

4 Implications of Microfinance Commercialization

So far, the discussion in this report of the progress of microfinance commercialization and the challenges that remain has assumed that commercialization would have a positive impact on poverty reduction, including increased outreach and long-term viability of microfinance providers. However, many Bangladeshis are concerned that further commercialization could have negative social impact or result in mission drift,⁷⁰ such as a reduced focus on reaching the poorest of the poor (or “hard-core” poor), shift the target market from women to men, increase loan sizes, and raise interest rates. This chapter reviews a few of the most common perceptions about the implications of microfinance commercialization and shows that while some of these outcomes are possible, the negative impact on the poor is probably less than some might think.

MANY POOR HOUSEHOLDS COULD REMAIN UNSERVED

From the analysis earlier in this report, as many as 70–80% of poor households currently have access to microcredit. In some of the more densely populated areas of central Bangladesh, such as Tangail, MFI competition for “bankable” clients⁷¹ is already present and the poor are enjoying MFI shifts toward developing more demand-driven products. While microfinance clients are widely perceived as “poor,” several studies indicate that many of the poorest are not adequately served by MFIs.

In rural Bangladesh, there is significant differentiation within the ranks of the poor. Roughly half of the poor (about 25% of the total population) are considered hard-core poor. The

Grameen Bank and other NGOs may have failed to target this group effectively. It is likely that most of the hard core are still not able to access microcredit either because they see themselves as “not credit-worthy and self-select out of group membership” or are excluded from joining groups because of the real or perceived credit risk they may represent to group members.⁷² Bangladesh MFIs use the rhetoric of serving “the poorest of the poor,” but it is generally understood that most do not reach the truly destitute groups composed of widows, orphans, the chronically sick, and the mobile landless.⁷³

Results of a study testing this finding⁷⁴ show that out of 498 target group households in four villages, only 284 (57%) joined Grameen and BRAC as members. The most common reason for not joining (49%) was a perceived inability to repay and reluctance to have to sell assets to pay off debt. A little over one quarter of respondents cited social and religious sanctions against joining credit programs and leaving the home for meetings with outside males. Only 13% of the women said they actually wanted to join but were not accepted because group members felt they were high risk (for example, they had gambling husbands, out-migration potential, or bad money management skills).

These findings suggest that there are other factors beside lack of targeted outreach that are hindering the hard-core poor, who comprise 10–15% of the population, from accessing and benefiting from microfinance services currently available. For example, rules such as mandatory weekly savings and regular attendance are either seen as too restrictive for the members or the organizations themselves have shied away from the hard-core poor in the quest for lending targets and financial viability.⁷⁵

Many countries have experienced a similar pattern that despite the success in outreach and sustainability of MFIs, the poorest of the poor are often unserved. The conclusion from these experiences is that an MFI's goal should not necessarily be to reach the poorest. Microcredit is not necessarily the way out of poverty for all poor, and perhaps especially the poorest. Indeed, the results of one study⁷⁶ suggest that targeting MFI support on the very poorest is, in many instances, harmful for them and that access to microenterprise finance is not their first priority.

For the destitute and for others with difficulty in making good use of loans (such as investing or purchasing an asset rather than meeting immediate consumption needs), credit programs may not be the answer, even with weekly repayment schedules that are geared to make repayment easier. Other targeted social programs are required to address their specific needs. Profitable MFIs with a social mission might be the best suited for this task, because they would have the funds to diversify and to cover the investment needed to reach lower end markets.

In order to serve better the needs of the poorest, BRAC began an Income Generation for the Vulnerable Group Development program. Other organizations, such as Ashrai, have also made a direct attempt to reach them. BRAC's program provides microfinance supplemented by social intermediation (including both social mobilization and "credit plus" services) to village-level groups that are exclusively very poor. Ashrai works mainly with tribal families in the Greater Rajshahi District by organizing them into village-level societies for the mobilization of savings and receipt of credit as well as occupational development training.⁷⁷ Both programs are still relatively small and their sustainability is uncertain, although Ashrai reports repayment of 100%, implying that it may well be progressing toward sustainability. What is clear is that a commercially viable MFI would have the option to use profits from loans to the less poor to cross-subsidize its efforts to reach the poorest.

