3 Challenges to Microfinance Commercialization

This chapter analyzes current challenges to MFI commercialization at two levels. Constraints to commercialization are the subject of the first section. Subsequent sections analyze these constraints in the operating environment for microfinance, with consideration of impediments in the policy environment, weaknesses in the legal and regulatory framework, and the plethora of subsidized rather than commercialized microfinance funding sources available to MFIs.

CONSTRAINTS TO MICROFINANCE INSTITUTION COMMERCIALIZATION

Widespread Negative Perceptions of Commercialization

Most MFIs do not adopt a commercial approach in pricing their products and services or consider their operations to be commercial. The widespread perception among microfinance providers appears to be that social considerations should predominate and overshadow profit concerns, because their operations target poor households (see Boxes 3.1 and 3.2 for views of two leaders in the microfinance field in Bangladesh). As a result, the interest rates charged by many MFIs are insufficient to cover their operating costs. Their pricing policies do not aim to protect the erosion of capital from inflation. Similarly, the emphasis on operational efficiency is inadequate. Therefore, many MFIs require continued subsidies to remain in business.

In addition to negative perceptions of commercialization by MFIs, the Bangladesh Government sees commercial microfinance's dual objectives of profitability and poverty alleviation as conflicting rather than mutually supportive. When meeting with a delegation of Dhaka Chamber of Commerce and Industry (DCCI) members in March 2002, a senior government official strongly denounced NGO involvement in operating business enterprises. "They should be engaged in their poverty

Box 3.1:

ASA's Perspective on Commercialization

I personally believe, from experience not only in Asia but also in other parts of the world, that formal financial institutions and those owned by individuals for profit cannot achieve significant outreach to very poor or remote clients and make a profit. However, commercialization may be possible in a few countries where per capita income is at least $2,000 per year. These are the countries where commercial MFIs may work, although even in these countries, people will still be reluctant to pay interest rates high enough to satisfy owners' profit motives.

I hope that in the future, by the year 2008, the microfinance sector will be able to reach 100 million clients around the world. For this to happen, the large institutions need to join together, such as CGAP [Consultative Group to Assist the Poorest], ADB, UNDP [United Nations Development Programme] MicroStart, the World Bank, etc. to provide technical assistance in the form of training and access to soft credit. MFIs should be run, however, on the basis of commercial principles, i.e. maximizing efficiency, which will allow profit for sustainability of MFIs in the long run.

Mr. Md. Shafiqual Haque Choudhury
Managing Director, ASA
Dhaka, Bangladesh, 2002

Box 3.2:

BRAC's Perspective on Commercialization

We are engaged in a grim battle to bring countless poor people out of the vicious cycle of poverty. To me, the idea of serving the poor, therefore, comes first. Literally, the term commercialization carries the connotation of absolute profit orientation, which is the eventual goal of for-profit organizations as opposed to those that are not. For commercialized organizations, profit is the bottom line, which is, however, not the case with the development organizations dealing with microfinance.

Against this backdrop, the term *commercialization* may be a misnomer. It may, therefore, be substituted with *self-sustaining microfinance services*, which will cover all the ingredients of commercialization. To continue to serve the poor on a long-term basis, it is necessary for MFIs to become sustainable, cover costs by charging an appropriate interest rate, bring in cost-efficiency, introduce diversified financial products, and provide collateral free loans.

As time goes by, donor grant money will dry up for microfinance. The time is coming when we will have to depend on loan funds. So subsidized funding may not be helpful for the long-term period. The realities on the ground suggest that MFIs will have to be more business-like without sacrificing the ingrained social mission.

Alongside commercialization is the issue of effective governance of MFIs. The type of people in the governing body of the MFIs should be such that they can truly understand the intricacies of microfinance and the nature and magnitude of risks involved, manage these risks effectively, and take prudent financial decisions as well.

Finally, what is of utmost importance is the creation of an enabling policy environment in the country that will be sensitive to the needs of the poor and facilitate growth of the microfinance industry. The microfinance sector has grown in the country at the benign neglect of our Government. Attempts to regulate the industry strictly are likely to increase risks of stifling its growth.

