

This report analyzes the progress toward commercialization of Bangladesh's relatively well-developed and diversified microfinance industry. It also explores the remaining challenges, implications, and positive approaches to the commercialization of microfinance.

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## METHODOLOGY AND ORGANIZATION OF THE STUDY

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The study on which this report is based includes theoretical considerations drawn from the “financial systems” paradigm<sup>6</sup> and practical field experience in analyzing the commercialization of microfinance. The main findings and recommendations presented here are the product of extensive consultation through individual and group meetings with a wide variety of microfinance stakeholders, including government ministries and microfinance programs, state-owned commercial banks, domestic and international nongovernment organizations (NGOs), funding organizations, and microfinance institution (MFI) client groups. In addition, several relevant domestic and international studies have informed this study, as noted throughout.

Responses to questionnaires eliciting stakeholders' views on microfinance commercialization and their latest institutional and financial data have been incorporated where possible. In addition to collecting such data and holding a wide variety of stakeholder meetings in Dhaka, the study team gathered data during field visits to several other districts.<sup>7</sup> It is important to note that all institutional and financial data are based on self-reporting by the MFIs surveyed by the authors, unless otherwise noted. Readers should be mindful that these self-reported data provided by MFIs and included in this report are often based on estimates only.

This is because of the widespread practice of MFIs in Bangladesh of not separating microfinance from other social programs (an issue in most medium and small microfinance NGOs) or from traditional financial intermediation (as in public sector banks).

The remainder of this chapter elaborates on the framework for analyzing the commercialization of microfinance used throughout the study and establishes the country context as it affects the microfinance industry. Chapter 2 examines the historical development of the microfinance industry, evaluates the progress made by current microfinance suppliers toward commercialization, and assesses the availability of commercial sources of funds for microfinance. Current challenges to microfinance commercialization are the focus of Chapter 3, which analyzes stakeholder perceptions, MFI operational weaknesses, impediments in the policy environment, and the legal and regulatory framework. Chapter 4 explores the potential negative implications of microfinance commercialization on access by the various types of clients, in terms of average microloan sizes and interest rates charged. The evidence of and potential for mission drift<sup>8</sup> is also assessed. Finally, Chapter 5 recommends positive approaches to commercialization for the Government, funding agencies, MFIs, and microfinance-support institutions.

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## UNDERSTANDING “COMMERCIALIZATION” OF MICROFINANCE

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In Bangladesh, the term *commercialization* carries with it a negative connotation in that many people equate it with exploiting the poor. This may be because NGOs are the predominant institutional form of microfinance provider and

that profit maximization (for the benefit of shareholders under most “commercial” enterprises) is seen as incompatible with the social missions of NGOs. Although NGOs are legally allowed to earn revenues in excess of expenses, any such “profits” are to be reinvested as operating capital (usually referred to as the NGO’s “own funds” in Bangladesh).

Several notions exist about what exactly microfinance commercialization means and no consensus in the field has yet emerged. Microfinance professionals worldwide, however, are increasingly using the term *commercialization* to mean “the application of market-based principles to microfinance” or “the expansion of profit-driven microfinance operations.”<sup>9</sup> This report adopts a comprehensive view of microfinance commercialization at two levels, proposing that it involves both institutional factors (MFI commercialization) and attributes of the environment within which the MFI operates (commercialization of the microfinance industry).

