VII Rural Financial Market Development in Bangladesh: Failing Banks, Thriving Microfinance

OVERVIEW OF THE FINANCIAL SYSTEM

Bangladesh is the poorest of the six case-study countries selected for this research. Per capita GDP in 1996 was estimated to be only $212 in 1987 US dollars. With its huge population of 126 million and relatively small land area, there is an average of 870 persons per square kilometer. The country lacks raw materials but has productive croplands. It is subject to periodic floods including a severe one that devastated the country in 1998.

In spite of its serious problems, the country has made notable progress in several areas (Quibria, 1997). Food production has increased by 3 percent per annum since the 1980s and the country is on the verge of food self-sufficiency, albeit at a low level of consumption. Considerable hunger and malnutrition still exists. With the widespread adoption of family planning practices, fertility has fallen and the annual population growth rate is just under 2 percent per annum. Poverty is serious but the incidence is reported to have declined from over 70 percent of the total population in the early 1980s to less than 50 percent by the early 1990s. This decline was attributed to broad-based growth that occurred through improved agricultural technology, labor-intensive industrialization, and rapid growth of the informal service sector. The country has achieved a degree of macroeconomic stability and has enjoyed a very low inflation rate, about 5 percent per annum, in the 1990s.

Bangladesh faces many serious problems, including relatively low savings and investment rates, and low levels of efficiency of the public sector. The commercial banking sector is inefficient, and its performance has worsened in recent years in several major dimensions. There are serious weaknesses in the regulatory framework and the legal and judiciary system to support the financial system.

The formal financial system today is comprised of the central bank (Bangladesh Bank - BB), four nationalized commercial banks (Sonali, Janata, Agrani, and Rupali - NCBs), 18 private commercial banks, 12 foreign commercial banks, and 4 nationalized specialized banks. Two of the four specialized development finance institutions (DFIs) serve agriculture: the Bangladesh Krishi Bank (BKB), and the *Rajshaki Krishi Unnayan* (RAKUB). In addition, two cooperative networks serve the rural sector. The traditional cooperatives are under the Registrar of Cooperative Societies financed by the Bangladesh Sambaya Bank Ltd. (BSBL). The two-tier Comilla type cooperatives are under the Bangladesh Rural Development Board (BRDB) and are financed by Sonali Bank (World Bank, 1996a; Hossain and Rashid, 1997; Wade et al., 1998).

The problems of the banking system originated several decades ago. The Pakistan Government of the 1950s and 1960s used financial institutions as a cheap source of credit for priority sectors including exports and industrialization. Beginning in the 1960s, loans were made to strengthen the Bengali entrepreneurial class. But at the time of Bangladesh Independence in 1971, the Bengalis owned only 23 percent of the fixed assets in the industrial sector (Sobhan, 1991). Controls over interest rates, selective credit allocation programs, complex rules and regulations for money and capital markets, and overvalued exchange rates were all part of a repressive financial system that Bangladesh inherited. The problem worsened in 1972 when the new Government nationalized the financial institutions and heavy industries and created three specialized banks. Much of the lending from 1972 to 1975 by the DFIs was directed at building up the public sector. Two of the NCBs (Pubali and Uttara) were denationalized in 1984. Several private banks were licensed in the 1980s and 1990s.

State intervention in the banking sector during the last two decades has included interest rate controls, targets for commercial bank lending to priority activities, and rules regarding the opening of new branches. Many nationalized industries have incurred heavy losses and, under instruction of the Government, the NCBs have provided loans to keep them alive. Loans were scarce after the priority sectors were accommodated and interest rates were negative in real terms. Thus, private sector demand has been rationed among the economically and politically powerful. This has contributed to inefficiency in investment and the nonpayment of loans. The NCBs had to be recapitalized in the late 1980s and early 1990s to keep them solvent (Hossain and Rashid, 1997).

After 1975, the principal donors to Bangladesh promoted the idea of curbing the public sector and channeling resources to the private sector. Sizeable lines of credit were extended to the private sector through the two industrial DFIs, the Bangladesh Shilpa Bank (BSB) and the *Bangladesh Shilpa Rin Sanstha*. Donor lending accelerated in the late 1970s, and the DFIs began to channel credits rather indiscriminately, without careful scrutiny of borrowers' entrepreneurial experience, collateral position, or the market worth of the projects. To obtain new credit lines, the DFIs sped disbursements to the point where loan portfolios became seriously compromised. Apparently, the donors did not conduct in-depth evaluations of DFI performance during this period (Sobhan, 1991).

The country's aid-based development strategy is alleged to contribute to the bad-debt problem. Businesses do not pay their debts because they know that sooner or later the aid givers will refinance the banking system and past loans will be written off. The notion that debts do not have to be paid affects most classes of people to the detriment of the country (Novak, 1993, cited in Hossain and Rashid, 1997).

In the early 1980s, the magnitude of the repayment problems became clearer, studies and audits were conducted, and agreements were signed with donors regarding collection efforts. The donors suspended disbursements and withheld new loans pending the outcome. Attempts were made to improve collections but by 30 June 1990, accumulated overdues reached taka (Tk) 10.5 billion compared with Tk8.5 billion disbursed; thus, the default rate was 123 percent of disbursement for the two DFIs (Sobhan, 1991). After five years of collection efforts, there was little evidence of improvement, but there were negative consequences for industrial investment and output. Moreover, the experience with these two DFIs established the culture of default that spread into the rest of the economy.

During the late 1980s and in the 1990s, several attempts were made to implement financial sector reforms, often with the encouragement and technical support of the donor community. The accomplishments include: significant deregulation of interest rates, decline in the role of directed credit, recapitalization of and greater freedom for the NCBs, introduction of loan provisioning to make loan recovery problems more transparent, licensing of several private and foreign banks, commitment to privatize Rupali Bank, and the initiation of commercial transactions for one DFI (Rana, 1997).

Many initiatives have been taken in attempts to deal with the loan recovery problem. For example, the 1986 loan recovery program included prosecution of willful defaulters, prohibitions against defaulters holding public offices or bank directorships, limitations on access to new loans, and denial of import licenses to industrial loan defaulters. An interest amnesty program was introduced in 1986 to induce payments on agricultural loans. A Financial Loan Courts Act was passed to establish loan courts at the district level, to close legal loopholes, and to allow the prosecution of defaulters. The Government has attempted to shame defaulters by publishing lists of the most egregious offenders (Hossain and Rashid, 1997). A Credit Information Bureau was established in the Bangladesh Bank to record the performance of borrowers, and a Large Loan Review Cell was set up to review all newly sanctioned bank loans over Tk1 crore (Tk10 million).

The results of these reform measures have been mixed. As a result of deregulation, real lending and deposit rates have risen. There is some evidence of greater competition but also of collusive pricing by the private banks. Political interference continues to be great. For example, a decision by the outgoing Government on the eve of the national election on 15 February 1996, permitted blanket rescheduling of all bank loans on the basis of a 10 percent down payment. This political action once again undermined the credibility of policymakers in their attempt to restore discipline, and apparently permitted influential defaulters to contest the parliamentary elections (Sobhan, 1997). These problems have contributed to the emergence of a bad-debt culture.

Recent data reveal that the banking system is unsound and that there has been little improvement. The problems are especially serious for the specialized banks. Classified loans in the NCBs rose from 32 to 37 percent from 1994 to 1997, while they fell from 44 to 31 percent in the private domestic banks. Moreover, these high levels understate the nonperforming loan problem when measured by more rigorous international standards (Wade et al., 1998). There is a low probability that many of these loans will be paid. Assuming an 80 percent loss rate, the expected loan losses are roughly estimated to be 6 percent of the country's GDP. The domestic banks are deficient in loan loss provisions and are effectively insolvent in spite of substantial recapitalization by the Government in the early 1990s in an amount of about 5 percent of GDP. The steady growth in deposits, however, has provided sufficient liquidity for the domestic banks.

