water supply, electricity, sanitation,

and the environment. Though Broad Money (M2) has grown at over 10 percent per annum over the past few years, there has not been much impact on the financial deepening of the economy with the M2/GDP ratio remaining static at around 36 percent between 1993/94 and 1997/98 (Bangladesh Bank 1998). This is significantly below other countries in the region, for example, Nepal's 41 percent ratio and India's 46 percent.

1.2 Financial Sector

The financial sector in Bangladesh¹ originated in the financial developments of undivided India in the early part of the twentieth century. As in other parts of British India, the cooperatives — registered under the Cooperative Societies Act — were the main source of institutional finance to the rural sector. As in India, the Pakistan government of the 1950s and 1960s used the financial sector as a cheap source of credit for the priority sectors. Thus, at Independence in 1971, Bangladesh inherited a repressive financial system incorporating controls over interest rates, directed credit, complex rules for money and capital markets, and overvalued exchange rates.

The Bangladesh Bank, established via the Bangladesh Bank Order of 1972, not only inherited a repressive financial regime but the problem was worsened by the nationalization of all financial institutions in the country and much of the heavy industrial sector. At this time, three specialized development banks were also created but their lending was mainly for the purpose of building up the public sector. There was a scarcity of credit as more and more resources were placed with these loss-making industries as well as the priority sectors. Combined with the negative real interest charged, this led to private sector demand being rationed amongst those with political influence. The net result was further inefficiency in investment, the nonpayment of loans, and ultimately in the early 1990s the recapitalization of the nationalized commercial banks (NCBs) in order to keep them solvent.

During the late 1980s and early 1990s, several attempts were made to implement financial sector reforms with the encouragement and technical support of Bangladesh's principal donors. Apart from the recapitalization of NCBs, this led to a significant deregulation of interest rates, a decline in the role of directed credit, introduction of loan provisioning to make loan recovery issues more transparent, the licensing of several new private banks and of foreign banks, and a commitment to privatize Rupali Bank.² However, the loan recovery problem continued to be acute despite the prosecution of some wilful defaulters, prohibitions on their holding public offices and bank directorships, limitations on access to new loans, and denial of import licenses. An interest amnesty program was also introduced and the Financial Loan Courts Act was passed to facilitate prosecution of defaulters. The Credit Information Bureau was established in the Bangladesh Bank to record the performance of borrowers, and the Large Loan Review Cell was set up to review all newly sanctioned bank loans over Tk10 million (now \$200,000).

These measures have met with mixed results. Deregulation has resulted in an increase in both lending and deposit rates but any increase in competition has been tempered by perceptions of collusive pricing. Political interference and outright corruption in the banking sector is, however, still rampant and, partly as a result, loan recovery continues to be a problem. Private banks have also been hit by the phenomenon as a waiver of small loans in 1991 greatly vitiated the credit culture in the agricultural sector and large loans are afflicted by insider lending. In 1996, the

As elsewhere in South Asia, government used the financial sector as a source of cheap credit

Attempts at financial sector reform date from the late 1980s

1 Modified and adapted from Meyer and Nagarajan (1999).

2 Uttara and Pubali banks were denationalized earlier, in 1984.

outgoing government further undermined credit discipline by permitting the blanket rescheduling of past due bank loans on the basis of a 10 percent down payment. While this description is pertinent directly to industrial and urban lending, the state of agricultural and rural lending in Bangladesh is no better. This will be further discussed in Section 3.

Overall, the formal financial system in Bangladesh is at a relatively early stage of development in terms of diversity and the range of products offered. The sector is currently comprised of nearly six thousand outlets of institutions including the central bank, the four NCBS (Sonali, Janata, Agrani, and Rupali), 17 private commercial banks (NBFIs), 13 foreign commercial banks, and 18 licensed nonbank financial institutions. In addition, there are five public sector specialized banks³ of which two, the Bangladesh Krishi Bank (BKB) and the Rajshahi Krishi Unnayan Bank (RAKUB), serve the rural sector along with two cooperative networks under the registrar of cooperative societies. The Bangladesh Samabaya Bank Ltd and the Bangladesh Rural Development Board or BRDB (with Sonali Bank funds) finance the cooperatives. Other segments of the financial sector include two government-controlled and 32 private insurance companies, and stock exchanges at Dhaka and Chittagong with, respectively, 224 and 124 listed securities at the end of 1997/98. There is also the House Building Finance Corporation with largely debenture financing, mostly from the Bangladesh Bank.

The formal financial system is still relatively undeveloped. However, there is a strong NGO micro-financial system

The specialized agricultural banks and NCBS have large branch networks in rural areas and have lent extensively in these areas, though most of their lending is not targeted to the poor. It is also based on traditional banking terms and cannot be described as microfinance. The foreign banks and private commercial banks have simply stayed away from rural lending, though there are a few cases of token involvement in microfinance. Unlike other countries in the region, “Bangladesh does not have a substructure of small banks operating at the local level” (McGuire et al. 1998).

At the same time, as is well known, a strong semi-formal nongovernment organization (NGO) financial system has emerged in the country. The Grameen Bank and financial NGOs, mostly modeled on the success of Grameen, operate in small towns, peri-urban areas and also, increasingly, in urban neighborhoods as well as in rural areas. These undertake microfinance lending to poor clients for mainly service sector trading, vending, and small production activities. The lending of these not-for-profit microfinance institutions (MFIs) in rural areas of Bangladesh takes place on a scale unparalleled anywhere in the world and more than matches the combined efforts of the formal financial sector, including the banks and the cooperatives.

2 Development of Microfinance

The network of cooperative societies first spread its wings throughout undivided India in the early part of the twentieth century, and grew significantly throughout the early years of rural credit expansion in Bangladesh, particularly in the 1970s and early 1980s. The process was bolstered by the activities of BRDB which organized them on a two-tier structure, called the “Comilla model,” consisting of primary cooperatives at the local level and secondary cooperatives at the *thana* (sub-district) level. The structure was quickly spread to most of the 460 *thanas* in the country. BRDB’s efforts

3 The Bangladesh Krishi Bank, Rajshahi Krishi Unnayan Bank, the Bangladesh Shilpa Bank, the Bangladesh Shilpa Rin Sangstha, and the Bank of Small Industries and Commerce Bangladesh Ltd (BASIC).

did not, however, achieve the goal of establishing self-sustaining cooperatives. Despite attempts to improve the functioning of the cooperatives, the domination of the village elites, who cornered most of the resources, undermined the efforts of BRDB to reach the poor (ADB 1998).

It was in 1976 that the first Grameen Bank project was established and, in time, demonstrated that lending to the poor could be an economically viable activity. Its experience was followed, in Bangladesh, by the establishment of other major microfinance programs by some of the existing NGOs with large multi-sectoral programs, such as the Bangladesh Rural Advancement Committee (BRAC) and Proshika. The success of these programs led to the rapid replication and multiplication of microfinance throughout Bangladesh both by NGOs with multi-sectoral programs and by specialized NGOs, newly established as MFIs on the Grameen Bank model.

2.1 Outreach and Sustainability

There are no reliable data on the size or outreach of the microfinance sector in Bangladesh. Estimates of the number of NGOs with microfinance programs in Bangladesh (henceforth referred to as MFIs) range from 500–600 to over a thousand. The Credit and Development Forum (CDF), a Dhaka-based MFI networking organization, makes a valiant attempt to keep track. Its statistical booklet (Credit and Development Forum 1999a) provides self-reported, and partially verified, information from 524 MFIs. These include all the well-known large MFIs in Bangladesh and it is, therefore, likely that coverage is of the order of 95 percent of NGO microfinance activity in the country. Interestingly, the CDF statistics show the organizational concentration of MFI activity in Bangladesh: the membership of the top 20 organizations on its list is 83 percent of the total for 524 MFIs and loans outstanding are 88 percent.

