5 Positive Approaches to Microfinance Commercialization

Commercialization of microfinance holds the promise of capitalizing on the achievements in outreach that MFIs have made to date. General improvements in their financial self-sufficiency are promising, but the industry is far from reaching the potential benefits of microfinance commercialization. Until there is an adequate legal and regulatory framework and greater access to commercial sources of funds, there will be little incentive for MFIs to commercialize further. MFIs' growth will be limited and client savings will continue to be at risk. Many stakeholders have a role in microfinance commercialization, including the Government, funding agencies, support institutions, and the MFIs themselves. This chapter draws conclusions and makes recommendations for each of these key stakeholders.

ROLES OF THE GOVERNMENT

Provide an Enabling Policy Environment

The main role the Government should play in commercialization of microfinance is to create and maintain an enabling macroeconomic and sectoral policy environment and an adequate legal, regulatory, and supervisory framework for microfinance. The Government should focus on maintaining stable economic growth and containing inflation at current levels. It should also undertake a private-public sector partnership to produce a cohesive national framework for microfinance development and rationalize its pervasive presence in the microfinance market.

Phase Out Direct Interventions

Several major, direct government interventions that have experienced poor performance in terms of the primary assessment criteria of outreach and sustainability should be phased out in favor of more indirect support of the microfinance sector. All direct financial sector interventions should be minimized over the long term to prevent market distortions and to allow private sector provision of microfinance services using proven methodologies for sustainable microfinance delivery. Those programs with repayment rates consistently less than 80% (12 of the 18 government microcredit programs) should be converted into transparent grant programs for social services and business development services to support the microenterprise sector without harming the repayment culture or "crowding out" more efficient NGO providers of microfinance.

Focus on Grant-based Approaches to Assist the Poorest

The Government should also consider complementary grant-based approaches to reach certain sections of the microfinance target market (for example, the lowest rung of the working poor), where the net benefits of using microcredit are exceeded by those of alternative interventions (for example, investments in training, human services, and physical infrastructure) to reach these target groups. Such focused government assistance could boost effective demand for microfinance services, thereby allowing MFIs to expand their client base.

Create a New Legal Structure for Commercial MFIs

While the Bangladesh Bank did recently warn microfinance NGOs against mobilizing nonmember savings, it needs to do more to ensure the safety of member deposits. NGOs lack owners; there is no one to oversee their management and protect the capital base. If a large microfinance NGO experiences financial difficulties that might threaten client savings, all similar institutions could suffer by association. The Bangladesh Bank should consider emulating what a few other countries, such as Bolivia, have done in successfully creating a distinct legal tier for nonbank MFIs, with regulation and supervision either by a distinct unit within the central bank or by a third party having delegated supervisory authority.

Such a new tier of licensed, nonbank MFIs would allow a few qualified microfinance NGOs that have achieved or are near financial self-sufficiency (not expected to number more than five MFIs in the short term) to transform themselves into regulated entities capable of legally mobilizing deposits to enhance their growth prospects. Introduction of such a tier could improve accountability and transparency of MFI operations. It is commonly acknowledged that these are necessary ingredients both for obtaining recognition as financial partners of the formal financial sector and for ensuring the security of savings. This is seen as an important measure for increasing the availability of capital funds to MFIs, both from the general public and as onlending funds from the commercial banks.[85]

Adopt Appropriate Regulation and Supervision

Some of the common adaptations of traditional bank prudential regulation and supervision that address the specialized operations of most MFIs are shown in Box 5.1. Bangladesh Bank would be the most appropriate institution to regulate and supervise the few MFIs that might come under a new tier of regulation. Given the difficulties that Bangladesh Bank still has in its supervision of the formal financial sector, however, it is apparent that any role assigned to it would have to be undertaken only after substantial capacity building to develop requisite understanding and professional expertise in microfinance, with support from funding agencies. Though such support, international practices in microfinance regulation and supervision could be introduced.

The sooner Bangladesh Bank can take on the role of regulation and supervision of deposit-mobilizing MFIs, the better. At a minimum, the regulatory structure should ensure that deposit-mobilizing MFIs have strong governance structures, with qualified, active board members; have effective internal control and risk management systems; and are thoroughly audited by an independent third party at least once per year. In addition, Bangladesh Bank should adopt stricter risk classification criteria, requiring higher levels of loan provisioning and faster write-offs. The Bank should set minimum standards for performance and monitor key indicators for capital adequacy, asset quality, and liquidity.