Mr. F.H. Abed
Founder Executive Director and Chairperson, BRAC
Dhaka, Bangladesh, 2002

alleviation activities, not in business," the official said, agreeing with DCCI leaders. Mentioning the name of a leading NGO, the official said that the Government had tried to prevent its access to a commercial banking business, but failed because the NGO received a court verdict in its favor. Responding to the demand of business leaders to prevent NGO engagement in business ventures, the senior official said that the Government was considering formulating a policy in this regard. The delegates also demanded strong action against NGOs involved in profit-making commercial operations instead of providing social services for which they were registered.

Pervasively Weak MFI Capacity

Pervasively weak institutional capacity exists in Bangladesh's microfinance industry and, along with the perception problem, is one of the main impediments to commercialization of the microfinance industry. Sustainable institutional development will be the key to the sector's viability to make it free of subsidies, operate commercially, and link with the formal financial sector. Several important internal challenges hamper the progress toward commercialization for many MFIs, especially for small and medium-sized NGOs.

There are many small microfinance NGOs that lack institutional capacity to manage a rapidly growing, financial intermediary. In particular, they suffer from lack of clarity in their mission, weak governance, and low levels of the technical skills required of banking and finance. Many of them lack transparency in their accounting and operations, especially as a result of mixing "credit plus" activities with their financial services activities in their books.

Lack of Clarity in Mission

Most microfinance NGOs tend to view their microfinance operations within the

bounds of social objectives and are complacent with that approach. While progress toward adopting a commercial approach is happening gradually, only a few of these NGOs are incorporating the necessary elements to accomplish their social missions with a commercial approach.

Weak Ownership and Governance

Accountability and transparency in most microfinance NGOs are low because of weaknesses in ownership and governance. NGOs have no true owners; profits are expected to be reinvested into operations and no one is liable for any loss. Without significant resources at risk, however, investors generally lack incentives to monitor the institutions adequately. Most of these NGOs have socially-motivated investors who tend to put a priority on the institution's achievement of social objectives. The boards of directors of most such institution are often ineffective in overseeing the institutions; frequently they are chosen because they are friends of the chief executive, close kin, or retired government officers with inadequate understanding of the financial management aspects of microfinance.

Low Levels of Technical Understanding of Banking and Finance

The capacity of MFIs largely depends on the quality of human resources, operating systems, procedures and practices, and the availability of support services. Unfortunately, the quality of human resources in the microfinance sector is abysmally low, especially among the small and medium-sized NGOs. Most MFI practitioners come from a social service background. Thus, most MFIs suffer from low levels of managerial and technical understanding of banking and finance, leading to adoption of inappropriate accounting practices, insufficient attention to developing an accurate and timely management information system, inadequate internal control, and ineffective risk management.

Very little thought is given by most of these institutions to the minimum number of clients or the lending interest rate needed to cover costs. Generally, there are no written operating manuals or information systems for quick decision making, detecting problems, and taking early corrective measures. Forecasting and business planning are still virtually unknown, and most small and medium-sized microfinance NGOs do not prepare any standard income statements or balance sheets, let alone have them audited.

Lack of Transparency

It is difficult to assess the exact number of sustainable MFIs, because direct information is limited by the fact that most NGOs provide non-financial services or "credit plus" activities as well and rarely publish or allow external access to any separate accounting of their microfinance operations. Virtually no MFIs adhere to the Consultative Group to Assist the Poorest (CGAP) guidelines for financial reporting by MFIs.

Thengamara Mohila Sabuj Sangha (TMSS) is a good example of a microfinance NGO that mixes "credit plus" with its microfinance operations, requiring borrowers to undergo training on entrepreneurship development and business management before accessing a loan, which results in reduced transparency and hinders financial viability.[54]

Based on available data (such as the CDF Statistics and other self-reported information), it appears likely that some of the largest and an overwhelming majority of small and medium-sized MFIs are not presently sustainable, and presumably, neither are any of the banking operations that provide small loans to poor farmers. One of the most important factors affecting sustainability is the issue of maintaining a high-quality microcredit loan portfolio. Recent poor repayment rates have affected much of the microfinance industry. As a leader in the industry, the case of the Grameen Bank is indicative, as even it has been prompted to revise its lending policies. The practice of borrowers being allowed to have more than one loan outstanding from

that bank has been sharply curtailed since January 2000 in an effort to improve loan repayment.[55]