The microfinance outreach of CDF's 524 reporting MFIs amounts to an active membership of 8.7 million in June 1999. Add to this the 2.4 million members of Grameen Bank, 1.3 million members of five ongoing BRDB projects, and the 270,000 members of the Ministry of Youth's TharDEP project, and total microfinance coverage in Bangladesh reaches some 12.7 million families. However, as even casual observation in some of the more accessible and populated areas of Bangladesh shows, there is considerable double counting and membership (by the poor) of multiple organizations. Based on this, it would be unrealistic to assume that actual coverage is in excess of 9 million families. Nevertheless, the Bangladesh Government's estimate is that 47 percent of the population, or some 9.9 million families of a total of 126 million people or 21 million families, are poor. If that is correct, microfinance services reach over 80 percent of them.⁴

The sustainability of these programs is another matter altogether. Direct information on this issue is limited by the fact that most NGOs provide nonfinancial services as well and rarely publish or allow external access to any separate accounting of their microfinance operations. However, the accounts of two important sources of microfinance in Bangladesh are indicative. Thus, the Grameen Bank, with total outstanding loans of Tk12.6 billion (with its 2.3 million members) at the end of 1997 reports a profit of Tk14.3 million for the year but only after taking into account grants worth Tk125 million. This suggests a net operating loss in 1997 of Tk110 million. (Grameen Bank 1997). The situation of other large MFIs such as BRAC and Proshika is widely perceived to be similar.

On the other hand, there are MFIs which, at currently large levels of operation, do manage to cover all their costs. One such is BURO, Tangail, which with 68,000

It is estimated that there are between 600 and 1000 MFIs in Bangladesh

Data on outreach are sketchy, but microfinance probably reaches some 9 million families

⁴ Assuming around 10 percent of microfinance services are utilized by the non-poor.

Sustainability is an issue — a few MFIs such as ASA and BURO, Tangail manage to cover costs

members and 40 branches is the tenth largest MFI in Bangladesh. For end-December 1998, BURO, Tangail reports a profit of Tk3.7 million (excluding operational grants) and still more than breaks even after making a notional provision for loan losses.⁵ Similarly, the Association for Social Advancement (ASA), with nearly 900,000 members the fourth largest MFI in Bangladesh, has established itself as a highly effective, low-cost organization which is perceived to be sustainable.

However, it is still true that some of the largest (and an overwhelming majority of the hundreds of small) MFIs in Bangladesh are not presently sustainable, and nor are any of the banking operations providing small loans to poor farmers. The most important factor affecting sustainability is the issue of loan recovery. While the formal financial institutions have suffered from pressures to disburse on noneconomic considerations, political loan forgiveness (or loan waiver) has also affected repayment rates. Thus, MFIs such as Grameen Bank which have traditionally reported loan recovery rates of 98–99 percent have had to expend much energy to convince borrowers that the political waivers do not apply to their loans. Yet, the actual current repayment rates of the MFI sector tend to be much lower than the aggregative rates normally reported. So Grameen Bank's overdues of more than one year are reported as being 9.45 percent of the amount due in 1997 (Grameen Bank 1997) and a case study of four villages in Madhupur in 1995 discovered the on-time repayment rate was only 47 percent (Matin 1998).

The issue of Grameen's sustainability is well known and researched. In common with most MFIs in the country, Grameen is dependent on foreign grants and soft loans and receives domestic subsidies besides. In recent years, government-guaranteed bonds have become a relatively large share of its overall resources. These grants and soft loans include borrowings of Tk1.2 billion (\$24.5 million) from the International Fund for Agricultural Development (IFAD) at 2–3 percent interest per annum, and purchase by NCBs of Tk6.5 billion (\$132 million) worth of 4–6 percent bonds. By imputing values to all the subsidies received by Grameen, it has been estimated that it would need to raise the nominal interest rate on its general loans from 20 percent per annum to 33 percent in order to break free from subsidies (Morduch 1998). Similar calculations would apply to other MFIs, of all sizes, which are equally well supported. However, it is also true that the Grameen Bank has steadily reduced its dependence on subsidies and the success, in these terms, of organizations like ASA and BURO, Tangail indicate the potential for MFIs in Bangladesh to achieve sustainability. Indeed, the fact that these latter organizations do not charge

Comparison of Sources of Revolving Loan Funds in Bangladesh

Sources	524 CDF members	
	Amount in June 1999 (Tk million)	% of Total Revolving Loan Funds
Member Savings	4,813	23.6
Foreign Donation	4,216	20.7
Service Charge	2,338	11.5
PKSF	4,784	23.5
Local Banks	2,343	11.5
Other NGOs	190	0.9
Own Funds	1,041	5.1
Other Sources	646	3.2
	20,371	100.0

Source: Credit and Development Forum (1999a).

5 Information from BURO, Tangail (1999), provisions estimated.

especially high interest rates, in the context of microfinance in Bangladesh, would appear to indicate that the solution to the sustainability problem, for the average Bangladeshi MFI, lies in improving operational efficiency rather than in raising interest rates.

It is apparent from CDF's compilation of statistics that other MFIs too are heavily dependent on donor grants and concessional loans (see table). Thus, 20.7 percent of the Tk20.4 billion (\$413 million) deployed in revolving loan funds by the 524 reporting MFIs consisted of donor grants and another 23.5 percent of soft loans from a major wholesaler of microfinance.

2.2 Diversity of Models

The microfinance scene in Bangladesh is not the sole preserve of the Grameen Bank, but it is certainly dominated by what may be termed the Grameen Bank model. All the major MFIs in the country have essentially copied, modified, and attempted to improve upon the pioneering approach of the Grameen Bank. As such, to an uninitiated observer, the models pursued for microfinance in Bangladesh are very similar indeed.

The basic Grameen model incorporates the organization of poor residents of a village (or urban slum) into groups of five and centers of six borrower groups. Both the members of the primary borrower group and those of the center act as co-guarantors for each other's loans, which acts as the basis for simplifying the lending procedure and forgoing tangible collateral. The normal loan product is of one year's duration, being repayable in 50 weekly installments with two weeks grace period. Interest rates range from 18 to 25 percent per annum on a flat basis.

The variations to this model, introduced particularly by latter day entrants, have incorporated the introduction of new savings and loan products. The variations in loan products include (i) collection by Proshika and Rangpur Dinajpur Rural Service (RDRS) of monthly instead of weekly installments; (ii) variations in ASA's loan conditions with the number of weekly installments reduced to 45 spread over the year, and abolition of the group guarantee as well as of the requirement to be present in weekly meetings at the same time;⁶ (iii) introduction of seasonal loans of three months' duration by most MFIs; and (iv) provisions for larger microenterprise loans for specific activities by some organizations such as BRAC, ASA, and the urban, Dhaka-based MFI, the Shakti Foundation. Other variations are described below.⁷

Flexible Savings

Over the past two to three years there has been a conscious effort by Bangladeshi MFIs to mobilize additional local resources through new savings products. ASA and BURO, Tangail, in particular, have now moved to a regime of more flexible savings products which enable members to withdraw savings at virtually any time — subject to a minimum balance equal to 15 percent of the face value of any outstanding loan in the member's name. As well, both BURO, Tangail and ASA have now introduced recurring (“accumulated term”) deposit schemes enabling members to deposit small, equated voluntary savings installments, in return for a higher rate of interest. BURO, Tangail reports an increase of 36 percent in its already substantial savings collections during the four months since launching its deposit collection drive in April 1999.⁸

Most MFIs, including industry leaders such as Grameen Bank, need grants and soft loans to balance the books

The basic Grameen “model” which dominates microfinance in Bangladesh is being extended, with a variety of innovations

6 ASA's members are only required to come to a designated place at a specified time each week to conduct their financial transactions.

7 Discussed and presented in detail by Alamgir (1999). The typology of MFIs in Bangladesh presented in this section is derived largely from this document.