Improve the Framework for Secured Transactions

Development of laws and regulations associated with the pledge of various forms of movable property should be undertaken and appropriate registries established. In addition, the Government should support the training of court officers on how to proceed in cases involving default.

ROLES OF FUNDING AGENCIES

Funding agencies, in close coordination with the Government, have four major roles to play in the commercialization of microfinance: (1) supporting an enabling environment, including appropriate regulation and supervision; (2) building MFI capacity; (3) promoting innovation in microenterprise development and assisting with the development of microfinance industry standards; and (4) promoting the development

Box 5.1:

Common Adaptations for MFIs of Bank Prudential Regulations and Supervision

Lower capital requirements. Minimum capital requirements should be low enough to attract new entrants into microfinance, but high enough to ensure the creation of a sound financial intermediary.

Risk weighting of assets for unsecured loans. The type of lending (unsecured or secured, and if secured, then by type of collateral) affects a bank's risk weighting of assets, capital adequacy, and provisioning. Regulators should assess the riskiness of MFIs based on overall portfolio quality and repayment history rather than on the value of traditional guarantees. Historical performance of portfolios, statistical sampling of arrears, the adequacy of management information systems, and the MFI's own policies for dealing with arrears should also be taken into account.

Higher capital adequacy ratios. The Basle Accord currently recommends a weighted capital adequacy ratio of 8% of risk-weighted assets. In view of their generally lower ability to diversify their risks, MFIs should be subject to even higher capital adequacy ratios as a means to safeguard investor funds. Consideration should be given to applying ratios approaching 20% with potential lowering to 12–15%, based on performance over time.

Stricter provisioning. Provisioning requirements should be based on the average loan maturity of the portfolio. MFI portfolios tend to have shorter average maturities, requiring more aggressive provisioning. Basle Accord requirements suggest that banks be subject to loan provisioning requirements of 25% for substandard loans, 50% for nonperforming loans, and 100% for loss loans. Stricter loan loss requirements for MFIs are needed. They should be at least

10% of the unpaid balance	0–30 days in arrears
25% of the unpaid balance	31–90 days in arrears
50% of the unpaid balance	91–180 days in arrears
100% of the unpaid balance	in arrears more than 180 days

Higher operational costs allowed. MFIs tend to have higher operational costs than traditional banks because they manage smaller loans and deposits. Allowing MFIs to offer incentive-based payments to staff; to have flexible hours of operation convenient for clients; and to engage in mobile banking, permitting them to disburse funds and collect payments outside branches, can help MFIs to minimize their operational costs. Also, incentive-based payments to staff would assist MFIs to reduce portfolio risk. Regulators should not penalize MFIs for higher operating costs if the latter can demonstrate a reasonable average return on assets.

Customized reporting requirements. Not all the reporting requirements of traditional banks are applicable to MFIs; microentrepreneurs usually cannot produce the amount of documentation required of traditional lending. Portfolio reporting formats should take into account the volume, loan size, and term of microfinance loans.

Sources: Berenbach and Churchill 1997, p.43; CGAP 1996.

of linkages between commercial banks and microfinance NGOs. Details follow.

Support an Effective Policy Environment

Funding agencies should work with the Government to ensure an environment for microfinance conducive to MFIs' progress toward financial sustainability, including advising on macroeconomic and sectoral policies, as well as on the legal and regulatory framework. Funding agencies should be careful not to fund unsustainable direct interventions by the Government (as may be the case with

Box 5.2:

Consensus Statement by Microfinance Industry Leaders

- Microcredit is about providing financial access to economically active poor people who, with access to credit, can build their economic activities and repay their loans.
- Microcredit services are about providing access to the poor and poorest; in many cases, different approaches and linkages among institutions will be needed to respond to the needs of the poorest households.
- It is important that microfinance serves the needs of poor microentrepreneurs, and that financial and nonfinancial services respond to the evolving needs of poor people as they grow their enterprises, and move beyond poverty.
- Microfinance must both work for poor people and be financially sustainable.
- It is most important to provide poor people with rapid, efficient, and responsive access to financial services.
- Increasing poor women's empowerment in decision making in her family, community, and country is important in the microlending transaction.
- Microfinance should be provided on a commercial basis, i.e. free of subsidies to the clients and the MFIs, once an MFI has achieved adequate scale and financial sustainability.