The persistence of the banking problem is attributed to a lack of political will to deal with the root causes. The Government has been deterred by the perceived strength of the major defaulters, and the fear of possible bank runs if weak banks are closed. Prudential regulations concerning loan classification, provisioning requirements, and capital adequacy are now close to international standards but the key problem is weak and inadequate enforcement. The NCBs are subject to priorities set by the Government that may differ from prudential concerns. The Bangladesh Bank is weakened by strong and militant unions that interfere in personnel, recruitment, and promotion decisions. The deposit insurance scheme is grossly underfunded compared with its legal liabilities. The commercial banks suffer from weak corporate governance, and the concentration of nonperforming loans in relatively few borrowers is indicative of an imprudent credit policy. The private banks are reported to be hampered by insider lending, fraud, and negligence (Wade et al., 1998).

APPROACH TO RURAL AND AGRICULTURAL FINANCE

The provision of financial services in the rural economy in Bangladesh has been subject to similar types of State and political intervention with similar disastrous results. The surprising feature of Bangladesh, however, is that a strong NGO financial system has emerged in spite of the bad-debt culture that has also infected agricultural lending. To understand developments affecting rural areas, it is necessary to analyze banks and cooperatives, the Grameen Bank (GB), and financial NGOs. The problem is that there is no easy way to aggregate the data for these three groups of institutions. Although the GB and many NGOs are considered to be rural institutions, they often operate in small towns and peri-urban areas, serving clients whose activities (e.g. trading) would not be considered agricultural in some economic classifications. Therefore, when statistics on agricultural loans are presented, they refer to banks and cooperatives only, and they underestimate total lending because of the important role of the GB and the NGOs. Yet it is incorrect to classify all GB and NGO lending and deposit mobilization as agricultural.

The NCBs and the agricultural DFIs have been subject to several measures designed to push financial services, especially loans, into rural areas. First, from 1978 to 1981, the banks were required to open two new rural branches for each new urban branch. As a result, about two thirds of the NCB branches, over half the denationalized bank branches, and 90 percent of the DFI branches are now in rural areas (Hassan, 1997). This branch expansion has contributed to the large commercial bank share of rural loans and deposits. Second, the Agricultural Credit Department (ACD) of the BB has set agricultural loan targets for banks. There have been few effective sanctions for not reaching the targets, such that between 1981/82 and 1994/95 the actual lending ranged from a low of 45 percent to a high of 100 percent of the target. Agricultural credit as a proportion of total credit rose from 20 percent in 1981/82 to a high of 34 percent in 1984/85, then gradually fell until it reached 22 percent in 1994/95 (Khalily, Huda, and Lalorukh, 1997). Third, lending rates have been controlled, and banks have been encouraged to make agricultural loans that the BB would refinance at a subsidized rate. The refinance subsidy was terminated for the NCBs in 1991 but was continued for the DFIs.

Five interest exemption programs were implemented during 1982–1991. Depending on the years, the basic objectives were either to ease the loan burden of the borrowers or to encourage them to repay overdue loans. The 1984 and 1985 programs provided for interest exemptions and loan rescheduling without penalty interest for borrowers affected by natural calamities. The 1985 program exempted interest only for cyclone-affected borrowers. The 1986 and 1987 interest exemption programs aimed at improving the recovery rate and were applicable countrywide to crop loans up to Tk10,000 (including principal, interest, and service charges).[1] The 1991 program was part of the Government's election promise. It provided for exemption of principal, interest, and overdue interest penalties up to Tk5,000.

[1] In this period, $1 = Tk30 approximately.

A study of agricultural loan recovery concluded that the 1991 program did increase loan repayment but at a huge cost. It not only contributed to revenue loss but also to capital loss for the banks. The exempted principal meant that the banks had to compensate depositors out of their capital and/or profits. The total cost of the 1991 program for the NCBs and DFIs was estimated at Tk350 million. The frequency of these programs has contributed to borrower expectations about future interest exemptions, and is believed to have contributed to low and declining recovery rates for agricultural loans (Khalily and Meyer, 1993).

Loan recovery was also found to be negatively affected by political elections. The Government is not likely to pursue loan recovery vigorously during an election period because of the negative effect it may have on voters. Moreover, local officials intervene during elections to influence who can most easily get loans, and which borrowers can avoid pressure from bank officials to collect overdue loans (Khalily and Meyer, 1993).

THE EVOLUTION AND CURRENT STATUS OF KEY RURAL FINANCIAL INSTITUTIONS

The evolution of agricultural lending is indicated in Table VII.1. Total disbursements to agriculture represented almost 7 percent of agricultural GDP in 1983/84, then fell in absolute and relative terms thereafter until 1990/91, when they represented less than 2 percent of agricultural GDP. They rose steadily in the 1990s and represented 3.6 and 3.8 percent of GDP in 1995/96 and 1996/97, respectively. The largest single source of funds has been the DFIs of BKB and RAKUB that together represented half to two thirds of total loans. The commercial banks have represented about one third, and cooperatives 1 to 10 percent depending on the year. About half the total disbursements have been for crop loans.

Table VII.1: Agricultural GDP and Loans Granted, 1983/84 to 1996/97
(taka crores[a] at current prices)

Year	Agricultural GDP	Loans by Organization				Loans by Type				Total Ag. credit as % of Ag. GDP
		NCB[b]	BKB/ RAKUB[c]	BRDB COOP[d]	BSBL COOP[e]	Crop	Term credit[f]	Other[g]	Total	
1983/84	14,840.3	324.1	592.4	66.8	22.0	635.9	278.7	80.8	1,005.3	6.77
1984/85	16,997.0	386.2	614.7	123.6	28.3	564.8	421.1	145.9	1,152.8	6.78
1985/86	18,838.2	156.7	365.1	96.0	14.0	275.6	192.8	168.8	631.8	3.35
1986/87	21,976.1	134.1	441.9	74.2	17.1	312.5	129.8	148.0	667.3[h]	3.04
1987/88	23,162.3	177.5	379.2	85.6	14.0	383.1	130.3	142.9	656.3	2.83
1988/89	24,539.2	240.9	487.0	62.3	17.7	340.0	186.7	171.0	807.6[h]	3.29
1989/90	27,179.0	207.0	423.0	54.8	1.9	359.8	156.9	170.1	686.8	2.53
1990/91	30,059.6	182.2	361.2	49.9	2.3	302.5	139.7	153.4	595.6	1.98
1991/92	31,243.8	270.7	503.5	17.4	3.1	346.4	260.4	187.8	794.6	2.54
1992/93	28,884.2	262.7	563.9	11.9	3.4	388.5	247.2	197.2	841.9	2.91
1993/94	30,589.0	345.3	742.3	12.0	1.2	515.1	392.4	193.3	1,100.8	3.59
1994/95	36,137.0	457.1	958.1	73.2	1.9	696.7			1,490.6	4.12
1995/96	38,990.0	437.8	951.0	91.0					1,479.8	3.80
1996/97	41,831.0	446.6	958.1	110.7					1,515.4	3.62

[a] One crore = Tk10 million.
[b] Nationalized Commercial Banks.
[c] BKB is the Bangladesh Krishi Bank; RAKUB is the Rajshaki Krishi Unnayan.
[d] BSBL is the Bangladesh Sambaya Bank Ltd.
[e] BRDB is the Bangladesh Rural Development Board.
[f] Includes agricultural term credit as well as financing for marketing, transportation, and agro-industries.
[g] Includes loans for fisheries, tea production, and cold storage facilities for agricultural products.
[h] Includes some loans for which breakdown is not available.

Source: World Bank (1996a). Updated with data from the Bangladesh Bank.