A more far-reaching variation is the introduction of a daily savings product by a small Dhaka-based MFI. In this model of SafeSave, each client is visited (sometimes twice) daily for the purpose of conducting financial transactions — deposit/withdraw savings, borrow, repay, pay interest on loans. Loans are, typically, much smaller than savings but are given for an indeterminate term at 2 percent per month without any up-front deduction of interest. A number of other MFIs have started spontaneously to replicate this innovative methodology, and it is expected that it will grow very quickly in Bangladesh.⁹

Urban Microfinance

Traditionally, MFIs in Bangladesh have avoided the urban slums. Microfinance in such areas is viewed generally as inherently risky. However, mainly since 1991, organizations such as the Shakti Foundation and Monobik Shahajya Sangstha have applied the Grameen model to urban areas and shown that it can work. Apart from these institutions, Proshika, ASA, and BRAC are also major urban microfinance providers and have all replicated their rural programs for this purpose. The example of these institutions has, since then, led to the establishment of a number of small MFIs, particularly in the urban slums of Dhaka, Chittagong, and Khulna cities for providing microfinance services to the poor. The INCOME project of CARE Bangladesh provides capacity-building support to these small urban initiatives.

Microfinance for the Very Poor

It is commonly accepted that while microfinance in Bangladesh has virtually reached saturation levels in most urban as well as rural levels, the very poorest sections of the community, 10–15 percent of the population, have not been properly covered. Many of the rules such as mandatory weekly savings and regular attendance are either seen as too restrictive for the members or the organizations themselves have shied away from them in the quest for lending targets and financial viability. In order to redress this balance, BRAC has started an Income Generation for the Vulnerable Group Development (IGVGD) program and other organizations such as Ashrai have also made a direct attempt to reach the very poor. BRAC's program provides microfinance, supplemented by credit-plus services, to village-level groups exclusively of the very poor. Ashrai works mainly in the tribal areas of Greater Rajshahi district by organizing

Special efforts are necessary to reach the very poor; a self-help group model is being trialed in a remote district

Some Variations Introduced to the Basic Grameen Model

Variations to the basic Grameen “model” include new savings and loan products with innovations such as:

- monthly, not weekly, installments
- abolition of group guarantees
- attendance at weekly meetings not required
- seasonal loans for (say) three months
- larger micro-enterprise loans
- flexible savings products, easier withdrawal
- daily transactions
- urban programs
- self-help groups for the very poor.

8 Interview with BURO, Tangail Finance Director, Mosharrof Hossain.

9 As reported in discussions by SANMFI, a Dhaka-based networking organization for MFIs.

village-level societies of the very poor and supporting them in undertaking microfinance by providing them on-lending funds, governance, and occupational development training on the pattern of the Indian self-help groups.¹⁰

Microfinance by Government Agencies

Microfinance programs in Bangladesh are reportedly undertaken by as many as five different government departments and ministries. These include BRDB, the Thana Resources Development and Employment Project (TharDEP) of the Ministry of Youth and Sports, the Department of Social Welfare, the Ministry of Land, and the Department of Women's Affairs. All these programs essentially replicate the Grameen model and report fairly high repayment rates in spite of being implemented directly by the staff of government departments.

Direct Microfinance by Banks

As the main source of short-term agricultural finance in Bangladesh, BKB, along with its associate bank, RAKUB, claims to be the largest source of microfinance in Bangladesh. During 1997/98 these banks between them disbursed total agricultural loans worth Tk16.43 billion (\$335 million). Crop loans amounted to Tk6.39 billion (\$130 million) and poverty alleviation loans were worth Tk3.17 billion (\$64.7 million). Poverty alleviation loans are apparently given to landless workers, distressed women, and "destitutes." The disbursement for this purpose may be compared with the Tk20 billion (\$408 million) disbursed by the leading MFIs in the country and another Tk19 billion (\$387 million) by Grameen Bank alone during the same period. In any case, the microfinance commitment of the agricultural banks consists very largely of conventional banking and, in the Bangladesh situation, results in repayment rates of less than 25 percent.¹¹

A difficulty encountered in attempting to understand the extent of involvement by commercial banks in microfinance is that, with the current emphasis on the subject, the banks themselves are anxious to reclassify much of their small loan portfolios as "microfinance." They do have much short-term crop financing in amounts below Tk30,000 (\$700), some of which might on the face of it qualify as microfinance. But there are no reliable data on what proportion of such credit is accessed by the poor. There are some instances of microfinancing by Bangladeshi commercial banks but they occur in an institutional environment which makes their longer term viability difficult.

Another program of direct microfinance by a bank is that undertaken by the Islami Bank Bangladesh Ltd (IBBL) which has a microcredit wing undertaking a rural development scheme for poverty alleviation. IBBL also uses the basic Grameen model but, as its name implies, uses Islamic banking concepts which require it to invest through methods such as leasing and hire purchase rather than cash lending. Repayments are in weekly installments, in terms of cost plus mark-up (12 percent), and the period of the credit is one to three years. This is a relatively small program with just 12,000 members and outstandings of only Tk36 million (\$0.75 million) in September 1998 (Alamgir 1999).

Commercial banks are reclassifying small lending as "microfinance" where they can, but genuine microfinancing by banks is hampered by their institutional environment

¹⁰ Described in more detail in Alamgir (1999).

¹¹ Derived from information presented in *Annual Report 1997-98*, Chapter V, of Bangladesh Bank (1998).

2.3 Wholesale Lending to MFIs

Another important feature of microfinance in Bangladesh is the emergence, since 1990, of wholesale lending as an important source of funds for revolving loans to poor clients of MFIs. As the information in the table in Section 2.1 shows, wholesalers — PKSf, local banks, and other NGOs — account for nearly 36 percent of the total amount of Tk20.4 billion (\$413 million) available as revolving loan funds to the 524 reporting members of CDF in June 1999. Pre-eminent amongst these, accounting for over 23 percent of the revolving loan funds, is the Palli Karma Sahayak Foundation (PKSF). PKSf was established in 1990 as a private, nonprofit organization but with government sponsorship. It is governed by an independent general body of 15 people, the majority of whom are from outside government. The main objective of PKSf is to provide finance, institutional, and capacity-building support to MFIs in order to enable them to undertake microfinance in Bangladesh more proficiently.

Wholesalers have emerged as an important new tier of microfinance institutions

PKSF was started up with funds to the extent of Tk1.1 billion (\$22.5 million) from the Government of Bangladesh up to 1995/96. Since then, the main pool of its lending resources had come from the World Bank though it has received smaller quantities of capacity-building funds from the United States Agency for International Development (USAID) and a small loan from the Asian Development Bank (ADB). By the end of 1997/98, PKSf's resources had grown to Tk4.1 billion (\$84 million) including part of the proceeds of a \$109 million loan from the World Bank. This was deployed, on 30 June 1998, to the extent of Tk2.6 billion (\$53 million) in 3–5 percent per annum loans to 168 MFIs covering some 1.21 million ultimate borrowers. The loan recovery rate of PKSf is reported to be 98 percent (PKSF 1998). Working through 112 staff members, PKSf has established a laudable reputation as a professional organization working in the interests of its partner organizations and of microfinance in Bangladesh. However, it is sometimes accused of favoring the purist Grameen replicators over those following more independent methodologies.

Other important wholesalers of funds for microfinance in Bangladesh are: (i) the commercial bank, BASIC (Bank of Small Industries and Commerce Bangladesh Ltd); (ii) the Grameen Trust fund for the replication of microfinance on the Grameen model; (iii) lending by the MFI, ASA; and (iv) NCBs such as the Sonali Bank. Under a Kreditanstalt für Wiederaufbau (KfW) line of credit, the government-owned bank, BASIC, lends to successful MFIs operating in urban and suburban areas at the rate of 7 percent per annum. Loans are given for a 2.5 year period and recovered in 18 monthly installments. BASIC has, so far, made loans averaging Tk2 million (\$40,500) to each of 16 MFIs and a larger 12 percent per annum loan of Tk90 million to the Grameen Krishi Foundation.¹² The Grameen Trust has, so far, committed over \$8 million to 80 replication projects in 28 countries but only 10 of these have been in Bangladesh. ASA has also made a contribution to stimulating small MFIs in the country, but its resources are limited and lending to a total of 16 MFIs in November 1998 amounted to just Tk27 million (\$555,000).