IMPEDIMENTS IN THE POLICY ENVIRONMENT

Lack of a Vision

Bangladesh has witnessed considerable political impasse since the 2001 general elections. The low level of political consensus on major national issues has impeded the implementation of key policy reforms needed for faster economic growth and poverty reduction. Despite the importance of microfinance, no comprehensive national policy for the continued development of the industry has been articulated. With the dramatic expansion of the microfinance industry in recent years and the increased reliance on savings as a funding source for most MFIs, there is an increasing need for private and public stakeholders to come together to develop a comprehensive vision for the commercialization of the microfinance industry and to push for the necessary policy and regulatory changes. A comprehensive policy statement may also serve to allay concerns about potential adverse government intervention in the sector and allow further growth of the microfinance industry.

Plethora of Subsidized Government Programs

At least 18 separate microcredit programs are carried out by as many as 13 different government ministries and divisions (Table 3.1). Most of these programs essentially replicate the Grameen model and report fairly high repayment rates despite being implemented directly by government staff. A closer look at the CDF Statistics, however, reveals that repayment rates vary between an abysmal 19.6% and a respectable 98.6%. The average cumulative repayment rate for the total of government microfinance programs in 2000 was reportedly only 83%.[56] These self-reported data may be misleading, however. Special, rural microlending programs run through several of the state-owned commercial banks were estimated to have collection rates below 20%, according to a World Bank analysis.[57]

Unlike the CDF Statistics for microfinance NGOs, the presentation of data on the government programs is focused on disbursements and rate of recovery (of "realized" amounts) for the last few years and on a cumulative basis. This represents traditional emphasis on achievements in outreach and disbursements over program sustainability and is neither consistent with the financial systems approach to microfinance nor the commercialization of the microfinance industry. One positive feature of the government microfinance program data is that it appears that most are winding down their activities, with disbursements declining in recent years. A negative contra-example, however, is an ADB loan approved in 1998 for $42.6 million for the Rural Livelihood Project that has been supporting the government's poverty reduction efforts by providing "sustainable microfinance services for the poor."[58] Given that the project is executed through BRDB under the Ministry of Local Government, Rural Development, and Cooperatives, it is likely to suffer from the same weaknesses found in the other government microcredit programs. Although it is difficult to assess whether individual programs are cost-effective in their operations, it appears from CDF Statistics that the majority experience very low repayment rates and probably incur large recurrent losses.

LEGAL AND REGULATORY WEAKNESSES

Inadequate Secured Transactions Framework

A secured transactions framework is of great importance in enabling MFIs to move toward commercialization by reducing their credit risks and costs of lending. Lenders need a system wherein claims against property can be created (legally defined), perfected (publicly registered),

Table 3.1: Disbursement and Repayment Rates of Government Microcredit Programs

Ministry/Division	Organization	Microcredit Disbursed FY2001 (Tk million)	Repayment Rate FY2001 (%)	Cumulative Microcredit Disbursed to End-2000 (Tk million)	Cumulative Repayment Rate to End-2000 (Tk million)
Ministry of Finance	1) Banking Wing	264.0	72.3	15,354.5	58.3
Rural Development and Cooperative Division	2) BRDB	1,013.0	91.1	17,103.0	89.8
	3) BARD	38.3	103.4	600.4	92.0
	4) RDA	10.3	97.5	50.7	94.9
Ministry of Women and Children Affairs	5) Women Affairs Dept.	96.5	93.6	1,455.7	81.2
	6) *Jatiya Mohila Samity*	20.5	0.0	139.2	58.4
Ministry of Social Welfare	7) Social Welfare Dept.	85.2	84.4	1,528.3	94.5
Ministry of Labor and Employment	8) BOMET	0.0	0.0	231.8	60.1
Cabinet Division	9)	0.0	0.0	259.4	92.7
Ministry of Fisheries and Livestock	10) Dept. of Fisheries	14.3	0.0	95.5	36.5
	11) Dept. of Livestock	257.2	0.0	873.2	52.9
Ministry of Industries	12) BSCIC	819.9	68.3	1,639.7	68.3
	13) Cotton Dev. Board	1.9	0.0	29.4	98.6
Ministry of Agriculture	14) Agriculture Extension Dept.	69.4	78.7	408.6	82.9
Ministry of Land	15)	73.2	57.9	212.7	76.8
LGED Division	16) Local Government Div.	9.2	84.8	89.9	82.4
Ministry of Youth and Sports	17) Dept. of Youth Development	306.2	88.6	3,795.4	76.3
Ministry of Textiles	18) Handloom Board	29.3	25.6	69.0	19.6
Total		**3,108.4**	**73.3**	**30,116.4**	**83.2**