**MFI Commercialization**

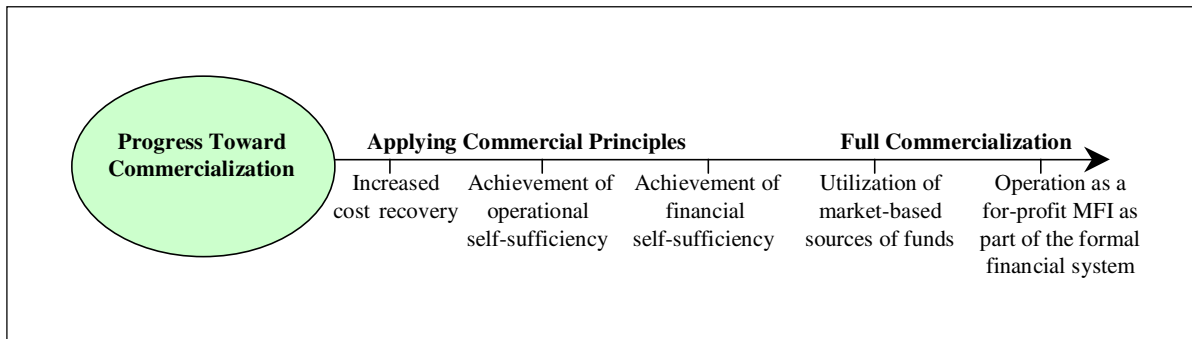
In this report, MFI commercialization is considered as progress along a continuum, which is depicted in the diagram below and described as follows.

- Adoption of a for-profit orientation in administration and operation, such as developing diversified, demand-driven financial products and applying cost-recovery interest rates.

- Progression toward operational and financial self-sufficiency by increasing cost recovery and cost efficiency, as well as expanding outreach.
- Use of market-based sources of funds, for example, loans from commercial banks, mobilization of voluntary savings, or other nonsubsidized sources.
- Operation as a for-profit, formal<sup>10</sup> financial institution that is subject to prudential regulation and supervision and able to attract equity investment.

Progress toward MFI commercialization is usually hastened by a strategic decision of an MFI’s owners/managers to adopt a for-profit orientation accompanied by a business plan to operationalize the strategy to reach full financial self-sufficiency and to increasingly use its funds to achieve greater levels of outreach. The recognition that building a sound financial institution is the key to achieving substantial levels of outreach essentially means that MFIs needs to charge cost-covering interest rates and continually strive for cost efficiencies in operation.

Advocates of this approach rightly argue that charging cost-covering interest rates is feasible because most clients would have to pay, and indeed do pay, even higher interest rates to informal moneylenders. MFIs that charge cost-covering interest rates are an attractive option for this clientele even though the interest



rates that an MFI might charge may seem high compared to those from a commercial bank. The relevant basis for comparing interest rates in the eyes of the client is, therefore, the informal sector where she or he usually can access funds, not the commercial banking sector, which rarely serves this market.<sup>11</sup>

As an MFI's interest and fee revenues cover first its operating costs and then the cost of its loanable funds, it may be considered to be increasingly operating on a commercial basis. MFI profitability enables expansion of operations out of retained earnings or access to market-based sources of funds. Operating as a for-profit, formal financial institution may be the most complete hallmark of MFI commercialization because this implies subjectivity to prudential regulation and supervision, and that the MFI has become fully integrated into the formal financial system.

However, MFIs strive for varying degrees of commercialization; not all aim to become formal financial institutions. This decision is usually closely linked to a host of external factors affecting the commercialization of microfinance, discussed next.

### **Commercialization of the Industry**

The extent of commercialization of the microfinance industry reflects the degree to which the operating environment is conducive to the establishment and growth of commercial MFIs. Commercialization of the microfinance industry involves several factors, including the degree to which the policy environment is conducive to the proliferation of commercial MFIs, the extent to which the legal and regulatory framework supports the development and growth of commercial MFIs, and the availability and access of commercial MFIs to market-based sources of funds.

The key attributes of the operating environment that determines the commercialization of the microfinance industry can be divided into the following three main categories.

#### **1. Policy Environment**

- Government policies that affect the ability of MFIs to make progress toward commercialization (examples of policies that may hamper MFI commercialization are interest rate caps and selective, ad hoc debt forgiveness programs).

- Presence of subsidized government or donor-supported microcredit programs that may stifle the development and growth of commercial MFIs.

#### **2. Legal and Regulatory Framework**

- The legal environment for secured transactions—the creation (legal definition), perfection (registration), and repossession (enforcement) of claims—as well as that for microenterprise formation and growth.<sup>12</sup>

- Existence of credit information collection and reporting services, such as credit information bureaus and credit rating agencies, that capture information useful to MFIs regarding borrower creditworthiness, loans outstanding, types of collateral pledged, etc.; or to potential MFI investors, for example, ratings of MFIs based on their portfolio quality and asset values.