While PKSf is the industry leader, other wholesalers are tapping different funding sources

Finally, in spite of the high profile achieved by the microfinance sector in Bangladesh, lending by NCBs or private banks is yet to achieve any momentum. For the most part, the banks shy away both from lending directly to the poor and from making wholesale loans to MFIs. Major factors in this reluctance in Bangladesh are MFIs' lack of a clear ownership structure, the perception that loans to the poor are inherently risky, and lack of familiarity with MFI modes of operation resulting in lack of confidence in assessing MFI creditworthiness (Goodwin-Groen 1998; Sinha 1999). Not surprisingly, loans from commercial banks to MFIs have so far been limited mainly to large loans to very well-established and well-connected organizations like the Grameen Krishi Foundation. Only a very small number of loans have been made

¹² Information provided by BASIC to the author in April 1999.

to other MFIs, such as the Sonali Bank's Tk50 million (\$1 million) line of credit to the Shakti Foundation.

2.4 Demand for Microfinance

It is apparent from the discussion in Section 2.1 that much of the potential effective demand for microfinance in Bangladesh is already being met by the extensive coverage of the country by MFIs large and small. Indeed, the situation is such that in some of the more densely populated areas of central Bangladesh there is intense competition amongst MFIs for attracting members. This is leading to beneficial effects for the poor in that MFIs are forced to innovate, and the new understanding of the need for flexible savings products is an example of the beneficial operation of market forces. Nevertheless, change is relatively slow as MFIs with substantial outreach but conventional methodologies are loath to upset established operating procedures for (relatively) small increases in membership or turnover. In this context, there probably continues to be a considerable unmet demand not only for flexible savings products but also for more flexible loan products. The latter have, so far, received even less attention than savings.

However, there remain pockets of urban areas, particularly in the smaller urban centers such as Rajshahi, Jessore, and Comilla, and some of the remote tribal belts of Sylhet, Rajshahi, and the hill tract areas around Chittagong, where coverage is relatively low in relation to estimates of the potential effective demand for microfinance services. Similarly, as discussed earlier, the very poor families of the hinterland of Bangladesh are also sometimes sidelined on account of their relatively low perceived creditworthiness. It is estimated that some 10–15 percent of poor families in Bangladesh still remain to be covered by microfinance.

2.5 Regulation of Microfinance

Except in the case of Grameen Bank, there is virtually no specific regulation of microfinance in Bangladesh. Most MFIs are registered as societies under the Societies Registration Act, 1860 (the same as in India) which is administered by the Department of Social Welfare. Others are registered as nonprofit companies under the Companies Act, 1913, or as trusts under the Trusts Act, 1882, or the Charitable and Religious Trust Act, 1920, or as cooperatives under the Cooperative Societies Ordinance, 1984. Such MFIs have to do little more than provide the related registering authority with audited statements of account to show that funds received are being utilized in accordance with their memorandums of association.

In the case of MFIs receiving foreign grants, the NGO Affairs Bureau established under the Foreign Donations (Voluntary Activities) Regulation Ordinance, 1978 has to be informed, and clearance to receive the funds obtained. While this requires some form filling and bureaucracy, it is a process that has been greatly streamlined in recent years and is, therefore, relatively smooth, transparent, and expeditious. On the other hand, it does sometimes give the NGO Bureau a handle to leverage concessions from NGOs, though this appears to operate more as an irritant than an obstacle.

Savings mobilization from the general public is not permitted in Bangladesh except with the express permission of the Bangladesh Bank. However, under the Cooperative Societies' Ordinance cooperative societies are permitted to mobilize savings from the general public though the registrar of cooperatives has little power, either preventive or protective, and conducts minimal supervision (McGuire et al. 1998). In practice, as discussed, MFIs in Bangladesh have compulsory savings from members built into their lending operations and this is not prohibited by law.

Closure of the demand-supply gap in some districts leads to intense competition, and innovation by suppliers, but there is probably excess demand overall

Aside from Grameen, other MFIs are subject to almost no specific regulation

Accepting deposits from the general public is not legal; some MFIs are testing the margins of legality

Second Tier Institutions

- Wholesale institutions are an important feature of the microfinance system in Bangladesh.
- They are called “second tier” because they occupy a space between MFIs (as retailers) and the institutional sources of loanable funds for microfinance — government, external donor agencies and foundations, commercial banks, and even some larger MFIs.
- PKSF is the major microfinance wholesaler in Bangladesh — financed by government but with an independent board.
- Other wholesale operations are conducted by banks such as BASIC and Sonali or nongovernment entities such as Grameen Trust and ASA.

A number of MFIs, such as BRAC, ASA, and BURO, Tangail, accept voluntary savings and include the deposits in their revolving loan funds. They have also now started accepting deposits from “associate members” who are not group members. Such activity may be regarded as testing the margins of legality since these MFIs are not subject to any form of prudential regulation at present.

Grameen bank is an exception and may accept deposits from the public under its own ordinance

The Grameen Bank is governed by its own special law, the Grameen Bank Ordinance, 1983. This provides for Grameen to accept deposits from the general public as well as from members, and to sell bonds and debentures guaranteed by the Government. The ordinance makes only minimal provisions for prudential regulation, leaving most decisions on capital ratios, liquidity ratios, loan loss provisioning, and reserve funds to the bank’s board. It does, however, provide for the auditing of Grameen’s accounts by at least two sets of auditors and for these accounts to be submitted to the Government, presumably the Ministry of Finance, for scrutiny.

3 Role of the Central Bank

3.1 Mandate and Role of the Bangladesh Bank

The Bangladesh Bank Order, 1972, states that:

... it is necessary to establish a central bank in Bangladesh to regulate the issue of currency and the keeping of reserves and manage the monetary and credit system in Bangladesh with a view to stabilizing domestic monetary value; preserving the par value of the Bangladesh Taka; promoting and maintaining a high level of production, employment and real income in Bangladesh; and fostering growth and development of the country’s productive resources in the best national interest ... (Government of Bangladesh 1972).

As part of this mandate, amongst the major responsibilities of the central bank are the regulation of the money supply and control of inflation through appropriate monetary and credit policies for stabilizing the monetary value of the currency. As part of maintaining the financial stability of the economy and the growth of an efficient and sound financial market in the country, the Bangladesh Bank dominated the (mainly public sector) formal financial system in the 1970s and 1980s, the early years of Bangladesh as an independent country. This included, as discussed earlier, a whole host of rules and regulations directing the banks, in particular, to channel and orient their lending, at least in theory, to the achievement of the Government’s social objectives.

3.2 Developmental and Promotional Activities

The Bangladesh Bank's developmental objectives have led to the establishment of numerous institutions for facilitating the functioning of the financial system in the country. These institutions and initiatives include:

- (i) The establishment of the five specialized development banks for promoting lending to agriculture and both large and small industry.
- (ii) The incorporation of the House Building Finance Corporation for facilitating investment in house building in urban areas and enabling middle class families to purchase houses and apartments.
- (iii) The establishment of stock exchanges at Dhaka and Chittagong.
- (iv) The creation of the Credit Information Bureau and the Large Loan Review Cell respectively to record the performance of large borrowers and to review the sanctions of all new bank loans in excess of Tk10 million (\$200,000).

While these institutions, along with the extensive network of insurance companies, have created a significant network of formal financial institutions, operations are relatively conservative and bureaucratic, resulting in sub-optimal access and relatively poor services to the public. While none of these institutions is fully subservient to the Bangladesh Bank, they are effectively controlled by the Government and the central bank between them. Thus, Bangladesh's financial system can be reasonably described as being at a relatively early stage of development.