MICROFINANCE INSTITUTIONS MIGHT TARGET WOMEN LESS

Women account for as much as 90% of total MFI clientele. Some Bangladeshis are concerned that the commercialization of microfinance could lead to reduction in lending to women. This section discusses women's current access to and control of financial resources and the changes that increased microfinance commercialization may bring.

Many MFIs target their loans to women. Women are generally found close to home and are relatively easier to organize and find for frequent visits. Empirical evidence also suggests that they are better credit risks because of the joint liability and usual bond between women in a credit group and because of their commitment to preserving access to resources for their families.

The increasing control by women over household cash through participation in a microfinance program may reflect greater household income rather than a substantive change in gender relations.⁷⁸ A study of four microcredit programs in Bangladesh⁷⁹ sheds light on how much women actually use of the money they borrow versus others in their household or extended family. Male relatives were found to use or control the majority of loans made to women. Many clients interviewed as part of that study, however, indicated that the fact that they had the money to give in the first place raised their standing in their household and community. Nevertheless, such slight control over cash sometimes comes at a heavy cost. The study found that when male relatives refused to repay installments, the women who accepted the loan through their borrowing group could end up impoverished trying to repay it from their own meager resources.

The study's findings suggest that although women may generally represent better credit risks than men, MFIs should consider providing access to credit to men on an individual basis. They also imply that where MFIs aim to enhance women's independence, rather than simply increase resources available to households,

support and training activities may enable women to undertake more lucrative activities. Opportunities to save can also play a large role in helping women to build up assets that they can control, in addition to the importance of such savings in smoothing consumption and mitigating risk. As such, savings should be an important part of any MFI's product and service menu.⁸⁰ However, MFIs that mobilize savings should be adequately regulated and supervised, a feature of commercial financial institutions.

Recently, competition has increased the incidence of individual lending and has prompted the design of alternative ways to ensure repayment. As this has occurred, MFIs have been increasing their direct lending to men. This has not come at the exclusion of women but rather represents an expansion of MFI operations. The creation of an appropriate legal and regulatory environment that would allow a few qualified MFIs to mobilize savings legally would ensure that as individual lending expands, women do not become excluded but rather have greater, safer opportunities through which to build up their assets.

**AVERAGE MICROLOAN SIZES WILL
LIKELY INCREASE**

Progress toward full financial self-sufficiency and commercialized operations is increasingly becoming important to MFIs that promise future, larger loans and that need to fulfill payment obligations on fixed-term deposit products they are increasingly offering now. Stepped lending as clients progress, a part of the Grameen model, is widespread and compels MFIs to offer larger and larger loans. MFIs are increasing their loan sizes through group and individual loans to microentrepreneurs. BRAC recently began small and medium-sized enterprise lending through the creation of BRAC Bank. The trend toward larger loan sizes will likely continue as MFIs become more commercialized and responsive to client needs.

Average Loan Sizes Are Rising

The results of institutional interviews conducted during the present study indicate that the average loan size of microfinance NGOs increased from Tk2,500 in 1998 to Tk2,700 in 1999 and Tk2,800 in 2000, based on the outstanding loan portfolio and the number of active borrowers (referred to in Bangladesh as "outstanding borrowers").⁸¹ Table 4.1 shows data for these years from different sized NGOs. With respect to the three largest NGOs, average outstanding loan sizes continued to rise in the three years. Some leading medium-sized NGOs had increasing average loan sizes while others showed lower loan sizes during the same period, but usually there was an overall rise from 1998 to 2000. This was true also of the three small NGOs. Based on discussions with several practitioners from microfinance NGOs, these increases represent more a "client graduation" to higher loan levels over many borrowing periods and less a fundamental shift to higher-income clients that would indicate mission drift.