- The regulatory and supervisory framework governing MFIs that mobilize voluntary savings from the public specifically or financial institutions in the broader financial markets generally, and the institutional capacity of the regulating body to carry out its mandate effectively.

#### **3. Money Markets and Capital Markets**

- Availability and access of MFIs to commercial sources of capital, such as second-tier lenders including apex institutions, private investment funds, and commercial bank loans.

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## SOCIAL AND MACROECONOMIC ENVIRONMENT

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Socioeconomic development as well as macroeconomic and financial sector stability are important components in ensuring an enabling environment for continued growth of the microfinance industry and for its potential commercialization. This section presents the social development context of Bangladesh, its recent macroeconomic performance, and development of the country's agricultural and financial sectors as a basis for establishing the operational context for MFIs.

### Socioeconomic Factors

Bangladesh has made great strides in improving the lives of its people since gaining independence in 1971, including raising literacy and school enrollment, reducing population growth and infant mortality rates, and improving health services (Table 1.1). Despite the impressive progress, however, poverty continues to be deep and pervasive and human development is still one of the lowest in the developing world. Gross national income per person was \$370 in 2000, lower than the average of \$460 for all South Asian<sup>13</sup> countries and \$420 for all low-income countries. According to the United Nations Development Programme's Human Development Report 2001, Bangladesh ranks 132 out of 162 countries in the Human Development Index (HDI).<sup>14</sup> Progress in human development needs to be accelerated for rapid and sustainable poverty reduction. Despite impressive improvements, the quality and equity (particularly for disadvantaged groups) of education, nutrition, and health services remain major areas of concern. The challenges are magnified by a population density of roughly 800 people per square kilometer—one of the highest in the world—and weak infrastructure, particularly regarding roads, bridges, power, water, and telecommunications, especially in rural areas.

Bangladesh's economic growth performance has been relatively robust during the last several

years, with average annual GDP per capita growth during 1996–2000 of 3.5% compared to 2.3% during the preceding five-year (1991–1995) period.<sup>15</sup> During FY2001, Bangladesh posted strong macroeconomic performance with increased economic growth, low inflation, and improvement in the current account balance of payments (Table 1.2). Growth of the gross domestic product (GDP) rose from 4.9% in FY1999 to 5.9% in FY2000, and to 6.0% in FY2001,<sup>16</sup> largely because of successive record crop harvests and recent rebounds in the industrial sector. The reported inflation rate declined to 3.4% in FY2000 and remains low, only 1.7% in October 2001 on a year-on-year basis.<sup>17</sup> Export growth recovered in FY2000, increasing from previous years to 8.2%, and the current account deficit declined to 1.0% of GDP. This has enabled microfinance activities 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.<sup>18</sup>

The structure of Bangladesh's economy shifted substantially during 1980–2001. The contribution of agriculture to GDP declined from as much as 50% to just 30%, while the share of services increased from 34% to 53%, and that of industry remained virtually unchanged at just under 20%. The 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 in urban areas.<sup>19</sup> Despite rural-urban migration, high population growth rates have increased population density in rural areas as well and heightened the reliance of the rural poor on the service sector of the economy. This, in turn, has also contributed to the high demand for microfinance.

Although positive, stable economic growth has been achieved over the last several years, the overall balance of payments position remains fragile. Foreign exchange reserves amounted to \$1.3 billion as of the end of December 2001, or 1.8 months equivalent of imports.<sup>20</sup> The balance of payments remains weak because of