In order to promote the development of the financial system, the Bangladesh Bank has, through various circulars, also been encouraging the involvement of development banks and NCBs in lending for foreign trade, investment in housing, and wholesale financing of MFIs. For the purpose of export financing, the Government of Bangladesh created the Export Development Fund with the assistance of the World Bank. While the banks have made an important contribution in trade financing and the housing sector, as indicated earlier, their contribution to microfinance is so small as to be almost negligible.

3.3 Financial Repression

NCBs and the agricultural development finance institutions have been subjected to several measures to encourage financial services in rural areas.¹³ During the period 1978–1981 the branch network was expanded by requiring NCBs to open two rural branches for every new urban branch. As a result, commercial banks have a large share in the formal sector total of rural loans and deposits. The Bangladesh Bank also set targets for agricultural lending, though between 1981/82 and 1994/95 such lending ranged from just 45 percent of the target to as much as 100 percent. As a proportion of total credit, agricultural credit rose from just 20 percent in 1981/82 to a high of 34 percent in 1984/85 and then fell back to just 19 percent in 1997/98. Lending rates were controlled and the Bangladesh Bank refinanced, at a subsidized rate, agricultural loans by banks. The refinance subsidy was terminated for NCBs in 1991¹⁴ but was continued for development finance institutions.

Apart from directed credit, the banks have also had to endure various forms of politically inspired exemption programs ostensibly intended to ease the burden of poor borrowers but, in fact, mainly having the effect of undermining credit discipline.

In early years, the central bank pursued government social objectives through the financial system

Relationships among government, central bank, and financial institutions show a financial system still at an early stage of development

¹³ This section is derived largely from Meyer and Nagarajan (1999).

¹⁴ Except for the refinance of Sonali Bank's BRDB portfolio though this has also now been terminated for 1999/00.

Politically inspired “loan forgiveness” decrees have weakened the credit culture and imposed losses on banks

There were five interest exemption programs during the period 1982–1991. In 1984 and 1985 interest exemptions and loan rescheduling were for borrowers affected by natural calamities. The 1986 and 1987 programs aimed at improving the recovery rate and were applicable to crop loans up to Tk10,000 (including principal and interest). The 1991 program was part of the Government’s election program and involved a complete waiver of principal and all charges on loans up to Tk5,000. Though this 1991 program is reported to have improved loan repayments, this happened at huge cost (around Tk350 million or \$7 million) and contributed to a capital as well as a revenue loss to the banks.¹⁵ Finally, the blanket rescheduling of all bank loans on the basis of a 10 percent down payment just before the 1996 election dealt yet another blow to credit discipline. While the Bangladesh Bank cannot be held directly responsible for any of these decisions, it is undoubtedly the weak position of the central bank with respect to the Government that allows such decisions to be taken.

Other forms of financial repression in Bangladesh include a cash reserve requirement of 5 percent of their total demand and time deposits and a liquidity ratio of 20 percent for all commercial banks except those operating under the Islamic Shariah. The latter were required to maintain a liquidity of 10 percent of their demand and time liabilities. The specialized development banks have no specified liquidity requirement. NBFIs are required to maintain a cash reserve ratio of 2.5 percent and a liquidity of 10 percent of total liabilities.

Instruments of financial repression are still employed

The Bangladesh Bank also operates a deposit insurance fund to insure bank deposits up to the extent of Tk100,000 (\$2,000) per account. For this coverage, banks are required to pay the central bank a premium of 0.05 percent for its deposits on a half-yearly basis.

Interest rate controls common in the Bangladeshi banking system until recently were withdrawn on deposits in February 1997. For the purpose of lending, interest rate bands were provided to the banks, ranging from 8–10 percent per annum on loans for exports to 10–14 percent per annum on loans to agriculture. The aim of these bands was to allow the banks some flexibility in pricing their loans but, in effect, did little more than limit competition since the actual rates charged clustered around the upper limits. As part of the Bangladesh Bank’s continuing efforts to reform the financial sector, however, these bands were also withdrawn at end-July 1999 (Bangladesh Bank 1999b).

3.4 Regulation, Supervision, and the Independence of the Bangladesh Bank

Interest rate controls have now been withdrawn as part of efforts to reform the financial system

The Bangladesh Bank Order, 1972 and the Bank Companies Act, 1991 empower the Bangladesh Bank to regulate and supervise the banking sector of the country. The Financial Institutions Act, 1993 also empowers the central bank to regulate and supervise NBFIs — the investment, leasing, and finance companies. Under these laws, the central bank has the authority to frame regulations aimed at limiting the risk undertaken by banks with depositors’ money in their quest for growth and profits. In practice, this means the power to grant and revoke licenses, to fix and enforce prudential reserve and provisioning norms, to inspect the institutions’ accounts and information systems and, in the extreme, to take control of a mismanaged institution.

Presently, the Banking Regulation and Policy Department of the Bangladesh Bank devises regulations governing the functioning of the banking system. Off-site supervision, the issuing of licenses, the monitoring of statutory and reserve requirements,

15 Khalily and Meyer (1993) cited in Meyer and Nagarajan (1999).

and the monitoring of large defaulters are the responsibilities of the Banking Operations and Development Department. On-site supervision of commercial banks is conducted by the Department of Banking Inspection, of specialized agricultural banks by the Agricultural Credit Inspection Department, and of NBFIs by a special department created for this purpose (Development Planners and Consultants 1999). Though this inspection is reportedly carried out with regularity, not only are the levels of motivation and commitment of the staff of these departments relatively low but the efficacy of the follow-up measures undertaken is also limited by the overall malaise and lack of discipline which is unfortunately prevalent in the entire financial system.

In practice, ownership of the largest institutions in the banking sector has, as this discussion shows, resulted in the use of the banking sector for achieving developmental, social, and even political objectives. Even today, the report of the Bangladesh Bank reflects the emphasis that there has been on achieving quantitative targets of disbursement rather than on the quality of the financial system, in terms of the capacity of borrowers to service loans and ensuring the productive use of capital. Not just directed lending but also a nonviable interest rate structure leads to the situation of negative net worth of the banks and a required recapitalization of NCBs in order to enable them to function.

It is apparent from the discussion in this paper that policy related to the banking system is largely formulated in the Ministry of Finance and at political levels of the Government rather than in the corridors of the Bangladesh Bank. In the past, the senior management of the central bank has consisted almost entirely of nominees/bureaucrats from the Government and it is only recently, with increasing pressure from international financial institutions, that a semblance of professionalism has been introduced by appointing professional bankers to these positions. Nevertheless, with terms of office constantly under threat as the complexion of government changes, the extent of professionalism and independence in decision making is extremely restricted. The independence of the central bank in Bangladesh is no more than a distant dream.

Bangladesh Bank needs to achieve the levels of professionalism and independence appropriate to its legislated mandate

4 Central Bank Support for Microfinance Initiatives

4.1 Perceptions of the Bangladesh Bank about Microfinance

As conveyed by its senior management, the Bangladesh Bank fully recognizes the importance of microfinance in the overall economy of the country. Since the combined disbursements of the microfinance sector were of the order of Tk40 billion (\$816 million) in 1997/98 and those of agricultural credit by the entire formal financial sector were just Tk16 billion (\$326 million) during that year, the Bangladesh Bank can hardly ignore it. Nevertheless, until now the central bank has seen its role as being mainly the regulation, supervision, and orderly development of the formal financial system in Bangladesh as well as the promotion of poverty-related lending, wherever possible, by the specialized agricultural banks and NCBs.

Thus, the position of the Bangladesh Bank at the time of writing of this paper was that it had its hands full with the tasks already undertaken by it. The management of the Bangladesh Bank recognizes the limitations faced by it in undertaking these tasks efficiently and effectively and, therefore, accepts that it may

Bangladesh Bank recognizes the importance of microfinance but has limited capacity to deal with it

not be in a position to supervise the microfinance sector as well. As discussed elsewhere in this paper, the Bangladesh Bank's management also recognizes a political constraint in undertaking microfinance regulation in the face of opposition to such regulation from the internationally influential leaders of the large MFIs in the country.