Trend Toward Individual Lending

In the past, most microfinance NGOs set a limit to their loan sizes in an effort to stay focused on the poor. Clients seeking larger loans were expected to graduate, but rarely found alternative sources of funds to meet their growth needs. As the MFIs have become more responsive to customer needs, they are increasingly offering larger individual loans to microentrepreneurs. Recent introduction of individual microenterprise lending programs by the three largest microfinance NGOs is indicative of the industry's movement toward providing larger loans targeted at slightly "up-market" clients. Some fear that this move suggests mission drift. In fact, the MFIs are simply serving an additional unmet or underserved demand for microfinance. However, given that these individual loans are strictly based on past loan performance and not on an assessment of the entrepreneurs' repayment ability, they are higher risks than Grameen-style loans, which also offer the group guarantee.

Table 4.1: Average Outstanding Loan Sizes of Microfinance NGOs (Taka)

Category	1998	1999	2000
Large NGOs			
BRAC	2,400	2,600	2,600
Proshika	3,000	3,500	3,400
ASA	2,800	3,400	3,500
Sample of Medium-sized NGOs			
TMSS	2,600	2,500	1,900
CARITAS	1,600	1,600	2,000
RDRS	3,000	1,800	2,200
SSS	3,300	3,500	3,500
CODEC	4,600	5,200	4,700
BURO, Tangail	3,100	2,700	3,900
SHAKTI	-	3,500	4,400
Sample of Small NGOs			
DIP	-	1,900	2,500
RASUS	1,700	2,300	1,900
PAGE	-	2,400	3,600

Source: CDF Statistics, various years.

ASA first introduced microenterprise loans in 1992 through its Small Entrepreneur Development Program (SEDP). Although loans are provided on an individual basis, clients for SEDP are organized into groups of about 20 borrowers. Loan sizes are Tk10,000–30,000, whereas the maximum under their more traditional microcredit program is Tk9,000. The interest rate is the same as on their other microcredit loans, with loan maturity of one year and repayments in 45 installments.

Proshika's Small Economic Enterprise Development (SEED) program was introduced in 1996 to cater to "graduated" borrowers of smaller microcredit. SEED loans are considerably larger than those of ASA, Tk50,000–400,000, and carry a 20% interest rate (flat), which is higher than the interest rate ASA charges on its other loans.

BRAC began a Micro Enterprise Lending and Assistance (MELA) program in 1996 aimed at microenterprise start-ups and expansions. MELA loans range between Tk20,000 and Tk200,000 and are targeted to individual women with entrepreneurial ability and to upgraded village

organization members for investment or working capital purposes. An equity participation of at least 20% (preferably 50%) is required. The interest rate is 15% (flat).⁸²

Most of the medium-sized NGOs are now offering some type of microenterprise loan, albeit on a smaller scale. Several small NGOs are also beginning to offer individual microenterprise loans. Generally, these take the form of ad hoc larger loans to a few better-performing clients. Variations include larger loan amounts and longer maturities, but the interest rates charged are usually the same as on their other microcredit products.

The development of the "missing middle" offers a compelling case for commercialization of microfinance, because funding agencies are unlikely to invest the huge sums needed to develop this profitable market segment.⁸³ Adaptation of the successful experience of PROFUND in Bolivia may be an attractive investment mechanism. PROFUND has proven that professionally managed social capital from funding agencies and private capital from national and international sources can yield

reasonable financial returns to both (Box 4.1). In addition to serving as an apex organization dedicated to promoting financial service provision to micro, small, and medium-sized enterprises, PROFUND has also funded local research and organized presentation of the research.⁸⁴ Such an independent source for research could also support capacity building of institutions and training programs for professional staff.

BRAC Bank's lending for Small and Medium-sized Enterprises

Interestingly, BRAC's MELA program may be seen as competing with its establishment of BRAC Bank in 2001. However, BRAC Bank is poised to capture small and medium-sized enterprise (SME) clients, that is, clients from the "missing middle," with effective demand for loan sizes between Tk200,000 and Tk3 million. The establishment of BRAC Bank is also important as a positive signal that the Government is open to commercialization of the microfinance industry. There were unsuccessful appeals to reverse the Bangladesh Bank's approval of the bank license, because part of the start-up money was from donor funds and therefore should not be used for commercial purposes.