**Table 1.1: Bangladesh Social Indicators**

Item	1985	1990	Latest Year	
<b>Population Indicators</b>				
Total Population (million)	97.5	109.6	130.2	1999/2000
Annual Population Growth Rate (% change)	2.1	1.9	1.6	1999/2000
<b>Social Indicators</b>				
Total Fertility Rate (births per woman)	4.7	4.3	3.0	1998
Maternal Mortality Rate (no. per 100,000 live births)		478.0	300.0	1998
Infant Mortality Rate (below 1 year; per 1,000 live births)	112.0	92.0	57.0	1998
Life Expectancy at Birth (years)	55.0	56.6	60.8	1998
Female	56.0	56.7	60.9	1998
Male	55.0	56.5	60.7	1998
Adult Literacy (%)	33.0	35.3	65.0	2001
Primary School Enrollment (% of school-age population)	63.0	77.0	96.5	1998
Female	43.8	70.0	94.5	1998
Secondary School Enrollment (% of school-age pop.)	17.0	19.0	33.0	1997
Female	10.0	14.0	31.0	1997
Child Malnutrition (% under age five)	70.0	68.0	56.0	1997
Population Below Poverty Line (%)	55.0	47.8	44.7	1999
Income Ratio of Highest 20% to Lowest 20% <sup>a</sup>		4.1	8.8	1995/96
Population with Access to Safe Water (%) <sup>b</sup>		80.0	95.0	1997
Population with Access to Safe Sanitation (%) <sup>c</sup>		40.0	43.0	1997
Public Education Expenditure as % of GDP	1.4	1.4	2.1	1997
Public Health Expenditure as % of GDP	0.9	0.6	1.0	1997

<sup>a</sup> Refers to expenditure ratio.

<sup>b</sup> Proportion of households with either tap or tubewell source.

<sup>c</sup> Refers to proportion of households.

Source: ADB 2001b, p.11.

high import growth and a drop in workers' remittances. Simultaneously, the budget deficit increased to 6.1% of GDP and monetary policy, fueled by rapid increase in government borrowing from the banking system, was expansionary.<sup>21</sup>

Prudent macroeconomic management is essential for implementing the country strategy and programs. Slippage in macroeconomic performance could seriously strain economic growth and poverty reduction efforts. For example, high inflation would be detrimental to MFIs, most of which are reluctant to increase interest rates to ensure financial self-sufficiency. The Government

needs to address the macroeconomic strains to sustain high rates of pro-poor growth, allocate additional funds for social sector investment, and improve the delivery and quality of social sector services. In particular, the Government needs to improve fiscal management by further strengthening revenue mobilization and containing unproductive expenditure, improving the utilization of external assistance, increasing foreign exchange reserves, and diversifying the export base, especially in light of the planned phase-out of the Multi-Fibre Arrangement (MFA) by the end of 2004.<sup>22</sup>

**Table 1.2: Bangladesh Economic Indicators**

Item	FY1996	FY1997	FY1998	FY1999	FY2000
<b>Income and Growth</b>					
Real GDP Growth (%)	4.6	5.4	5.2	4.9	5.9
GDP per Capita (\$)	334	340	348	357	363
<b>Savings and Investment (% of GDP)</b>					
Domestic Saving	12.4	14.6	16.7	16.7	16.9
National Saving	16.0	18.6	20.6	20.8	22.0
Gross Investment	20.0	20.7	21.7	22.2	23.0
Public	6.4	7.0	6.4	6.7	7.4
Private	13.6	13.7	15.3	15.5	15.6
<b>Government Finance (% of GDP)</b>					
Total Revenue	9.0	9.2	9.3	9.0	8.9
Tax Revenue	7.2	7.4	7.3	7.2	7.1
Total Expenditure	13.4	13.5	13.3	13.8	15.0
Current Expenditure <sup>a</sup>	6.8	6.8	7.2	7.6	7.6
Overall Budget Deficit <sup>b</sup>	(4.4)	(4.3)	(4.1)	(4.8)	(6.1)
<b>Balance of Payments (% of GDP)</b>					
Exports <sup>c</sup>	9.5	10.5	11.7	11.7	12.0
Imports <sup>d</sup>	16.9	16.9	17.1	17.6	17.5
Current Account Balance	(4.0)	(2.1)	(1.1)	(1.4)	(1.0)
Debt Service Ratio <sup>e</sup>	10.7	9.5	7.8	6.7	7.3
<b>Money, Credit, and Inflation (% change)</b>					
Broad Money	8.2	10.8	10.4	12.8	18.6
Credit to Government	36.8	27.1	15.7	21.3	31.3
Credit to Private Sector	19.2	12.6	12.6	13.8	10.7
Rate of Inflation <sup>f</sup>	6.6	2.6	7.0	9.0	3.4
<b>External Debt (\$ billion)</b>					
	14.5	14.4	14.8	15.3	15.8
<b>Memorandum Items</b>					
Bangladesh Bank Gross Reserves					
in \$ billion	2.0	1.7	1.8	1.5	1.6
in Months of Imports	3.6	2.9	2.9	2.3	2.3
Exchange Rate (Tk/\$)	40.9	42.7	45.4	47.8	50.3