4.2 Developmental and Promotional Activities for Microfinance

The "developmental" role of the Bangladesh Bank in microfinance may be subdivided into indirect and direct roles. The Bangladesh Bank has played a constructive, if indirect, role in microfinance by ensuring price stability in the country. While the average annual rate of inflation in Bangladesh over the past 25 years has been around 9.6 percent, over the past three to four years price increases have been even lower, in the range 2–7 percent (Bangladesh Bank 1998). This has enabled microfinance activities to be undertaken in the country in an atmosphere of economic stability, facilitating financial planning by MFIs and protecting the value of the savings of the millions of poor clients that MFIs serve. Further, in spite of some services of MFIs, particularly deposit mobilization from nonmembers, being in obvious contravention of the Bangladesh Bank Order and the Banking Companies Act, the Bangladesh Bank has not attempted to hinder the activities of MFIs. This has been in recognition of the significant role microfinance services now play in the lives of the large numbers of poor people in Bangladesh.

The direct role of the Bangladesh Bank has been carried out mainly through the refinancing of agricultural loans of the specialized agricultural banks — BKB and RAKUB — and the Sonali Bank's lending to the Thana Cooperative Credit Associations under the BRDB program. Such refinancing is relatively limited, however, and amounted to no more than Tk4.7 billion (\$96 million) or 29 percent of agricultural credit disbursed during 1997/98 (Bangladesh Bank 1998). As indicated earlier, this refinancing is being reduced gradually and has now been discontinued for the Sonali Bank. In 1993/94, the Bangladesh Bank also provided a line of credit of Tk6 billion (\$122 million) to the Grameen Bank though less than half of this was drawn down. Grameen quickly replaced this, in 1994, with government-guaranteed bonds, most of which were purchased by NCBs since the bonds enabled them to meet the statutory liquidity requirements of the central bank.

The two other significant official developmental interventions in microfinance in Bangladesh are those of the Government in enabling the Grameen Bank and PKSF to obtain resources from the local money market and foreign development finance institutions. However, Grameen's outstandings to the local money market (NCBs) amounting to Tk5.6 billion (\$115 million) at the end of 1997 were guaranteed by the Government and not by the Bangladesh Bank. Indeed, contrary to popular perception, the central bank is not a shareholder in Grameen Bank which is owned by the Government to the extent of 4.88 percent and 1.22 percent each by the Sonali Bank and the Bangladesh Krishi Bank.¹⁶ A number of the foreign borrowings of Grameen are also through subsidiary loan agreements with the Government and not with the Bangladesh Bank. Similarly, in the case of PKSF, resources have been provided either directly by the Government or been obtained from foreign sources through subsidiary loan agreements with the Government.

The "promotional" role of the Bangladesh Bank in microfinance has, so far, been limited to occasional circulars encouraging the commercial banks to lend to MFIs in view of the significant role played by such institutions in poverty alleviation.

The central bank has not intervened to restrict MFI deposit taking

¹⁶ Grameen Bank (1997). The members of the Grameen Bank hold the rest of the shares.

The latest such circular (Bangladesh Bank 1999a) states that:

For the socio-economic development of poor villagers, banking groups should not only make different schemes for the distribution of loans directly but also establish linkages with NGOs/self-help groups for the same. The banking groups can give service charges to the NGOs/self-help groups for motivating, training and to look after the distribution of loans. To establish such linkages, the banking groups need not follow the limits fixed on the normal interest for agricultural/rural loans.

The Bangladesh Bank also conducted a seminar in 1994 on the issue of promoting linkages between commercial banks and MFIs. Unfortunately, the impact of such measures appears to have been limited and, as noted previously, the volume of commercial bank lending to MFIs has remained a negligible proportion of the total.

Under the World Bank-assisted Poverty Alleviation and Micro Finance Project, the Bangladesh Bank has been provided resources to undertake two studies: one to look at the appropriate regulatory framework and institutions for regulating and monitoring deposit taking by MFIs, and the other to study regulatory reforms and proactive measures to enhance linkages between MFIs and the formal financial sector. These studies were undertaken as one exercise which was completed in January 1999.¹⁷

Overall, it is apparent that the Bangladesh Bank has not played a very significant role in either the development or promotion of the very important microfinance sector in the country. It was allocated no role in either of the Government's two major initiatives in microfinance promotion, the incorporation of the Grameen Bank with its own statutes and the formation of PKSF as a major wholesale financier of MFIs.

The Government of Bangladesh, rather than the central bank, has been the financial backer of Grameen

Bangladesh Bank has so far played a quite limited promotional role in support of microfinance

5 Regulation and Supervision of Banks

5.1 Licensing and Minimum Capital Requirements

The Bank Companies Act, 1991 provides that an institution, other than Grameen Bank, must have a banking license issued by the Bangladesh Bank in order to accept deposits from the general public. Similarly, the Financial Institutions Act, 1993 empowers the Bangladesh Bank to license NBFIs to undertake the financing of industry, trade and agriculture, or housing by way of loans and advances, leasing, or provision of venture capital. NBFIs may accept deposits from the general public provided they cannot be withdrawn by check or draft. No cash transactions are allowed either and all transactions must be carried out through a bank. Amongst MFIs, the Grameen Bank operates under a separate law as a financial institution authorized to mobilize deposits from the public, but other MFIs are not allowed to mobilize deposits from nonmembers.

The Bank Companies Act specifies that a company must have a minimum paid-up capital of Tk200 million (\$4.1 million) or sponsors' minimum equity of 6 percent of deposit liability (whichever is higher) as well as satisfying other criteria in order to obtain a banking license (Development Planners and Consultants 1999). Even so, licensing is not easy and it has taken several years for BRAC to obtain a banking license for its proposed bank. The Bangladesh Bank has, traditionally, been

¹⁷ The results of this study, Development Planners and Consultants (1999), are discussed in Section 7.

There is no provision for setting up small, locally based commercial banks, which might go in for microfinance

conservative in issuing banking licenses at least partly because of regulatory concerns. However, this policy has been liberalized recently and it is reported that, in addition to the 39 scheduled banks indicated in Section 1, some 10 new private banks have been licensed during the first half of 1999. The Grameen Bank, by contrast, was established with a paid-up capital of Tk100 million but now has an authorized capital of Tk500 million and paid-up capital of around Tk250 million (\$5.1 million).

The licensing requirements of NBFIs include a minimum capital of Tk50 million (\$1 million) or 6 percent of total liabilities as equity (whichever is higher). Other conditions include sound financial condition of an existing/related public limited company, efficient and qualified management, and a clear indication of operations being in the public interest. Here, again, there has been a spate of new approvals in recent months and concern has started to emerge about the (excessive) rate of growth of the number of companies in the financial sector.

As already noted, unlike in many other countries, there is no provision in Bangladeshi law for the establishment of small banks to undertake limited regional operations (such as rural banks) or any other form of limited banking activities (thrift banks). Given the high capital requirements and stringency (until now) in issuing commercial banking licenses, it has been very difficult for MFIs or others to establish small banks for localized operations. Yet, as is apparent from the experience of other countries such as the Philippines and Indonesia, small banks are more likely to become involved in microfinance than large ones (McGuire et al. 1998).

5.2 Interest Rate Regulation

Until recently banks in Bangladesh were required to limit their lending rates within certain specified bands for lending to agriculture, exports, and small and cottage industries, and most such loans were refinanced by the Bangladesh Bank at a subsidized rate. As noted earlier, however, these limitations have now been abolished and banks are now free to lend as well as to mobilize deposits at market-determined rates. On account of the many restrictions in place until early 1999, however, effective competition has been virtually unknown in the banking sector in Bangladesh. For this reason, it is widely expected that interest rates will continue to cluster around the (abolished) specified bands in the immediate future, and it will take some really adventurous financial entrepreneurship to break this mold. Nevertheless, it does mean that an MFI-associated bank such as the newly licensed BRAC Bank can undertake direct microfinance activity if it so desires without inviting the wrath of the regulatory authorities.