The aggregate data suggest that member-based institutions (GB and the NGOs) advanced Tk1,660 crore[2] in 1993/94, while the banks and cooperatives disbursed about Tk1,100 crore as agricultural credit and another Tk11 crore in poverty alleviation programs. If all these funds went into agriculture, then the ratio of total agricultural credit to agricultural GDP would have reached about 9 percent, surpassing the 1983/84 levels. Obviously, the growth in disbursements in recent years has been due to the microfinance organizations (MFOs).

Participants

The formal banking sector is composed of the NCBs, the DFIs, and agricultural cooperatives. As described above, they have played the predominant role in agricultural lending, but in recent years their role has declined in relative importance in financing the rural sector. They make loans largely to individual farmers and focus on crop lending; they do not serve the wider demands for rural finance. An important development has been the emergence of member-based institutions that include the GB and hundreds of MFOs that make loans, often to groups of borrowers. The most important of these institutions are described here, beginning with the GB. Most MFOs in Bangladesh, unlike those in many developing countries, are rural oriented. The expansion into urban areas has been recent (Chowdhury, 1998).

The concept of the GB had its origin in 1976 when its founder, Professor Muhammad Yunus, began making working capital loans to poor people in rural villages. Initially, he worked with local banks that provided the funds, but in October 1983, the GB was chartered as a specialized bank for the poor. He adopted the idea of joint-liability group lending, that had been used without great success in other countries for small farm

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[2] One crore = Tk10 million. At the official exchange rate in February 1996 of $1 = Tk41.00, a crore was equal to $243,900.

lending programs, and made it work in Bangladesh. Over time, the clients have increasingly been poor women. Individuals organize themselves into borrowing groups of five persons, usually of the same gender, and elect a chairperson who is responsible for group discipline. Membership is limited to people who own less than one-half acre of land, are not members of the same household, have similar economic resources, and live in the same village. The similarity of residence and economic background contributes to the effective functioning of the groups (Khandker, Khalily, and Khan, 1996).

The groups meet weekly, at which time each member makes an obligatory small savings deposit (Tk1 per week). Initially two members are given credit and are observed for one or two months. If they repay regularly in weekly installments, the next two members are granted loans. The leader is usually last to get a loan. The loans tend to be small, Tk2,000–5,000 ($48–120) up to a maximum of Tk10,000 ($250). They are given to individuals in the group, but peer pressure is created because if any member defaults, the entire group becomes ineligible to receive additional loans. This feature has been identified as key to good repayment, but loan repayment behavior is increasingly recognized as being more complex than simply using joint liability as a collateral substitute. For example, the Grameen staff attend the meetings of the Grameen centers, which are comprised of five to eight borrowing groups that meet weekly, and monitor loan use. The credit transactions are openly conducted at these center meetings such that everyone sees who borrows and who repays.

In addition to the weekly savings, each member is required to contribute 5 percent of each loan received to a group fund managed by the group. Each borrower is also required to contribute 25 percent of the total interest due on the loan principal to an emergency fund that the GB manages for use as insurance against potential default due to death, disability, or other misfortune. This fund is also used to provide life and accident insurance, to repay bad debts, and to undertake activities to improve the members' health, skills, and education and investment opportunities. Members also develop a stake in the organization by being required to buy an equity share of Tk100.

The GB has targeted women as clients because they are poorer than men, have been overlooked in other development projects, have been found to be better credit risks, and are better at following program rules. The bank has a comprehensive social development program outlined in 16 decisions that members must follow.

Six types of loans were granted by the GB in 1992. General loans (82 percent of total volume) are provided for one year at a nominal interest rate of 20 percent. Collective loans (0.2 percent) are made to centers for joint ventures, but they are declining in total share because of poor repayment. House-building loans (8.8 percent) require weekly payments over ten years and are charged an 8 percent nominal interest rate. Technology loans (9.4 percent) fund larger projects and are made for larger amounts of money. Several categories of general loans were added in 1992. They included short-term seasonal loans, special loans, food storage loans, and capital recovery and destitute loans in areas where floods destroyed assets used for income generation (Khandker, Khalily, and Khan, 1996).

One of the outcomes of the poor quality of public services in Bangladesh has been the emergence of thousands of NGOs. It is estimated there may be as many as 1,000 that are MFOs. All provide loans, some mobilize savings, and many provide nonfinancial services, such as training, consciousness raising and skills development. Most use the group lending technology popularized by the GB, but some work with much larger groups. The majority are small, serving only a few hundred persons, while others are huge. For example, the Bangladesh Rural Advancement Committee (BRAC) served more than 15 percent of the country's 82,000 villages in December 1994. It had many programs and commercial enterprises, and its rural development and rural credit project contained credit components that covered 13,224 villages with 196 branches (Khandker and Khalily, 1996).

The ten largest MFOs in the country in terms of loans outstanding are listed in Table VII.2. The total membership of

Table VII.2: Top Ten Financial NGOs: Members, Disbursements, Loans Outstanding and Staff, December 1997

Rank (1)	Name of NGO (2)	Inception year of credit program (3)	Total members (4)	Net savings (Tk''000) (5)	Loans (Tk'000) Disburse-ments during 1997 (6)	Loans (Tk'000) Outstanding December 1997 (7)	Total staff (8)	Savings-ratio 5/7 (9)
1	BRAC	1974	2,011,417	1,750,000	6,880,000	3,686,000	20,433	0.47
2	PROSHIKA	1976	1,231,883	10,583	2,421,450	2,090,710	3,197	0.01
3	ASA	1991	805,631	721,914	2,967,199	1,566,966	4,787	0.46
4	SWANIRVAR Bangladesh	1979	682,350	138,285	86,300	321,500	2,319	0.43
5	RDRS-Bangladesh	1991	274,275	84,257	345,731	264,152	1,611	0.32
6	Thengamara Mohila Sabuj Sangha (TMSS)	1987	268,200	53,155	267,856	146,985	952	0.36
7	Society for Social Service (SSS)	1991	60,577	50,584	231,479	128,099	481	0.39
8	Bangladesh Extension Education Services (BEES)	1988	38,230	25,283	99,121	92,354	440	0.27
9	CODEC	1985	29,155	-	88,511	83,261	526	-
10	Buro, Tangail	1990	45,003	26,677	119,565	65,960	424	0.40

Source: Credit and Development Forum (1997).

BRAC is listed at over 2 million, but it is not clear what proportion of the members receive loans in any one year. PROSHIKA also offers many nonfinancial services and it is also not clear how many of the 1.2 million clients receive loans. ASA is one of the most interesting MFOs, and it may be the most dynamic MFO in the country today. It started in the 1980s by providing many services, but found they were not highly valued by its members, so it switched in the 1990s to providing financial services only. It is now aggressively mobilizing savings, and has added an individual loan product for clients who either outgrow group lending or are never attracted to it.

Outreach

It is difficult to assess the total outreach of the formal financial system and the MFOs into rural areas. The World Bank (1996a) used a number of assumptions to arrive at the estimate that the banking system may have reached about 5 percent of the country's 16 million rural households in fiscal year 1994. It was further assumed that GB and the MFOs might have served about 4.9 million clients that year for a coverage of over 25 percent of the households (Table VII.3). If those numbers are roughly correct and if one household is served by only one institution, then over 30 percent of total households received commercial bank or MFO loans in that year.