Increasing Average Loan Sizes Do Not Indicate Mission Drift

Although microfinance NGOs may be increasingly involved in individual microenterprise lending and even SME lending, this is a trend of more established organizations that have had the opportunity to build up a "graduated" client base ready for such loans. It is not yet a sign of mission drift in the fundamental sense, because the client base and the initial loan amounts are the same: only the average loan amounts are increasing. Mission drift in the industry will be more evident in coming years if more small NGOs engage increasingly in microenterprise lending, since most in this group are unlikely to have been established long enough to have "graduated" clients and may be seeking to expand their client base by attracting higher-income, lower-risk clients.

Box 4.1:

Funding Microenterprise Lending—the Experience of PROFUND

PROFUND is a for-profit investment fund incorporated in Panama in 1995 and administered from San José, Costa Rica. PROFUND's objective is to achieve superior financial returns for its investors by supporting the growth of regulated, efficient financial intermediaries to serve primarily micro and small-sized enterprises (MSEs) in Latin America and the Caribbean. PROFUND provides equity and quasi-equity to eligible financial institutions so that they may improve their operations on a sustainable basis while expanding their scale.

PROFUND invests in three types of institutions:

- 1) Microfinance NGOs serving MSEs and seeking to become formal financial institutions.
- 2) New financial institutions dedicated to financing MSEs.
- 3) Established financial institutions seeking to enter into or to enhance their activities in MSE finance.

Since PROFUND's incorporation in 1995, many other shareholders have joined, including the World Bank's International Finance Corporation, the Inter-American Development Bank's Multilateral Investment Fund, Corporación Andina de Fomento (CAF), the Central American Bank for Economic Integration, the Commonwealth Development Corporation, the Swiss Government, and Calvert Investment Fund.

PROFUND does not perceive a conflict between poverty alleviation and profitability. In fact, it believes that financial viability is a necessity for the long-term success of poverty alleviation efforts in microfinance. Accordingly, while most of PROFUND's shareholders are interested in the development of the microfinance industry, the fund seeks primarily to receive an adequate return on its investments, which it considers the most efficient way to entice commercial capital into microfinance.

Source: Silva 2000, p.1.

This trend of increasing loan size is expected to increase as competition between NGOs intensifies and commercialization takes a stronger foothold in the industry. However, larger loan sizes also pose greater risks for smaller NGOs and could threaten their operations if enough larger loans default. These risks may be contained as long as the clients receiving the larger loans are indeed “graduated” and fund further expansion of existing businesses.

INTEREST RATES COULD KEEP RISING

The fears that microfinance commercialization could lead MFIs to raise their interest rates on loans are borne out in recent trends. Few MFIs charge interest rates high enough to cover their full operational and financial costs. Some increase may be necessary if MFIs want to be sustainable. And as MFIs become more concerned with achieving full financial self-sufficiency, interest rates could rise further.

However, given the current levels of competition among MFIs, this is unlikely to happen until grants and soft funds become less available and some unsustainable MFIs disappear.

Few NGOs Charge Sustainable Interest Rates

CDF Statistics (up to December 2000) show that 455 or 80% of microfinance NGOs charge annual interest rates of 11–15% (on a flat basis) and 78 (14%) of them charge 16–20% (flat). With regard to savings, 268 (53%) NGOs provide annual interest on savings of 6–7% while 110 NGOs (22%) provide interest rates of 8–10%. The variation of interest rates on loans and savings is shown in Table 4.2.