Interest rate flexibility is now permitted, but the idea of price competition may take a while to catch on

5.3 Prudential Regulation and Supervision

Commercial banks in Bangladesh are subject to a capital adequacy ratio of 8 percent of risk-weighted assets and a liquidity ratio of 20 percent (including a cash reserve of 5 percent). These requirements appear to be in line with international norms. While there are no regulations in respect of loan documentation or collateral security, there are fairly stringent requirements on reporting to the central bank. These include weekly, monthly, half-yearly, and annual statements as well as returns covering asset quality, investments, nonperforming accounts, deposits, advances, and branch expansion. NBFIs face similar regulatory and reporting requirements except that the statutory liquidity ratio is 10 percent (including a cash reserve of just 2.5 percent).

Loan classification and provisioning requirements for financial institutions in Bangladesh have graduated from the very liberal to stringent norms which now fully conform to the Basle Accord recommendations in the case of the general banking

business. However, for agricultural and microfinance loans norms are still quite liberal. Thus, all such loans must be provided for at the level of 5 percent of outstandings, while loans are classified as bad (100 percent provisioning) only when three years overdue.

In performing the regulatory function, the Bangladesh Bank employs a number of interrelated techniques apart from bank and branch licensing. Off-site supervision is undertaken through a CAMEL rating undertaken via tabulation and computation of information from the regular statutory returns. On-site supervision is carried out through inspections by the related departments as indicated earlier. Thus, during 1997/98, comprehensive inspection of 1,140 branches of the 39 scheduled banks was undertaken. This included special inspection of 366 branches. The Agricultural Credit Inspection Department also carried out some 700 inspections of the specialized agricultural banks and local credit associations. Unfortunately, it is widely acknowledged in Bangladesh that the quality of this supervision is poor and, partly on account of rampant corruption in the system, confidence in its efficacy is extremely low.

Norms for prudential regulation are set at international standards, but bank supervision falls short

6 Regulation and Supervision of Nonbank MFIs

As previously discussed, there are no specific regulatory provisions in Bangladesh relating to MFIs that go beyond the simple administrative and accounting requirements of the laws related to charitable societies, trusts, cooperatives, and nonprofit companies. Currently, there are no provisions in which the Bangladesh Bank plays a role. As noted, the Bangladesh Bank does not even play a role in regulating or supervising significant financial institutions such as the Grameen Bank and PKSF which were specifically established for the purpose of promoting microfinance. Reporting of some financial data by the Grameen Bank to the central bank is mainly for the purpose of centralized data compilation on the performance of the banking sector.

Microfinance institutions are virtually unregulated

7 Conclusions and Recommendations

7.1 Conclusions

It is apparent from the discussion that the Bangladesh Bank has only been able to play a relatively small and mostly indirect role in the development of the microfinance sector in the country. Thus, it has been able, in conjunction with government policy, to ensure the macroeconomic and price stability that is essential to the smooth conduct of financial services. It has also avoided interfering in the activities of microfinance institutions (MFIs) even though some of these have been in technical contravention particularly of the laws related to the mobilization of public deposits. The direct interventions of the Bangladesh Bank have been limited to the refinancing of the loan portfolios of the specialized agricultural banks and the Sonali Bank's lending under a BRDB program. A line of credit to the Grameen Bank in 1993/94 was not fully utilized and was soon replaced by government-guaranteed bonds. The Bangladesh Bank has not had the opportunity of direct supervision of the Grameen Bank. The presidential ordinance of 1983 made only minimal provisions for the prudential regulation of the

Grameen Bank, limiting external supervision to strict auditing provisions and the submission of accounts direct to the Government for scrutiny.

Bangladesh has set a fine example in the field of microfinance for most of the rest of the developing world to follow. With a carefully thought out policy for promoting systematic and responsible growth of the microfinance sector, it could yet demonstrate to the world the sustainability and efficacy of its alternative paradigm for poverty alleviation.

7.2 Recommendations

(1) Bangladesh bank should support the establishment by government of a legal framework to facilitate resource mobilization for microfinance.

Though it is generally accepted in Bangladesh that savings mobilization from members is a legitimate activity undertaken by MFIs and that deposit mobilization from nonmembers may not be, the success of efforts at deposit mobilization by organizations such as the Association for Social Advancement (ASA) and BURO, Tangail is increasingly blurring the distinction. At the same time, commercial banks in Bangladesh repeatedly point to the lack of an appropriate legal framework for microfinance as an important reason for the limited progress in linking banks with MFIs conducted by NGOs. As reported in Section 2, the lack of owners' equity and a clear ownership structure are major impediments to the formal financial institutions entering into loan agreements with such MFIs.

In this situation, it is apparent that there is a need for enacting a separate law for microfinance in Bangladesh. The purpose of this law would be to create a clear organizational structure and regulatory framework specifically for microfinance operations. Important features of such an "MFI Act" would be:

- (i) All organizations providing microfinance services to more than 10,000 members¹⁸ should obtain registration as companies with specific provisions for equity shareholding but limitations on the extent of ownership by individuals or private companies. Such companies could be registered as not-for-profit if the nature of the entity makes this appropriate.
- (ii) Clear permission should be granted to these companies to mobilize deposits from nonmembers (or associate members) provided the company is established specifically for the purpose of microfinance and does not advance loans greater than Tk50,000 for any purpose.
- (iii) Specific income tax exemption should be granted to such companies registered as not-for-profit, enabling them to incorporate any surpluses generated into their revolving loan funds.
- (iv) In return for acceptance of a regulatory framework under the new law, MFIs should have freedom from all the requirements of existing legislation for permissions and reporting to various ministries and the NGO Affairs Bureau.

It is expected in Bangladesh that the regulatory framework created under the provisions of such an Act would increase transparency and accountability of MFI operations. It is commonly acknowledged that such transparency and accountability are necessary both for obtaining recognition as financial partners of the formal financial sector (as already noted) and for ensuring the security of the savings of clients/members.¹⁹ This is seen as an important measure for increasing the

Banks claim the lack of a legal framework makes it hard for them to deal with MFIs

18 This would affect around 51 MFIs according to CDF (1999a).

19 This perception emerges in private discussion with MFI observers and was also articulated at the workshops organized by CDF to discuss the topic of regulation (see CDF 1999b).

Elements of a Legal Framework for MFIs

- Incorporation of larger MFIs as companies
- Freedom for incorporated MFIs to mobilize nonmember savings
- Income tax exemptions to permit profit plowback
- Freedom of incorporated MFIs from other regulation

availability of funds to MFIs both from the general public and as on-lending funds from the commercial banks.

- (2) Bangladesh Bank should participate in establishing prudential regulation and supervision for larger MFIs. This should be done through the creation, under the MFI legislation just discussed, of a new and separate regulatory entity. This entity, while independent, could be a subsidiary of the central bank. It would be absorbed in due course into the mainstream operations of the central bank, once the latter's understanding of, and capacities for supervising, microfinance have been upgraded to appropriate levels. PKSf should also come under the new regulatory umbrella established for MFIs.**

In the absence of an MFI Act, with large numbers of, often very small, organizations becoming increasingly involved in microfinance, it is clear that it would be impractical, and possibly even counter-productive, to attempt to regulate and supervise all of them. Whether or not there is an MFI Act, therefore, prudential regulation and supervision should be applied only to those with more than 5,000 members (around 100 of the largest MFIs in Bangladesh).

Unfortunately, there is no immediately obvious institution to undertake this role. Given the Bangladesh Bank's difficulties in the supervision of the formal financial sector, it is apparent that any role assigned to it would have to be undertaken with caution. It presently lacks not only the staff capacity to add the regulation of microfinance to its many roles but also the requisite understanding and professional expertise in microfinance necessary for this purpose. For this reason, it could not be the only actor in such an exercise even though, as the supervisory/regulatory authority for the financial sector, it should certainly be an integral part of any initiative to develop prudential standards and introduce regulation for microfinance in Bangladesh.