Notes: BRDB = Bangladesh Rural Development Board; BARD = Bangladesh Academy for Rural Development; BOMET = Bureau of Manpower, Employment, and Training; BSCIC = Bangladesh Small and Cottage Industries Corporation; LGED = Local Government Engineering Department; RDA = Rural Development Academy.

Source: Credit and Development Forum 2001b.

and enforced. The more uncertain and expensive this process, the less willing may be MFIs to lend.[59] Virtually no current or potential microcredit clients are able to take advantage of immovable property laws to collateralize their loan request, because they lack such assets (for example, land or permanent dwellings, which are taken as traditional collateral) and there is no legal basis on which to develop security interests in movable property. Most MFIs, therefore, have followed the Grameen model and avoided the use of collateral altogether through the use of joint liability and client access to repeat loans as incentives to repay. However, great potential exists for further risk reduction and cost efficiency in MFI operations if some forms of collateral, especially movable collateral, are supported by the legal framework.

The United States Agency for International Development has recently drafted a law for developing security interests in movable property and has submitted it to the Ministry of Finance.

The law endorses the financing of microcredit clients by securing movable assets as opposed to immovable property. Banks and all leasing companies will eventually apply this law. Such a law has the potential to decrease costs of lending for microfinance NGOs (by allowing borrowers to use nontraditional sources of collateral to access larger loans) and allow private commercial bank entrance into the microfinance market, because the proposed law holds promise of reducing costs of enforcing even small claims.

Absence of a Credit Bureau for Microcredit

In Bangladesh, a credit information bureau (CIB) has been established for providing reports to commercial banks on the status of a borrower in regard to his/her credit history and current outstanding loans with any other banks/branches. The credit report is considered to be one of the basic sources of information for consideration of a loan. The aim of the report is to avoid client over-indebtedness and reduce defaults. It is mandatory for all banks to collect data from the CIB before sanctioning any loan proposal above Tk5 million ($87,700). Also, in this regard, nationalized commercial banks have reported to the Bangladesh Bank regularly on their progress in collection of larger overdue loans sanctioned since January 1990.

No information on microloans is contained in the commercial bank CIB or any other centralized system. While overlap in lending is not officially encouraged by MFIs, it is widely believed to be occurring on a significant scale and to be a main cause for the rising nonrepayment of microloans in several of the largest MFIs. There is a growing realization that the microfinance industry needs access to a CIB that includes information on microcredit in order to mitigate the problems of client overlap and loan defaults.

In light of the problems that lack of a national identification system poses in terms of creating a CIB, one idea that has been promoted is the sharing of MFI borrower lists. However, such sharing could, in fact, increase overlapping, because MFIs would have access to the names of borrowers of competing MFIs. Participants at a recent Women's World Banking gathering of microfinance industry leaders believed that it would probably be most feasible to get branches to report on blacklisted borrowers–those who have failed to repay their credit obligation, and to whom an MFI will make no further loans.[60]

Lack of Supportive Legal and Regulatory Framework

The Bangladesh Bank has taken a fairly "hands-off" approach to the development of the microfinance industry, allowing it to innovate and grow with minimal government intervention. However, as the MFIs grow and the environment changes, there are more legitimate needs for some regulatory framework for microfinance. The substantial and increasing reliance by NGOs on savings for onlending is cause for concern, considering that these institutions are placing clients' life savings at risk without any type of prudent regulation or supervision. Even the Grameen Bank operates largely independent of government supervision, despite its special regulatory status (Box 3.3).

The only legal options currently available to MFIs are becoming a commercial bank (requiring an initial capital base the equivalent of $3.25 million and subjectivity to commercial bank prudential regulations and supervision) or the hope of obtaining a special legal charter like that of the Grameen Bank. The Bangladesh Bank, however, appears not to want MFIs to operate as commercial banks or to allow any similar special cases.