Source: Women's World Banking 2002, p.4.

the ADB microfinance project executed by the BRDB) and to promote more indirect government interventions to allow efficient, private sector-led market operation. These agencies should also encourage the Government to stop supporting refinancing loan schemes that have subsidized interest rates. Finally, funding agencies have a comparative advantage in building consensus between the Government and microfinance practitioners regarding a unified vision for the microfinance industry. Box 5.2 shows a consensus statement toward such a vision by microfinance leaders who participated in the March 2002 Women's World Banking seminar.

Build MFI Institutional Capacity

Funding agencies should help to build institutional capacity by providing exposure to and training in microfinance best practices, along with performance-based support for capacity building. In particular, MFIs would benefit from training and technical assistance in governance, management information systems, internal control, risk management, and new product development. If onlending funds are provided, they should be coupled with time-bound, quantitative performance indicators, the achievement of which determines the timing and amount of subsequent funding within a maximum two- to three-year period for continued funding access. It will be important for funding agencies to focus also on increasing the domestic availability of microfinance training courses and programs. Expansion of CDF would be a natural starting point for such an endeavor. In addition, opportunities for senior managers of MFIs to be exposed to successful programs in other leading microfinance countries, such as Indonesia and the Philippines, should be supported.

Support Microenterprise and Microfinance Innovation

Funding agencies, in cooperation with the Government, should promote the development of innovative microfinance methodologies and products as well as complementary, grant-based social service and business development service programs. This is especially important in the areas of social mobilization (group formation and amalgamation), basic skills development, business training, and building physical infrastructure, especially in rural areas. Microfinance NGOs desiring sustainability should shift the responsibility for (pre-microcredit) social mobilization efforts and (post-microcredit) business development services or "credit plus" activities (such as in product standards and marketing) to purely social service-oriented NGOs. These microfinance NGOs will then be more able to concentrate on satisfying the financial needs of their clients. In addition, assistance from funding agencies will be vital in the areas of developing and testing new or adapted delivery methods and products that can be used to increase access to financial services by underserved groups.

Further, funding agencies, together with a wide range of stakeholders and drawing on international experience, should assist in the development of commonly accepted performance and reporting standards. Although there are no commonly accepted performance and reporting standards in Bangladesh at present, it is widely agreed that they are needed. Reliable microfinance standards reinforce trust and confidence in MFIs and can be used to enhance operational efficiency. Such a set of standards would be especially helpful for those smaller microfinance NGOs wanting to elevate their status based on their good performance record. Formulation of such a set of standards could be led by PKSF in cooperation with CDF and various independent microfinance technical committees.[86]

Promote Linkage Development

Finally, as noted earlier, funding agencies should promote linkage development between commercial banks and NGOs as a means to increase access of the latter to more commercial sources of funds. The component of the CARE INCOME project on building financial linkages focuses on constructing such linkages so that small and medium-sized microfinance NGOs will not always depend on donor funds to support increasing financial requirements. Additional donor efforts along these lines may assist in removing some of the obstacles between the NGOs and commercial banks so that mutually beneficial business relationships can develop between them.

ROLES OF MICROFINANCE INSTITUTIONS

Balance Commercial and Social Objectives

MFIs are vulnerable to social mission drift if they do not have a clearly defined target market and monitoring mechanisms to ensure that they are providing appropriate financial services to the intended clients. MFIs are exposed to commercial mission risk if they do not set interest rates (and fees) high enough to cover costs and if they are not managed as a business. MFIs have pursued their social missions but need to balance these with commercial objectives. In order to capitalize on their impressive achievements in outreach, it is imperative that they move toward financial self-sufficiency through a combination of strategic and business planning and adoption of cost-recovery interest rates. The large NGOs have proven in the Bangladesh context that only through achievements in financial self-sustainability can outreach be expanded in a substantial and sustainable manner.

Increase Cost Efficiency

In addition to bringing their commercial and social objectives into balance, MFIs should strive for cost-efficient operations. The emphasis on cost efficiency is in line with the MFI's social objectives in that increases in cost efficiency allow commensurate reduction in the interest rate needed for cost recovery. ASA's achievements in this regard are proof that dramatic cost efficiency can be attained, even when serving poor clients. While few MFIs would be willing and able to realize the extreme efficiency of ASA, all MFIs have a responsibility to reduce costs in order to achieve their social mission.