Other organizations discussed by the study team commissioned to consider a regulatory framework for microfinance in Bangladesh (Development Planners and Consultants 1999) as possibilities for undertaking the regulatory role were Palli Karma Sahayak Foundation (PKSF) and the networking organization, the Credit and Development Forum (CDF). There are important reasons why neither of these organizations could perform the regulatory role in microfinance in Bangladesh:

- PKSF has established an excellent reputation as a wholesale lender. While it monitors and provides its over 150 borrowers with both implementation guidelines and capacity-building support, it would face major conflict of interest issues if it were to be required to perform the role of regulator as well.
- CDF's main roles are those of advocacy and capacity building of MFIs. It was formed by a coalition of MFIs for this purpose. It is generally thought that it could not play an enforcement or statutory supervision role without compromising its other activities. It is also a relatively small organization with limited capacities.

The consensus on this issue in the microfinance sector in Bangladesh is that there is a need for the establishment of a separate superintendency for MFIs on the

The proposed MFI Act should apply only to large institutions (the top 100)

The central bank is not yet equipped to take on the role

PKSF would have a conflict of interest and CDF has other objectives

PKSF management model. Thus, it is argued that the best option would be the creation of an independent entity under the MFI Act which could both register MFIs with operations above the threshold of 5,000 members and regulate them. As in the case of PKSF, an independent governing body drawn from the Bangladesh Bank, NGO/MFI sector, the commercial banks, and academia, would provide the management guidelines to the office of the independent regulator. Operational management would be undertaken by professionals from both the microfinance and formal financial sectors, and staff would be recruited on the open market, with or without experience of microfinance, and trained appropriately.

A separate new “superintendency” of MFIs should be created

Though the idea of an independent regulator is certainly appealing in the context of the limitations of the central bank it would, effectively, sideline the Bangladesh Bank and perhaps even reinforce its image as a marginal player in microfinance. For this reason, it may be more appropriate to establish the independent microfinance regulator as a subsidiary organization of the Bangladesh Bank with its own board, independent premises, and separately recruited and trained professional staff. As a subsidiary organization, the microfinance regulator would be the responsibility of its management but its independence could be ensured by including on the board researchers and other eminent persons acceptable to MFIs as well as to the Bangladesh Bank. The separation of premises as well as of staff recruitment and training would, in this situation, enable the microfinance regulator to earn and establish its own track record uninfluenced by the existing perceptions of the central bank.

Bangladesh Bank should have an important role in relation to the new superintendency

Bangladesh Bank’s own understanding of, and capacities for supervision of, MFIs could in the meantime be upgraded by an appropriate program of technical assistance in microfinance. In the longer term, once technical assistance for this and for improving the broader regulatory operations of the Bangladesh Bank has taken effect, the independent office whose creation is recommended in the previous paragraph could be absorbed into the central bank’s mainstream operations as a regular microfinance supervision division. The central bank could in the meantime commence or support an appropriate program of research on microfinance, both to improve its understanding of the issues and to contribute to the identification and dissemination of best practice in the field.

PKSF should be subject to the provisions of the new MFI Act

PKSF is not presently supervised by the central bank, and there is no suggestion to do so. However, in the long term, as a microfinance wholesaler, it should form an integral part of the microfinance sector. In this context, any regulatory system applied to MFIs as a whole should also be applied to PKSF which would then come under the superintendency of the microfinance regulator.

Major MFIs opposed to comprehensive MFI legislation are an obstacle to reform

There is, however, a major impediment to the introduction of regulation for MFIs in Bangladesh. The largest and most influential microfinance organizations in the country, organizations which can and do act as role models for the other MFIs, are for the most part strongly opposed to any kind of regulation. This opposition is rationalized as resistance to bureaucracy and control, a legitimate fear in the Bangladeshi context where, as already mentioned, banking regulation is widely acknowledged to have been poorly applied. Unfortunately, this is an argument that is made by those who are well endowed with resources — and, therefore, do not need a legal framework to ensure their legitimacy — and who are sometimes, regrettably, less than transparent. Medium-sized organizations that would be equally subject to such bureaucracy but would have a lot to gain from the legitimacy conferred by regulation, display greater interest in it. The opposition of the largest MFIs helps preserve the present situation and could hinder the growth and professionalization of the sector as a whole.

(3) Bangladesh Bank should work with other stakeholders toward defining commonly accepted performance and reporting standards, drawing on international experience.

Though there are no commonly accepted performance and reporting standards in Bangladesh at present, it is widely agreed that there is a need for such standards. As part of its obligations under the World Bank-funded project for poverty alleviation, PKSf is supposed to develop appropriate standards for its own borrowers. There is, currently, a move for PKSf to develop these standards in collaboration with CDF. This is entirely appropriate and would be particularly effective if it were to take into consideration the standards employed in some of the more advanced regulatory systems for microfinance in Latin America and elsewhere.

Any regulatory initiative of the Bangladesh Bank could then use these standards as a starting point to be strengthened by a process of consultation with nationalized commercial banks (NCBs) as well as the microfinance sector so that the interests and needs of all microfinance models and their variations are taken into account. This would help to establish commonly accepted standards for Bangladesh as a whole and could form the basis for the application of prudential regulation in the country (recommended previously).

(4) Bangladesh Bank should encourage commercial bank linkages with MFIs and nurture diversity in the microfinance sector. As a corollary, it should avoid positioning PKSf as the exclusive intermediary for donor resources.

The excellent reputation of PKSf has demonstrated the potential for fully professionalizing the provision of both wholesale finance and retail microfinance services in Bangladesh. It certainly shows that a suitably strong and independent-minded governing board and a firm commitment to autonomy are key factors in ensuring operational efficiency in Bangladesh. However, it would be a mistake to kill the organization with kindness. The suggestion that donors should consider channeling all their resources through PKSf should, therefore, be viewed cautiously rather than with enthusiasm. Not only should PKSf be allowed to develop its capacities steadily, rather than suddenly. It also needs to avoid the well-known dangers of monopoly. Some diversity in funding sources is welcomed also by MFIs.

The commercial banks having done little, so far, to establish linkages with MFIs could be encouraged more strongly (but not coerced) by the Bangladesh Bank and other concerned, including donor, organizations to lend to MFIs. The enactment of a law directly for MFIs would confer legal legitimacy on microfinance as an activity and would, thereby, encourage this process. The availability of capacity assessment (credit rating) services, since late 1998, should also facilitate decision making by commercial banks in the context of applications from MFIs for wholesale funding.

PKSf and CDF are among the stakeholders

Agreed performance and reporting standards would give a basis for regulation

PKSf should not be placed in a monopoly situation

Commercial banks need encouragement to do more

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Appendix: Persons Consulted

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Hossain, Mr. K. Zakir	Executive Director, Credit and Development Forum
Hossain, Mr. Mosharrof	Finance Director, BURO, Tangail
Huq, Mr. Muzammel	General Manager, Grameen Bank
Islam, Mr. Md Masrurul	Deputy Director, Proshika
Khaled, Mr. Ibrahim	Deputy Governor, Bangladesh Bank
Khan, Mr. Mosharraf Hossain	General Manager, Palli Karma Sahayak Foundation
Mollah, Mr. Nurul Islam	General Manager, Janata Bank
Nayar, Ms. Nina	Chief Executive Officer, South Asia Network of Microfinance Initiatives
Quader, Mr. M. Fazlul	Deputy General Manager, Palli Karma Sahayak Foundation
Rahman, Dr. Atiur	Senior Research Fellow, Bangladesh Institute of Development Studies; Director, Sonali Bank
Rao, Mr. Narhari	Senior Economist, Asian Development Bank
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Rehman, Mr. S. M.	Director, Credit and Development Forum
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