<sup>a</sup> Excludes food subsidies.

<sup>b</sup> Defined as the difference between the expenditure GDP and revenue GDP ratios, adjusted to reflect the difference between fiscal accounts and estimates of total government financing.

<sup>c</sup> Exports imply merchandise exports only.

<sup>d</sup> Imports imply merchandise imports only.

<sup>e</sup> Represents the ratio of debt to total foreign exchange from exports of goods and nonfactor services, plus workers' remittances.

<sup>f</sup> Based on national consumer price index (using 1985/86 base).

Source: ADB 2001b, p.10.

## Agricultural Development

In agriculture, Bangladesh has made great strides in food grain production, which has more than doubled over the last 25 years. In addition, it has made progress in diversifying agriculture by expanding into value-added products, such as fruits, vegetables, poultry, dairy, and fish. Still, the sector is well under its capacity, as demonstrated by the fact that it employs more than 60% of the labor force but contributes only 25% of the GDP.<sup>23</sup> Despite the growing use of high-yielding varieties, crop yields on average are lower than in other Asian countries with comparable environment and population density. Improved agricultural performance must come from higher yields of rice, wheat, and other traditional crops and diversification into more profitable activities, such as horticulture, livestock, fisheries, and sericulture. Both thrusts need effective extension services to disseminate appropriate research-supported technologies to farmers.<sup>24</sup> Such efforts have the potential to increase the financial returns to agricultural production, especially for smallholders, and to boost the effective demand for microfinance.

## The Formal Financial Sector

Bangladesh's financial sector is at a relatively early stage of development in terms of the diversity and the range of products offered by financial institutions, the low savings and investment rates, a low degree of monetization of the domestic economy, and low financial sector contribution to GDP. The formal financial sector comprises mainly banks and nonbank financial institutions.<sup>25</sup> Formal financial sector assets are heavily concentrated in the banking sector, with nationalized commercial banks accounting for about 80% of total banking sector assets.

Despite the importance of banks to the general financial sector, commercial banks in the country serve no more than 20% of the population.<sup>26</sup> Historically, the remaining populace has not had access to formal financial services. The specialized banks and nationalized commercial banks with large branch networks have lent extensively even in rural areas, but most of their lending is not targeted to the poor. Their lending is also based on traditional banking terms (larger loans requiring collateral) and cannot be described as microfinance. The foreign banks and private commercial banks have stayed away from rural lending, although there are a few cases of token involvement in microfinance. Most show a general reluctance to make small loans that are relatively administratively costly. Unlike other countries in the region, "Bangladesh does not have a substructure of small banks operating at the local level."<sup>27</sup>

At the same time, as is well known, a strong semiformal NGO microfinance system has emerged in the country. The Grameen Bank and hundreds of microfinance NGOs that predominantly follow the Grameen model operate in rural areas, small towns, peri-urban areas, and increasingly, urban neighborhoods as well. Neither the Grameen Bank nor microfinance NGOs are subject to the Banking Companies Ordinance or any other law related to financial institutions.<sup>28</sup> These MFIs mainly undertake nontraditional lending to poor clients for service sector trading, vending, and small production activities. Lending by not-for-profit microfinance NGOs 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.<sup>29</sup>