This is likely going to continue to be an obstacle to commercialization, because the Bangladesh Bank has only limited capacity to regulate and supervise the existing banks and its bank reporting standards are much less stringent than international standards. This, along with other concerns about government intervention, has caused some of the largest MFIs to discourage any attempt to create a legal and regulatory framework for microfinance within the Bangladesh Bank. However, given the large number of MFIs that mobilize client

Box 3.3:

The Grameen Bank Charter

In 1983, a special charter was adopted that describes Grameen's management and governance structures and its supervision by the Ministry of Finance. The Grameen Bank Ordinance addresses licensing, monitoring, and supervision, which are similar to those of banks but with a few adaptations to fit its microfinance mission. Specifically, it has several features that are counter to microfinance commercialization:

- Partial ownership by the Government, through the Bangladesh Bank.
- Access to soft loan funds from the Bangladesh Bank.
- No taxes for at least the first 10 years.

Because Grameen is operating in a noncommercial manner, the Ordinance places no limits on the scope of its activities, allowing it to mobilize member and nonmember savings, while not ensuring that adequate risk management and internal control mechanisms are in place. The Ordinance does call for higher capital requirements, requiring paid-in capital of $4.25 million, but there are no ongoing capital adequacy or liquidity requirements to ensure that the initial capital is preserved. In addition, the Ordinance requires compliance with standard portfolio risk classifications for delinquency, loan losses, and write-offs that are weak and not appropriate for shorter-term loans. For example, provisioning of 100 % is made for loans overdue more than two years and loans are only written off once they are four years past due. These are very loose risk classification requirements for an MFI that has mostly short-term loans.

Source: Carpenter (1997, p.22).

savings and lend to them, international best practice suggests that some legal form for MFIs requiring prudential regulation and supervision is necessary. Some MFIs are currently considering self-regulation as an alternative. PKSF has devised a set of 12 policy guidelines and standards for microcredit management, including the management of member savings, which it offers to its partner organizations to ensure that they are prudently managing their clients' savings. Each of these issues is examined below.

Insufficient Institutional Capacity of the Bangladesh Bank

Public ownership of the largest institutions in the commercial banking sector has a long history of influencing bank lending based on developmental (or political) concerns versus economic realities. Bangladesh Bank's annual reports still reflect this culture; inordinate emphasis is put on loan disbursements rather than on the quality of the loan portfolio or overall financial health of the banking system. Enforcement of regulation and supervision are widely acknowledged to be perfunctory at best because of lack of morale in the Bangladesh Bank and general malaise in the banking sector. This is likely the result of poor financial performance associated with continued directed and subsidized credit programs, and the fact that senior management is still partially based on political appointment rather than on banking skills and merit. It is also generally understood that policies related to the banking system are largely formulated in the Ministry of Finance and by policymakers outside the Bangladesh Bank, which undermines its independence and credibility.

Bangladesh Bank's management recognizes the importance of microfinance but has limited capacity to deal with it. The Bank's management recognizes a political constraint in undertaking microfinance regulation in the face of opposition from the internationally influential leaders of the large MFIs in the country.[61] Such reticence stems from the weakness and lack of independence of the Bangladesh Bank, which will be slow to change. Perhaps the greatest contribution that funding agencies can make to the continued growth and health of the microfinance industry is to strengthen the Bangladesh Bank sufficiently to undertake regulation and supervision of at least

a few MFIs in order to enable them to commercialize their operations further through transformation into regulated entities.

Dominant MFIs Discourage the Creation of a Regulatory Framework

The political influence of a few large MFIs that serve as role models for the rest of the industry inhibits progress on regulation and supervision. These MFIs are, for the most part, strongly opposed to any kind of regulation being applied to microfinance NGOs. This opposition is rationalized as resistance to bureaucracy and control, a legitimate fear in the Bangladeshi context where banking regulations are widely acknowledged to have been poorly applied. Unfortunately, this argument is made by institutions that are well endowed with resources–and, therefore, do not need a legal framework to ensure their legitimacy–and that operate with little transparency. A few medium-sized NGOs–which would be equally subject to such bureaucracy but would have a lot to gain from the legitimacy conferred by regulation–display greater interest in such regulation.