The GB has been quite successful in several performance measures. Total annual disbursements rose from Tk54.8 crore in 1986 to Tk265.6 crore in 1990 and Tk1,525.1 crore in 1994. It had a membership of 1.9 million by 1994 of which 94 percent were women (Khandker, Khalily, and Khan, 1996). By 1996, it had 2.1 million members, reached about half of all villages in the country, had a network of 112 area officers and 1,056 village branches, and had Tk11,798 million ($289 million) in outstanding loans. The average outstanding loan was Tk5,708 ($142) or about 64 percent of GDP per capita. Savings represented almost half of loan volume at Tk5,366

Table VII.3: Major Microcredit Programs: Annual Disbursements During 1990–1995 (Tk million) and Number of Borrowers ('000) in 1994/95

Programs	1990/91	1991/92	1992/93	1993/94	1994/95	Borrowers
			Formal Sector			
Grameen Bank	2,642	5,200	10,622	13,912	15,000	1,861
BRDB	205	352	688	878	1,647	521
Commercial banks	53	43	52	80	104	
			NGOs			
PROSHIKA	121	127	224	303	423	417
Small PKSF partners	-	44	198	399	675	290
SWANIRVAR	45	44	62	109	132	598
NGO Subtotal	606	1,015	1,790	3,066	4,451	2,397
Grand Total	3,506	6,610	13,152	17,936	21,172	4,779
Total ($ million)	98	173	336	448	520	-

Source: Nagarajan and Gonzalez-Vega (1998b); original in World Bank (1996a).

million ($133 million) with an average savings account of Tk2,605 ($65) (Yaron, Benjamin, and Piprek, 1997).

The next two largest MFOs were BRAC, serving 700,000 borrowers, and ASA with almost 400,000 (Table VII.3). BRAC disbursed just over Tk2 billion in 1994/95 and ASA just over Tk1 billion. PROSHIKA and SWANIRVAR are next in number of clients served, but they disburse relatively smaller amounts of funds per client. A large number of smaller MFOs together disbursed 15 percent of total disbursements in 1994/95.

Data were reported to the Credit and Development Forum by 380 NGOs as of December 1997 (Credit and Development Forum, 1997). These NGOs reported a total membership of over 6.7 million persons, of which 81 percent were female. Just over 4.2 million were reported as borrowers with total disbursements during the year of Tk15 billion. There are many small NGOs that make loans, but they represent a small share of the total market. The top 20 NGOs had 86 percent of the members and 95 percent of the value of the loans outstanding.

As noted above, the amount of credit now going into agriculture as a share of GDP may be approximately equal to that in the early 1980s. The mix of borrowers is likely to be quite different, however, because of the efforts made by the MFOs and the GB to reach the poor. The uses of borrowed funds may also be quite different because many of the credit lines provided by banks and cooperatives were directed toward tubewells and other targeted inputs designed to stimulate agricultural production. Many MFOs, however, are more flexible regarding loan purpose, and the most important criterion is that the borrower repay the loan rather than use it for some specific purpose. Flexibility in loan use makes MFO loans more attractive to the borrowers.

There are relatively few studies to determine who is borrowing, for what purpose, and how far down the poverty profile the commercial banks, cooperatives, and MFOs reach. A small World Bank survey revealed that 44 percent of households had borrowed in the past two years. Of these, 56 percent borrowed from informal sources, 44 percent from the banks or cooperatives, and 10 percent from GB or the MFOs. There was little overlap reported in borrowing. Only 8 percent reported borrowing from both informal sources and banks, and 1.7 percent from informal sources and GB or an MFO. These results may not be fully representative because this sample was drawn from geographic areas close to bank branches (World Bank, 1996a). Moreover, anthropological studies tend to show rich patterns of financial behavior, in which persons borrow from informal sources in anticipation of getting an MFO loan or to pay an MFO loan installment (e.g. Rahman, 1999; Todd, 1997).

Sustainability

The most important factor affecting the sustainability of financial institutions in Bangladesh is loan recovery. The IMF estimated that about a quarter of total overdue loans were attributable to the agricultural sector (Wade et al., 1998). The evolution in agricultural loan recovery is shown in Table VII.4. The recovery rate fell from over 40 percent in 1983/84 to a low of 13.7 percent in 1990/91. Then it slowly rose but by the mid-1990s recovery was still only half that 12 to 13 years earlier. The total loans outstanding in 1996/97 amounted to Tk8,256 crore (about $2 billion) compared with the annual disbursement that year of Tk1,517 crore (about $370 million). In most years, the actual disbursements have been less than the targeted amounts set by the BB.

Agricultural loan recovery data for 1994/95 are presented in Table VII.5 by type of intermediary. The highest recovery rate for loans due in that year was achieved by DFIs at 65 percent. NCBs were second at 37 percent and cooperatives were third at 33 percent. Overall loan recovery for current loans increased from 50 percent in 1993/94 to 56 percent in 1994/95, but the percentage of total recovery fell from about 9.5 to 7.8 percent. Moreover, there were fairly large differences among the institutions within each category. Analysis of loan recovery data revealed that some banks did a better job of collecting loans made through their own financial programs than through the collaborative schemes designed by donors for poverty alleviation (World Bank, 1996a). Recovery rates were also expected to be poorer for larger farmers, and there was little evidence that weather risk explained differences in loan recovery between 1991 and 1994.

In contrast with this negative recovery experience, the GB disbursements for general crop loans, which were about 25 percent of its portfolio in 1994, had a loan recovery rate of 99 percent. Likewise, data reported for two NGOs that lend to agriculture showed good recovery. The problem, therefore, is that public ownership has made the formal institutions vulnerable to political interference. Pressures to disburse, noneconomic considerations in loan approvals, and political forgiveness contribute to poor portfolios (World Bank, 1996a). So far, the GB and the major MFOs have avoided the worst of these problems. Anecdotal evidence suggests that during periods of loan waivers, they have had to work energetically to convince their borrowers that the waivers did not apply to their loans.

Total loan recovery has been regularly reported by the GB to be 98 or 99 percent. However, these numbers are based on the amount overdue as a fraction of loans due. Morduch

Table VII.4: Agricultural Credit Disbursement and Recoveries, 1983/84 to 1996/97
(taka crores at current price)

Year	Program target	Disbursement	Falling due and overdue	Recovery	Percentage of recovery	Overdue	Outstanding
1983/84	1,115.0	1,005.3	1,238.2	517.6	41.8	755.7	2,077.4
1984/85	1,150.0	1,152.8	1,515.0	583.9	38.5	1,158.9	3,034.2
1985/86	1,276.5	631.7	2,375.2	607.2	25.6	1,778.8	3,514.3
1986/87	1,075.0	667.3	2,683.5	1,107.6	41.3	1,576.0	3,294.4
1987/88	1,050.0	656.3	2,528.2	595.8	23.6	1,932.4	3,863.5
1988/89	1,250.0	807.6	3,044.7	578.0	19.0	2,355.7	4,711.7
1989/90	1,350.0	686.8	3,986.3	701.9	17.6	3,284.3	5,381.3
1990/91	1,310.0	595.6	4,556.7	625.3	13.7	3,933.8	5,703.5
1991/92	1,322.1	794.6	4,170.2	662.1	15.9	3,572.3	5,369.6
1992/93	1,474.4	841.9	4,719.9	869.2	18.4	3,854.4	5,692.8
1993/94	1,643.1	1,100.8	5,141.2	979.1	19.0	4,203.7	6,222.0
1994/95	1,963.0	1,490.4	5,613.3	1,124.1	20.0	4,490.5	7,045.2
1995/96	2,442.0	1,481.6	6,193.5	1,273.1	20.6	4,920.4	7,769.1
1996/97	2,196.8	1,517.3	6,900.7	1,594.3	23.1	5,312.8	8,256.2

Source: World Bank (1996a). Updated with data from the Bangladesh Bank.