It is widely agreed that most MFIs need to charge at least 15% interest (on a flat basis) per annum to cover the relatively high cost of microlending (to account for cost of funds, risk, etc.). From Table 4.2 above, it is evident that less than 15% of all microfinance NGOs currently

Table 4.2: Microfinance NGO Interest Rates on Loans and Savings

Interest Rates Charged on Loans (flat basis) per Annum		
Range	No. NGOs	% NGOs
Up to 10%	31	5.5
11–15%	455	80.2
16–20%	78	13.7
21–25%	2	0.4
More than 25%	1	0.2
Total	567	100.0
Interest Rates Paid on Savings per Annum		
Range	No. NGOs	% NGOs
Up to 5%	116	22.7
6–7%	268	52.5
8–10%	110	21.5
11–15%	17	3.3
Total	511	100.0

Source: Credit and Development Forum 2001b.

charge interest rates on microcredit that would make their operations commercially viable. This approach is consistent with traditional thinking that the poor cannot afford to pay rates of interest on microcredit that would be cost-covering for the MFI. It appears that 85% of the microfinance industry is content to impose “hidden” costs onto clients in the form of transaction costs associated with program indoctrination, group formation, peer monitoring, and weekly meetings designed to enhance repayment prospects.

Two major reasons for the prevalence of below-market interest rates on microcredit are that the Grameen Bank (which still heavily influences the operations of most medium-sized and small NGOs that follow the Grameen model) has not yet adopted lending interest rates sufficient to cover its costs, and NGOs that borrow from PKSF (174 during 1999/2000) are subject to a maximum onlending interest rate of 15% (flat) per annum. In addition to these factors, competition keeps most MFIs from charging lending at interest rates higher than this. The few that charge more than 15% mainly compete on product and service quality to attract and keep clients.

Microfinance Institutions Are Increasing Interest Rates on Loans

The nominal lending interest rates of microfinance NGOs have been rising in recent years by changing the method of interest calculation and incorporating service charges and other indirect means to improve cost recovery that are not captured when simply looking at the lending interest rate. Several NGOs are realizing that to compete over the long term, they need to increase their sustainability and that they have several means at their disposal to do so.

One of the most popular means has been to shift the lending interest rate calculation from a declining balance to a flat basis. Evidence of this is seen in MFIs of all sizes. Until 1990, BRAC charged 25% interest on a declining basis and thereafter, 15% on a flat basis, making the effective rate much higher than it was before. ASA charged a lending interest rate of 12.5% flat until

1999, after which the rate was raised to 15% flat. Proshika initially charged interest on its loans of 18% on a declining basis, then raised the rate to 20% on a declining basis and increased it again to 20% flat in 2000.

Medium-sized NGOs have followed a similar pattern. For example, CARITAS charged 12.5% flat until 1999, afterward raising it to 15% flat. SHAKTI charged 20% on a declining basis until 1999, then changed to 20% flat. However, BURO Tangail, which charged 25% flat until 1999, decreased its rate to 20% flat in 2000. Among the small NGOs, RASUS (*Rupgonj Artha Samajik Unnayan Sangstha*) charged an interest rate of 25% flat until 1999 then decreased the rate to 15% flat.

It is likely that BURO Tangail and RASUS were compelled to lower their lending interest rates because of intense local competition; clients had become aware of the differences between flat and declining balance methods of interest rate calculation. This is also the expected longer-term impact of competition—loan amounts and terms, including interest rates, will likely become more demand driven over time and allow for the scale of outreach needed for good performing MFIs to achieve greater cost efficiency. The main obstacle at this point will be the constraint placed on onlending interest rates imposed by PKSF on those microfinance NGOs that borrow from it.

While concerns for sustainability have led MFIs to raise interest rates in the past few years, the prevalence of grants and soft loan funds reduces the MFIs’ sense of urgency to achieve full financial self-sufficiency. The existence of concessional funds combined with competition for clients among MFIs will keep interest rates from rising quickly in the short term. However, over the long term, donor funds will diminish and MFIs will need to find ways of reducing costs or increasing revenues to sustain their operations.

The trends noted in this chapter of MFI’s up-scaling and serving more male clients, as well as increasing loan sizes and interest rates all indicate that these MFIs are applying more commercial principles to their operations. Increased commercialization could accelerate

these trends, resulting in some negative consequences, in terms of a lesser focus on certain target markets, such as the hard-core poor and women. However, the trends also have

some positive implications in terms of expanded markets served and increased provision of higher-quality, demand-driven products by more sustainable MFIs.