Improve Institutional Capacity

Given that institutional capacity in the vast majority of microfinance NGOs is extremely weak, certain improvements should take top priority. MFIs need to build capacity in a way that recognizes the need to balance the social mission with a commercial approach, strengthens governance, improves operating efficiencies, maintains portfolio quality, and moves the MFIs toward operational and financial self-sufficiency.

MFI missions should be clarified to incorporate a sustainable view of microfinance provision. Weaknesses in ownership and governance should be acknowledged and minimized through the establishment of clear lines of responsibility, staff incentives that promote sustainable outreach, and adequate systems to monitor progress toward commercialization.

When MFIs begin to offer larger individual loans, they should conduct risk analysis based on the client's cash flow and true repayment capacity, rather than issue bigger loans based strictly on past loan performance. Increased attention should be given to strengthening human resources in banking and financial analysis, in particular for strategic and business planning. Improving boards of directors by including members who have understanding of business and finance is crucial.

Accountability and transparency need to be built in through integrated systems and practices, and a professional financial management culture. Audited standard income statements and balance sheets will increase the transparency and performance of an MFI's operations. Ultimately, these improvements will facilitate MFIs' access to commercial sources of capital.

Few actors are as yet involved in capacity building, although PKSF has instilled some financial discipline in NGOs hoping to borrow from it. CDF produces reports and studies on various aspects of the microfinance industry, as does CARE Bangladesh. However, the existing support services remain inadequate to address the capacity-building needs of the sector.

ROLES OF MICROFINANCE SUPPORT INSTITUTIONS

PKSF

As the microfinance industry matures, PKSF should focus on improving its core business of onlending funds to partner organizations and monitoring MFI performance. To support microfinance commercialization, PKSF, with support from the Government, will need to eliminate its criterion of a maximum onlending interest rate. With increasing efforts by microfinance NGOs to commercialize their operations (provided there are adequate incentives to do so), PKSF should enjoy a larger demand for its funds. It will likely need to strengthen and streamline its loan approval process and allow greater variation in the way an MFI carries out its microfinance operations beyond the standard Grameen model. PKSF is an important member of the 11-member steering committee on regulation and is also the convener of the 8-member technical committee. It can influence the Government through selected policymakers to design supportive regulation and supervision standards for the proposed new tier of specialized financial institutions engaging in microfinance operations.

As noted, this topic has inspired growing discussion in microfinance circles worldwide over the past several years. Commentators have come to understand how inappropriate approaches to regulating and supervising MFIs have constrained the future development and sustainability of the microfinance industry. Also, as the sector has matured in many parts of the world, there has been growing awareness of the financial systems approach that considers MFIs as players within a continuum of financial service providers needed to address the needs of the population as a whole. This awareness has helped to inspire attempts to harmonize the regulatory and supervisory treatment of MFIs with that of other players in this continuum and, where appropriate, to differentiate between MFIs and other players in such treatment.[87]

PKSF's attempts to create a framework for MFIs' self-regulation are a good start. However, the principle of self-regulation assumes that there are owners who will vigilantly oversee management and seek to preserve the capital base. Microfinance NGOs do not have such owners, and PKSF has a strong conflict of interest in attempting to play a supervisory role while also acting as a wholesale lender. Thus, self-regulation should be considered a temporary solution.

CDF

CDF, in cooperation with PKSF and other microfinance stakeholders, should continue to work toward introducing a standard accounting system among its members and other MFIs. Its efforts related to developing performance standards for microfinance NGOs (standardized accounting practices, subjectivity to external audit, standard presentation of financials with an eye toward eventual ratings) are commendable and should also be continued. Further, CDF should continue to play the important role of motivating these NGOs to understand the necessity and implications of regulation. CDF's capacity-building training programs for MFIs are consistent with commercialization of the industry and should be expanded, particularly in stressing operational and financial self-sustainability, product pricing/costing, cost efficiency, productivity, and linking with commercial sources of funds. CDF should also continue to play a role in linking its members with PKSF funds and, whenever possible, commercial bank credit.

Credit Information Bureau

Given the significance of overlapping microcredit borrowers, major stakeholders should consider support for a bureau for credit information sharing and risk reduction. The absence of a national identification system poses difficulties for the private sector to provide such a service. The Government or funding agencies could fund a pilot system for sharing information on blacklisted clients. Researchers could coordinate the system, engaging several MFIs from one or two areas. Findings from the pilot system could help industry leaders understand better the incentives and disincentives to building a decentralized system for sharing information on borrowers[88].