Table VII.5: Status of Agricultural Loan Recoveries from 1 July 1994 to 30 June 1995*

(taka crores at current prices)

Name of bank/ organization (1)	Amount of loans overdue from previous years (2)	Recovery from loans overdue from previous years (3)	Percentage of recovery of overdue loans (4)	Amount of loans due in the current year (5)	Recovery from loans due in the current year (6)	Percentage of recovery of current loans (7)	Total recoverable loans (2+5) (8)	Total loans recovered (3+6) (9)	Percentage of recovery (10)
Nationalized Commercial Banks									
Sonali	595.23	59.01	9.91	149.35	60.89	40.77	744.58	119.90	16.10
Janata	239.73	42.48	17.72	102.80	40.44	39.34	342.53	82.92	24.21
Agrani	141.93	43.36	30.55	94.42	30.00	31.77	236.35	73.36	31.04
Rupali	65.19	7.86	12.06	13.72	2.91	21.21	78.91	10.77	13.65
Subtotal	**1,042.08**	**152.71**	**19.65**	**360.29**	**134.24**	**37.26**	**1,402.37**	**286.95**	**20.46**
Development Banks									
BKB	1,562.53	106.17	6.79	642.16	488.17	76.00	2,204.69	594.34	26.96
RAKUB	752.68	58.49	7.77	300.44	120.34	40.05	1,053.12	178.83	16.98
Subtotal	**2,315.21**	**164.66**	**7.11**	**942.60**	**608.51**	**64.56**	**3,257.81**	**773.17**	**23.73**
Cooperatives									
BRDB	651.73	8.23	1.26	81.74	26.87	32.87	733.47	35.10	4.79
BSBL	179.43	1.26	0.70	1.10	0.29	26.36	180.53	1.55	0.86
Subtotal	**831.16**	**9.49**	**1.14**	**82.84**	**27.16**	**32.79**	**914.00**	**36.65**	**4.01**
Grand Total	**4,188.45**	**326.86**	**7.80**	**1,385.73**	**769.91**	**55.56**	**5,574.18**	**1,096.77**	**19.68**
Summary FY: 1993/94	3,921.03	370.80	9.46	1,220.83	608.32	49.83	5,141.96	979.12	19.04

* Provisional data for FY 1995.

Source: World Bank (1996a).

(1998b) estimated that 7.76 percent of loans were not repaid after more than one year, and 5.87 percent were not repaid after more than two years. These estimates refer to all loans made from 1985 to 1997. Moreover, there was a declining trend in loan repayment at the end of the period.

Matin (1998) studied the GB repayment problem in a case study of four villages in Madhupur. He discovered that the on-time repayment rates in 1995 were only 47 percent. Surprisingly, none of the borrowers interviewed thought poor repayment would adversely affect their chances of getting future Grameen loans. The GB had introduced seasonal and housing loans in the area as well as standard general loans. Rising levels of indebtedness was one factor explaining the rise in loan recovery problems.

Sustainability of the GB has been directly measured. Many NGOs in Bangladesh are dependent on foreign funds, and Grameen has received many domestic subsidies and foreign grants and soft loans. Recently, Government-guaranteed bonds have become a larger share of its total resources. The bank reported profits of $1.5 million during 1995/96, but this was attributed to a variety of direct grants and implicit subsidies. By imputing values for all these subsidies, Morduch (1998b) estimated that the GB would need to raise its nominal rate on general loans from 20 to 33 percent per year to become free of subsidies. There are legitimate questions about the ability of borrowers to absorb such a large increase. These results suggest that the GB will have to continue to rely on subsidies for its survival, and this raises questions about its ability to become completely self-sufficient as has occurred with some MFOs in Latin America.

Information on the sustainability of the NGOs is limited. Part of the problem is that many provide nonfinancial services to their members; a complete analysis would require that their financial operations be accounted for separately. CDF statistics (Credit and Development Forum, 1997) for 1997 for the 380 NGOs showed that foreign donations were the source of over 30 percent of their total revolving loan funds. Just over 16 percent was lent by the apex organization, Palli Karma-Sahayak

Foundation, a similar amount was mobilized from savers, and just less than 14 percent came from bank loans. Service charges, own funds, and other sources represented the balance.

The second most important issue affecting the sustainability of financial institutions after loan repayment is net income. Bangladesh has made some progress in deregulating interest rates for NCBs and DFIs, enabling them to move within a band set by the central bank. The problem is that with loan recovery so low, interest rates cannot be raised high enough to cover losses. This makes loan recovery the major problem for banks.

The sustainability issue is more complicated for the GB and the MFOs. Their reliance on subsidies helps keep interest rates low relative to their costs. However, there is considerable resistance to the concept of charging poor clients rates that are high enough to cover the full costs and risks of serving them. Moreover, if the estimate that the GB must raise its rates from 20 to 33 percent is indicative of the MFO sector, then raising the rates by this magnitude may reduce the demand for loans. The microlenders, therefore, must continuously evaluate the efficiency of their operations, the types of products and services offered, and the demands of existing and future clients.

DEPOSIT MOBILIZATION

NCBs have been the most aggressive financial institutions in mobilizing savings while the DFIs have largely lent funds provided by the BB. Unfortunately, the most recent analysis is for 1973–1984. In 1973, the NCBs held 90 percent of total bank deposits. By 1984, their share had fallen to 70 percent while the share of the DFIs had risen from 2.0 to 5.5 percent. Private and foreign banks held the balance. The expansion of bank branches into rural areas made a significant impact because the share of rural deposits in total deposits rose from 9 percent in 1976 to 17 percent in 1984. About half of the rural accounts in 1983 and 1984 were Tk5,000 or less (Khalily, Meyer, and Hushak, 1987).

District-level deposit data were studied for 1983 and 1984, and it was found that the number of bank branches and interest rates paid on deposits had a significant impact on the volume of district deposits (Khalily and Meyer, 1992). Total rural deposits grew rapidly during this period with the expansion of rural bank branches, in spite of notoriously poor quality service and the lack of significant marketing of savings products.

Most MFOs are not nearly as aggressive in providing savings services to their clients as they are in making loans, as noted in the savings-to-loan ratios reported in Table VII.2. BRAC and ASA are best in mobilizing savings, which now are close to half their total loan volume. The sources of funds for these MFOs are shown in Table VII.6. Foreign donations are still the major source of funding for BRAC and PROSHIKA, but some of these funds are designated for expansion purposes and for nonfinancial services. ASA has been more aggressive in mobilizing deposits, and savings now represent more than a third of its total funds. The 380 NGOs reported to CDF that total member savings represented just 16 percent of their revolving loan funds, and the top 20 held 90 percent of those savings.

Most MFOs undervalue savings services for poor households and they have not been aggressive in creating attractive products for voluntary savings. The GB members have perceived their obligatory savings to be an additional cost of borrowing. Lack of access in times of emergency reduces the value of these savings as a means for the poor to manage emergencies, and reduces the value of the MFOs to assist the poor to escape poverty (Hulme and Mosley, 1996).

The success of ASA has promoted some MFOs to pay more attention to the demand by the poor for financial services other than loans. A particularly interesting approach is being tested by SafeSave, a cooperative organized by Stuart Rutherford, in collecting savings on a daily basis from urban slum dwellers in Dhaka. It began operations in August 1996 and by 31 October 1998 had mobilized over Tk2 million (approximately $45,000) in savings. It also uses borrowed funds and had over Tk3 million ($65,000) in outstanding loans made

Table VII.6: Top Ten Bangladesh Financial NGOs: Sources of Funds

Rank	Name of NGO	Sources (percent)						
		Member savings	PKSF	Local bank	Foreign donations	Service charges	Own funds	Others
1	BRAC	17.5	10.3	2.9	50.7	13.8	0.0	4.9
2	PROSHIKA	6.5	20.2	1.1	43.6	23.9	0.0	4.7
3	ASA	38.2	22.6	0.0	24.3	12.6	2.4	0.0
4	SWANIRVAR Bangladesh	0.0	0.1	99.9	0.0	0.0	0.0	0.0
5	RDRS-Bangladesh	0.0	15.7	0.0	0.0	30.8	53.5	0.0
6	Thengamara Mohila Sabuj Sangha (TMSS)	19.9	69.9	0.0	0.0	10.2	0.0	0.0
7	Society for Social Service (SSS)	24.4	45.6	0.0	1.3	23.5	0.0	5.3
8	Bangladesh Extension Education Services (BEES)	21.8	0.0	0.8	38.6	20.0	6.7	12.1
9	CODEC	19.5	0.0	0.0	60.7	4.6	7.2	7.9
10	Buro, Tangail	28.3	0.0	0.0	45.6	20.3	0.0	5.7

Source: Credit and Development Forum (1997).

to the savers. Surprisingly, saving and repayment patterns were little affected by the July 1998 flood. The organization aims to be innovative in the design of savings instruments and to train other organizations in the approach. One replication has 100,000 clients in 50 urban branches (SafeSave, 1998).