A number of different legal forms have been employed by formal and semiformal institutions as vehicles for microfinance. Except for the Grameen Bank, there is virtually no specific regulation of microfinance. The relevant laws and regulations currently in effect[62] establish varyingly stringent requirements that an entity providing financial services must meet, depending on its characteristics and range of activities. These prudential rules, however, are not adequately tied to the specific risks presented by financial service activities that range from simple extensions of credit, to limited deposit-taking from members, to full-scale collection of deposits from the general public.

Many Unregulated Microfinance NGOs Mobilize Substantial Savings

As mentioned, savings mobilization from the general public is not permitted except with the permission of the Bangladesh Bank. However, under the Cooperative Societies Ordinance, cooperative societies are permitted to mobilize savings from the general public though the registrar of cooperatives, which has little power, either preventive or protective, and conducts minimal supervision.[63] In practice, MFIs have compulsory savings from members built into their lending operations and law does not prohibit this. Net savings account for about 30% of the revolving loan funds of microfinance NGOs; reliance on savings as a source of funds appears to be growing, according to the latest CDF Statistics. This implies that these NGOs mobilize a significant amount of savings for onlending and points to an urgent need to create a legal and regulatory framework for MFIs to undertake savings mobilization in a legal and prudent way.

No Framework for Self-regulation

Self-regulation is one alternative to government regulation that many MFIs practitioners are considering. To date, there is no specific and effective self-regulation to protect member savings in most of the NGOs. However, PKSF has devised a set of 12 major policy guidelines and standards that include measures to protect savings and that may be a basis for self-regulation. These guidelines include

- selection of small-scale partner organizations;
- selection of large-scale partner organizations;
- guidelines for management of savings;
- guidelines for managing service charges;
- policy for loan classification and reserves;
- guidelines for avoiding borrower overlap;
- guidelines for performance evaluation and categorization of partner organizations;
- policy for use of disaster management funds;
- financial ratio analysis;
- indicators for an early warning system (for monitoring loan repayment);
- policies for interest-free loans; and
- internal control for partner organizations.

The standards regarding savings, for example, include norms and procedures of savings mobilization, maintenance of savings accounts, withdrawal of savings, utilization of savings by partner organizations (including guidelines for maintaining sufficient reserves at licensed banks), and rate of interest paid on savings. The partner organizations are required to send monthly financial statements to PKSF. The overall guidelines and standards package assists the partner organizations to manage their microfinance operations efficiently and transparently.

GRANTS AND SOFT LOANS HINDER COMMERCIALIZATION

Although savings are the major source of funds for many MFIs, there is still high reliance on concessional funds for lending operations. For example, such funds accounted for about 41% of the loanable funds in the microfinance industry at the end of 2000. Many microfinance stakeholders refer to declining donor support of the microfinance sector. Yet, donor funds have been rising in absolute terms. Only their relative share in total RLFs has been declining. Grants and soft loans have allowed many MFIs to achieve economies of scale in their operations, but the continued availability of these funding sources partly removes the incentives for MFIs to access commercial sources of funds. Easy access to grants and soft loan funds inhibits MFIs' progress toward commercialization.

Through their various interventions, the Government and funding agencies have had both positive and negative impact on microfinance commercialization. The Government has taken two actions that have greatly fostered the industry's growth. The first of these helpful interventions was the granting of the special ordinance that allowed the establishment of the Grameen Bank in 1983. The Government gave considerable support to funding the new institution, allowing it to consolidate its achievements up to that point and to continue to expand its outreach. Second, to alleviate concerns about lack of seed capital and onlending funds for NGOs to engage in microfinance activities, the Government established PKSF in 1990 to channel public and external funds to MFIs meeting certain eligibility and performance criteria. However, it has come to light that one stipulation for accessing PKSF funds is the promise not to onlend funds at a flat annual interest rate higher than 15%. Both continued access to "cheap" PKSF funds and the onlending interest rate ceiling are disincentives for these MFIs to charge sustainable interest rates.