MICROFINANCE

Most of the financial services provided by the GB and MFOs can be classified as microfinance, in contrast to most of the loans made by NCBs and DFIs. It is interesting to note how well the GB and MFOs have performed in expanding outreach and recovering loans compared with the dismal performance of the NCBs and DFIs.

An important feature of the microfinance sector in Bangladesh is the large apex organization established in 1990, the Palli Karma-Sahayak Foundation (PKSF). It has the dual objective of making loans to large NGOs, and building the capacity of small NGOs as well as lending to them. It operates with funds obtained from the Government and donors. It receives requests from MFOs for loans for on-lending to their clients, reviews them, decides which to fund, monitors the loans, and provides some technical assistance to the MFOs. By early 1998, it was providing funding for 154 partner organizations (Table VII.7). In 1996/97, it disbursed Tk1.6 billion. The total disbursements for its MFO partners during 1990–1998 amounted to Tk3.4 billion compared with an annual disbursement of Tk15 billion made by GB in 1994/95 (Table VII.3).

PKSF enjoys a great deal of autonomy. It has a 25-member governing body, about half of whom consist of private sector members, including leading personalities and social workers of international reputation. Policies and daily operations including loan approvals are the responsibility of a seven-member Governing Board. The Board has full autonomy over staff compensation, and salary levels are higher

Table VII.7: Number of Partner Organizations and Volume of Loans Disbursed by PKSF, 1990–1997

Year	Annual number of new partners	Total number of partners	Annual rate of growth of partners	Amount disbursed (Tk million)	Amount recovered (Tk million)	Average amount disbursed[a] (Tk million)
1990/91	23	23	-	3	-	0.13
1991/92	27	50	11	27	1	0.53
1992/93	31	81	62	113	10	1.39
1993/94	18	99	22	185	40	1.87
1994/95	15	114	15	302	110	2.65
1995/96	12	126	11	470	197	3.73
1996/97	22	148	18	1,620	129	10.95
Jul. 97– March 98	14	154	4	1,473	291	9.56

[a] Amount per organization based on the cumulative number of active partner organizations at that time and the volume disbursed that year.

Source: Nagarajan and Gonzalez-Vega (1998b).

than those paid by the Government and the large NGOs. PKSF encourages its partner organizations to fully recover recurring costs from interest income. It lends at nominal annual rates ranging from 3 to 4.5 percent and requires a minimum on-lending nominal rate to final borrowers of 16 percent (ADB, 1997a; Nagarajan and Gonzalez-Vega, 1998b).

Although there is considerable enthusiasm in many Asian countries for creating apex institutions, it seems that Bangladesh is one of the few countries that meets the necessary conditions for reasonable success. These conditions are described in Box VII.1.

The MFOs generally are not well linked to banks although they use bank branches for their financial operations. Before becoming a specialized bank for the poor, Grameen operated as an NGO that screened and organized borrowers, and introduced them to banks. It was hoped that by incurring these costs the banks would then develop banking relations with the borrowers without further Grameen involvement. Since that rarely happened, the Grameen program was converted into a bank. As noted in the CDF statistics, the 380 NGOs reported borrowing only 14 percent of their revolving loans from a bank. Among the large NGOs, for some time there was only one example reported in which an NGO successfully borrowed from a bank. This was a loan from Agrani Bank (an NCB) to ASA. It came about because of strong donor pressure, and the bank required ASA to provide its headquarters building as collateral. Because of this collateral requirement, a second loan was not requested after the first was repaid.

An important issue in the microfinance community around the world and in Bangladesh in particular, has been the impact of being a member of an MFO and receiving a loan. This issue would not be as significant a question if MFOs were commercially self-sufficient organizations. However, since some MFOs cannot or do not want to become independent from government and donor grants and loans, a logical question is whether the subsidies provided to them make a positive impact on their borrower-members. Impact analysis in this

Box VII.1 The Palli Karma-Sahayak Foundation (PKSF) in Bangladesh

PKSF is owned by the Government of Bangladesh but has complete autonomy. It functions in a densely populated country, which has an established microfinance market with several big MFOs. Some have been serving a large clientele for over two decades with proven technologies. Several small NGOs also exist. It is reported that about 300 to 350 potentially sustainable MFOs exist among the specialized MFOs currently operating in the country. Several big NGOs such as ASA, BRAC, Grameen Bank and PROSHIKA also function as apexes to help develop MFOs and link them with PKSF. It is in this environment that PKSF plays a role as an intermediary and capacity builder of MFOs. Some donor projects also work to upgrade the MFOs.

A strong board, composed of distinguished leaders in the field of microfinance, heads PKSF. It applies clear and strict criteria in the selection of partners for funding. The financial intermediary role is the primary function, while some capacity building is carried out in collaboration with the existing big NGOs. It has recorded profits since 1997 and is expected to be financially sustainable by 2002.

As of March 1998, PKSF served 154 MFOs of which about 20 have more than 50,000 clients each. The loan recovery rate from MFOs has been around 98 percent and loan recovery by partner MFOs from their clients has been around 99 percent.

There are some concerns about PKSF. The implicit use of Grameen technology as a base to screen applicants may restrict entry by some innovative MFOs that follow alternative technologies. Also, the provision of a uniform loan size for first-time borrowers may have to be altered to suit the demand and repayment capacity of the MFOs. Not withstanding these concerns, PKSF is a comparatively successful domestic apex organization. It has been recommended as a role model for apex organizations in other developing countries. The following favorable conditions explain PKSF's success.

(continued next page)

Box VII.1 (continued)

- PKSF operates in a large, advanced microfinance market, where several leading MFOs have developed and adapted effective lending technologies and are directly involved in disseminating them.
- It has access to abundant funding, most of which is invested rather than granted as loans to MFOs. This asset structure curbs disbursement pressures and generates income to cover costs.
- PKSF has access to a large pool of cheap, well-educated human resources appropriate for its labor-intensive operations.
- PKSF has operated in an environment characterized by a supportive but not interventionist Government. This, combined with the exceptional standing of its board members, has guaranteed independence from political pressures despite Government ownership. This has helped PKSF to fend off disbursement pressures.
- The leaders of the organization have been primarily concerned with its sustainability and, consequently, with the sustainability of its MFO clients.

Source: Abstracted from Nagarajan and Gonzales-Vega (1998b).

situation is recognized as being extremely complex. One of the most comprehensive and sophisticated impact studies conducted to date was the World Bank's attempt to measure several dimensions of impact on members of the GB and other MFOs. One study concluded that borrowing had a positive impact on household expenditures, nonland assets held by women, male and female labor supply, and schooling of children. Credit supplied to women had more impact than credit provided to men (Pitt and Khandker, 1998). But in a later study of the same data using a different approach, Morduch (1998a) found little difference in consumption between members and the control group, and that children of members were not more likely to go to school. This study found, however, that members had less variability in consumption and labor supply across seasons; thus, membership may do more to reduce vulnerability than to reduce poverty.

A number of impact studies have attempted to demonstrate that women have or have not become empowered by membership and borrowing (e.g. Amin, Becker, and Bayes, 1998). The most recent is an in-depth anthropological study of Grameen Bank borrowers in one village (Rahman, 1999). The author observed some negative features of peer pressure. For example, if one member is delinquent in making a loan payment, all members are detained beyond the normal ending time of their weekly center meetings. Due to this delay, women have been beaten because they did not return home in time to prepare regular meals. Such incidents demonstrate the difficulty in using credit as a tool to change complex, traditional social patterns.

INFORMAL FINANCE

Informal finance has not been as well studied in Bangladesh as in some other Asian countries, but a few key studies suggest patterns similar to those found elsewhere (Rutherford, 1996). Islam, Von Pischke, and de Waard (1995) summarized the results of 16 industry case studies. None of the industries were specifically linked to or located in rural areas. The results were similar to those typically found in small industry studies. The initial capital for the businesses came from owners' savings and loans from friends and relatives. Retained earnings were the major source of funds for expansion. Working capital was frequently obtained through trade channels in the form of raw materials and supplies obtained on credit, and advances received from clients.

The total magnitude of informal lending is hard to estimate. Ghate (1992) reported on surveys suggesting that about one third of borrowings came from informal sources, and two thirds from formal. Some 8 percent of households reported formal loans versus 36 percent for informal. There was no information to judge the representativeness of these data.

Anthropological studies in the mid-1980s described a large number of different types of informal loans in rural areas (Maloney and Ahmed, 1988). Ghate (1992) summarized several Bangladesh case studies conducted in 1988 as part of a regional ADB study. He found that the main types of informal loans were (i) *dadon* or forward sales of crops to finance crop production; (ii) trade credit extended on a profit-sharing basis or against tied sales or purchases; (iii) small loans for consumption or for petty trading and processing; and (iv) larger and longer-term loans for both consumption and production collateralized by usufructuary land mortgages.

The Islamic prohibition of interest had four consequences: a large proportion of *dadon*, in which the price discounts and forward sales substitute for interest; a high frequency of profit sharing in lieu of interest; an extremely high share of interest-free credit; and frequency of usufructuary land mortgages. Maloney and Ahmed (1988) reported that 57 percent of informal loans carried no explicit interest. These loans were often made by relatives, friends, neighbors, and patrons, and were mostly small loans for subsistence. When interest was charged, the nominal interest rates varied widely between 2 and 10 percent per month. People who borrowed from moneylenders usually paid 5 to 10 percent per month. Women who lent to each other charged 10 to 20 percent per month. Rates of 5 to 10 percent per month were not viewed as too high considering the cost and trouble for the lender to make small short-term loans.

One case study of noninterest transaction costs for formal bank loans in Bangladesh found a range in nominal interest rates of 245 percent for small loans to 58 percent for large loans (Ahmed, 1989). These costs include travel costs, the value of time lost, bribes, and other incidentals. Such high transaction costs help explain why some borrowers choose informal loans with higher interest rates but lower transaction costs rather than formal loans with lower interest rates.

Anthropological accounts (e.g. Todd, 1997) refer to microfinance borrowers using loan proceeds to pay off informal loans, and women borrowing informally to pay their MFO loan installments. Sinha and Matin (1998) investigated credit transactions in one northern village and found that most borrowers from the GB and other MFOs active in the area also borrowed from informal sources. Informal loans enabled some borrowers to invest more rapidly than permitted by the rigid lending technology of the formal lenders. For others, however, the informal loans helped smooth consumption and pay formal loans, and some were on a spiraling debt cycle. These accounts suggest that poor people in Bangladesh use a variety of loan sources to manage their household accounts. This pattern is consistent with the findings of detailed household studies in most developing countries.

FINANCIAL CRISIS AND NATURAL DISASTERS

Bangladesh was largely unaffected by the financial and economic crisis in Asia. The country has not attracted much private foreign capital, has not experienced rapid economic growth, and did not suffer from a highly overvalued exchange rate, as did Indonesia, Thailand, and other countries in the region. Bangladesh may suffer problems in the future, however, due to increased competition in export markets from other countries that were forced to devalue. This problem could worsen if China also devalues its currency.

The most recent serious shock that Bangladesh has faced was the severe flooding that started in July 1998 and continued into September. An important question concerns how the financial sector was affected, and what needs to be done to safeguard financial systems that face such natural disasters.

Some reports suggested that this flood was much larger than others in recent years. The GB reported that 71 percent of its branches and 52 percent of its members were affected (Barua, 1998). CARE Bangladesh reported that 24 of its partner NGOs in urban and peri-urban Dhaka had over 100,000 affected households (CARE Bangladesh, 1998). The GB did not provide information on loan recovery, but there were immediate reports that its liquidity problems might require donor assistance. CARE reported serious cash-flow problems for the 24 NGOs. For June–September, total cash inflows (savings plus loan payments) were 22 percent below projected levels. Only 57 percent of clients maintained on-time payments after the flood, and only 48 percent continued to make regular savings deposits. This shortfall forced the NGOs to suspend paying staff salaries, rent and other recurrent expenses, employing new staff, and disbursing new loans. A plan was developed to mobilize additional donor resources in order that emergency loans could be made to current members of the NGOs.

The effects of this natural disaster prompt two questions. First, what mechanisms need to be designed to support financial institutions in these kinds of crises? Second, what is the appropriate role of the MFOs in responding to the needs of their members? The answers will vary from one situation to another, but two answers seem to be obvious. The first is that any financial institution that is subject to periodic shocks, such as floods in Bangladesh, must anticipate the problem and design methods to assure its survival. The problem with NGOs is that they have no owners who can be expected to inject more capital to restore liquidity, nor do they have access to central bank emergency funds. NGOs should hold extraordinarily high reserves as precautionary balances, but in practice most are undercapitalized and hold few reserves. Second, analysis of previous natural disasters provides lessons for disaster-prone countries (Nagarajan, 1998). The affected MFOs should not write-off existing loans as this may jeopardize their future viability and set a bad precedent for borrowers. Any special relief activities should be short term and channeled through separate disaster-management windows to distinguish the relief from regular MFO operations. Longer-term strategies include portfolio diversification by increasing the range of type and location of clients and type of enterprises funded.

CURRENT POTENTIAL AND CONSTRAINTS FOR RURAL FINANCE

Bangladesh has had an unfortunate history with its financial system ever since Independence. The original strategy to use State-directed credit to build an entrepreneurial class has evolved into a financial system undermined by politics. Bad debts strangle the system and there are few signs that the problem will be solved in the near future. Initially, donor projects contributed to the problem, and subsequent donor activities have been unsuccessful in resolving it. The country has become addicted to foreign aid for bailouts of its financial system.

The policies designed to push financial services into rural areas had the positive effect of expanding the rural network of NCB and DFI branches, and contributed to the growth of rural bank deposits. This branch network is used to channel subsidized loans to farmers. Unfortunately, the rural financial system became infected with the same bad-debt disease that affects the urban bank branches. A huge NGO system has emerged because of the failure of the public sector to supply basic services. The GB and the financial NGOs have surpassed the banks in making loans, a large portion of which go to rural areas. Surprisingly, they have avoided serious default problems in their programs of lending to the poor. They have succeeded in developing systems to deliver highly standardized small loans to poor people. They have been more successful at serving female clients than male. The chief weakness is that many MFOs are highly dependent on Government and donor funding; therefore, they are not self-sustaining in spite of good loan recovery. Many also lag behind MFOs in other parts of the world in creating more individualized products to meet the heterogeneous needs of the poor for financial services.