Prior to the establishment of PKSF, the microfinance NGOs were largely supported by grants from funding agencies for seed capital or for operational cost coverage. Until the mid-1990s, the concept of MFI sustainability was hardly stressed since the effective use of microcredit for poverty alleviation goals was the primary focus. Gradually, the funding agencies have helped to make these NGOs more familiar with the benefits of sustainability and many have begun to embrace the goal of OSS and, eventually, FSS. Donor funding, by helping numerous NGOs to expand their revolving loan funds and capital bases, has helped pave the way toward commercialization. Competitive market forces have also shifted the attention of some microfinance NGOs to developing more demand-driven products and services in order to maintain their growth and keep or increase their relative market shares.

While soft loans are not considered commercial, one could argue that PKSF has played a role in moving the microfinance industry toward commercialization in the sense that its soft loan funds have partially replaced grants to MFIs. Some 186 microfinance NGOs have received loans from PKSF. About 60% of PKSF funds have gone to the few large NGOs and 40% to the medium-sized and small ones.

World Bank assistance has fueled PKSF's dramatic growth and increasing importance as a source of funds for MFIs. In 2001, the World Bank approved a $151 million (taka equivalent) International Development Agency (IDA) credit

as a follow-up loan to a 1996 IDA credit of $105 million in support of MFIs, with PKSF as the implementing agency. However, the interest rate charged on PKSF loans to various MFIs is significantly below market rates (i.e., the interest rates that commercial banks charge on loans to microfinance NGOs) (Box 3.4). The World Bank set these lower rates as a direct result of the low, subsidy-dependent rates charged by Grameen Bank, Bangladesh's largest MFI. Grameen uses part of the subsidy to fund its operation and passes some of it on to its clients through low interest rates. As a result, funding agencies, through their desire to help Grameen, essentially limit the sustainability of other MFIs by keeping interest rates below full cost recovery.

Although the World Bank is the largest funder of PKSF, other agencies also contribute to its operations under similar terms. ADB's 1997 Participatory Livestock Development Project provided $17.2 million (taka equivalent) to PKSF for participating NGOs to onlend to the ultimate clients for "smallholder poultry, beef-fattening, and goat rearing (and other small animals)."[64] In addition, PKSF received funding support through the European Commission's Integrated Food Assisted Development Project.[65] Both projects continue despite the 15% cap on lending interest rates that PKSF imposes on its partner organizations.

In the case of ADB, the intention was not to encourage below-market lending by MFIs to their clients. ADB's understanding was that participating NGOs would "pass on the proceeds of the subloan from PKSF...at the prevailing market rate, currently 16-20%, keeping a margin of at least 9.75% to 13.75% to cover social mobilization, group formation, social awareness training, skills training, monitoring loan collection and extension activities, other operating costs, and allowances for bad debt and profit."[66] By continuing to provide these subsidies, funding agencies are hindering natural market mechanisms and impeding microfinance commercialization. Even if all the subsidies go to the neediest, the system cannot expand as rapidly as it could if full sustainable interest rates were charged.

Box 3.4:

World Bank Support to PKSF—Interest Rate Issues

"The onlending rate from PKSF to partner organizations (POs) has to take into account that the industry is dichotomous, with large NGOs-MFIs accounting for about four fifths of the microcredit market. It is strategically important that the onlending rate be increased to encourage POs toward integration with the formal financial market. At the same time, building up their equity capital is equally important to reduce their dependence on donors for resources. Therefore, the onlending rate from PKSF to POs should be such that it considers the issue of market integration of POs and, at the same time, makes provision for their equity build-up to lessen donor fund dependence. An analysis of PKSF's current interest rate structure shows that adoption of an interest rate of 4.5% for small and medium-size POs, and 7% for big POs with a three to four-year maturity for all POs, would help the industry move towards sustainability. The rationale for adoption of a lower interest rate for small and medium-sized POs derives from their need for greater nurturing. Big POs, on the other hand, need to be encouraged to access financial markets sooner."

Source: World Bank 2000, p.5.

It has been argued that subsidized interest rates reduce the rate at which microfinance outreach can increase, which assumes a very low interest rate elasticity of demand for microcredit. However, there is empirical evidence[67] that interest rate increases are not correlated with decreased demand. The MicroBanking Bulletin[68] further supports this view with information gathered from participant MFIs in its MicroBanking Standards Project. The World Bank noted that "even if below-cost recovery interest rates for borrowers were the most efficient means to reduce poverty, such an approach creates problems for MFIs not participating in donor funded poverty alleviation."[69]