The inescapable conclusion is that the rural financial system in Bangladesh is fragile. A gap has emerged between the rural market segments served by the banks and those served by the NGOs (McGregor, 1994). The formal financial institutions are saddled with bad debts with few signs of improvement in spite of vast amounts of donor assistance. The GB and MFOs have stepped in to substitute for the poorly performing banks, but they are highly dependent on Government and foreign funding. Although some 25 to 30 percent of rural residents may currently have access to formal loans, future access is uncertain because many financial institutions are not self-sufficient. Moreover, even the financial NGOs cannot meet all the demands for financial services of the poor because of insufficient total supplies, program requirements that discourage some of the poor from participating, and high dropout rates (Evans et al., 1999). Even if outreach increases, many of the problems of the rural poor cannot be solved by financial services alone (Khandker, 1998). Important reforms are required before the country can be assured of an efficient and sustainable rural financial system.

Creating the Policy Environment

Political intrusion is currently the single biggest obstacle to the development of a sound market-based financial system in Bangladesh. Resolving this problem must be the top financial policy priority. Donors have funded one project after another over the past two decades with the expectation that each time the Government would seriously commit itself to reforms. But each improvement made in the system seemed to reveal a new problem. For example, at one time privatization of NCBs and licensing of new banks was expected to make a major improvement. But, as noted above, the loan recovery problems of private banks are almost as serious as those of State-owned banks. Donors can make little impact on the formal financial system until politics are excluded from financial transactions.

It is time for donors to stop providing financial assistance to the banking system until that happens.

The second key policy issue concerns interest rates. Because of political pressure and social resistance, the country has resisted charging the level of rates needed to cover the costs and risks of financial operations. The financial institutions need greater freedom to price their products and services. Subsidies to MFOs, unless they are limited to capacity building, retard the process of achieving sustainability and discourage competition.

Creating and Strengthening the Financial Infrastructure

The most important financial infrastructure issue is the current status and future needs of the system of prudential regulations and supervision for financial institutions. At the top end of the financial system, many reforms have been made in the past two decades concerning the regulatory framework and the legal system to support financial transactions. An obvious problem is that the regulatory role of the Bangladesh Bank is undercut by political intervention, such that the technical merits of these recent reforms have not been tested. In spite of the special debt courts, legal enforcement can drag on for years due to undisciplined procedural wrangles, politics favoring debtors, and lack of execution capacity (Lee and Meagher, 1999). It is unclear exactly what reforms remain to be undertaken. The GB has a special charter from the BB, but in practice it operates relatively independently of the Government (Carpenter, 1997). It has accessed huge amounts of foreign funds so its survival has not been threatened, and there has been little reason for the regulatory authorities to exercise an active supervisory role. It is not clear how appropriate the terms of the charter and regulatory relationship will be, or how well the BB will effectively exercise its role as the GB becomes less dependent on donor funds and mobilizes more savings.

Since many MFOs have received financial support from foreign sources and savings mobilization is relatively underdeveloped, there has been little pressure to regulate them. Now that some are mobilizing more voluntary savings, the regulatory issue is becoming more important. As long as the MFOs avoid being infected by the bad-debt disease, the savings mobilized from the poor may not be at great risk. Recent information about higher delinquency rates than expected in the GB is unsettling, however, and may portend problems for other MFOs as well. Donors have a huge stake in the NGOs that they have created and nurtured. Now their responsibility is to take the next step by helping to create an appropriate regulatory system to protect these organizations, but not strangle them with excessive rules and regulations.

There are various ways in which MFOs may evolve as they strive for sustainability. Different forms of regulation will be required for different situations. Some of the largest and better organized may become licensed banks for the poor under charters similar to GB.[3] This would give them the opportunity to legally mobilize deposits from the public. Others may find the charter requirements too onerous and may become specialized lenders of funds provided to them by banks and the PKSF. As part of their relationship with banks, some may mobilize savings and deposit them in banks. Some NGOs may continue to be largely self-regulated while a third party could be licensed to regulate others.

A Credit Information Bureau has been created, but it is located in the Bangladesh Bank, so it may not have as much independence as would be ideal. It is reported that it covers only the largest transactions, and the perfection of liens in the various registries is subject to delays of three weeks to a month (Lee and Meagher, 1999). In the mid-1980s, the Agricultural Credit Department of the Bangladesh Bank was swamped as

[3] Eight new private licenses were issued for eight new private banks in 1999. BRAC received one of these licenses but it is unclear what market niche it will try to serve relative to its current clients as an NGO.

a result of collecting information from all rural branches to inform the Government and donors about disbursements and recoveries for hundreds of different credit lines. This problem distracted the banks from collecting information needed to improve management. The situation highlighted the importance of good information systems for efficient bank regulation and supervision.

Institutional Development

Several technical assistance projects have been implemented over the past two decades to strengthen the NCBs and DFIs. The changes these projects nurtured have been undermined by lack of enforcement. There is little reason to do anything further with the banks, however, until the political intrusion question is resolved. Moreover, at one time the system of targeted agricultural credit was so highly structured, there was little opportunity for loan officers to exercise judgement in making loan decisions. Likewise, the staff of the GB and other MFOs that use group lending have been given relatively little discretion in selecting clients and determining loan amounts and conditions. Their skills will need to be significantly upgraded as loan sizes rise and more attention is required to evaluate borrower creditworthiness and debt repayment capacity.

The formal banking institutions, GB, and the large MFOs have hundreds of outlets, and have developed information systems to monitor operations, savings accounts, loan disbursements, and repayments. Information is not available to evaluate how efficient these internal systems are in collecting and managing information, and the extent to which inefficiencies contribute to loan recovery problems. At one time the accounting systems of the banks were admittedly quite inadequate. Presumably they have improved, but the problem may now be with small NGOs that began their operations by providing nonfinancial services and are now involved in lending. Donor projects aim to resolve these problems but it is unclear how far they have progressed.

The recent floods underscore the risks of agricultural lending in a country regularly subject to natural disasters. Since they occur with such frequency in Bangladesh, financial institutions should be prepared to deal with them. If they are not, it represents a failure in their management and the Government and donors that support them. More attention is needed to devise appropriate levels of reserves and speedy access to emergency funds for MFOs that by design have few capital reserves. Donors need to give as much attention to helping MFOs develop long-term risk management strategies as they do to providing funds for on-lending to clients. They need to assist the NGOs to develop prudent savings mobilization strategies so they can eventually become financially self-sufficient.

There are suggestions that the MFOs in Bangladesh are approaching a critical point in their approach to serving clients. The GB and the large MFOs have successfully lent to millions of poor people. By offering only a few highly standardized loan products and utilizing a simple system of obligatory savings collection, they have reduced internal accounting and control problems. But this simplicity comes at a cost: clients have to adapt to the services offered rather than the MFOs tailoring their services to client preferences. This inflexibility may contribute to the high rates of client drop-outs, which reach 10 to 15 percent per year in the GB and BRAC. Drop-outs cost the MFOs money because, to maintain credit volumes, they must be replaced by new clients who have to be oriented and trained.

One solution is to introduce more flexibility in the financial services offered (Wright, 1999). ASA and Buro Tangail are already doing so in their programs. The problem is that flexibility implies more complicated tasks for credit officers and more sophisticated systems for financial controls. Cash flows will become more complex to plan, predict, and manage for the MFOs. Costs may rise, but most MFOs are already having difficulty in covering costs with revenues. It may be difficult for some clients to pay the higher cost of more individualized products.

A more general issue concerns the ability of MFOs to expand their scale of operations, serve more male clients, extend larger and longer term loans, and lend to farmers engaged in larger-scale, more seasonal crop and livestock operations. This involves upscaling, that is making larger more complex loans in which the earnings from the enterprise or activity financed are more important than other sources of household income in determining repayment. If the MFOs become successful in upscaling, it would represent an important breakthrough because it would show that their products, services, and lending technologies are robust enough to serve not just the poor, but also the market segments traditionally served by the NCB and DFIs. This would be a truly remarkable breakthrough in banking in Bangladesh.