Executive Summary

This report analyzes the progress toward commercialization of Bangladesh's relatively developed and competitive microfinance industry. It also explores the remaining challenges and implications for various types of stakeholders (including microfinance clients, microfinance practitioners, government officials, and funding agencies). In addition, it recommends positive approaches to the commercialization of microfinance while preserving the traditional social objective of microfinance institutions (MFIs)[1] of expanding access by the poor to financial services.

UNDERSTANDING MICROFINANCE COMMERCIALIZATION

Commercialization of microfinance is a relatively new consideration in Bangladesh. The term *commercialization* carries with it a negative connotation among many domestic microfinance stakeholders who equate commercialization with exploitation of the poor. Microfinance professionals worldwide, however, are increasingly using the term to include "the application of market-based principles to microfinance," with the realization that only through achievements in sustainability can MFIs achieve levels of outreach commensurate with demand. There is a growing realization that commercialization allows MFIs greater opportunity to fulfill their social objectives of providing the poor with increased access to an array of demand-driven microfinance products and services, including not only credit but also savings, insurance, payments, and money transfers.

The report considers commercialization of microfinance at both micro and macro levels. At the micro level, MFI commercialization implies institutional progress along a continuum, 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 financial institution that is subject to prudential regulation and supervision and able to attract equity investment.

At the macro level, commercialization of the microfinance industry means the increased provision of microfinance by MFIs sharing the above characteristics in an enabling environment.

Commercialization of the microfinance industry involves several factors, including the degree to which the policy environment and legal and regulatory framework are conducive to the proliferation of commercialized MFIs, and availability and access of market-based sources of funds to MFIs.

PROGRESS TOWARD COMMERCIALIZATION

Social visionaries have led the rapid expansion of microcredit, which began and continues to be strongly oriented toward serving the unmet or underserved demand by the poor for financial services. Dominated by the Grameen Bank and nongovernment organizations (NGOs), microfinance in Bangladesh has historically operated largely on a noncommercial basis, although two of the largest such NGOs, the Association for Social Advancement (ASA) and the Bangladesh Rural

Advancement Committee (BRAC), are commercially viable and currently reach about half the national market. In addition, there are numerous poorly performing, subsidy-dependent NGOs and government microcredit programs. In addition to their poor management and operating performance, many of these small NGOs and programs simultaneously operate (pre-microcredit) social mobilization efforts and (post-microcredit) business development services or "credit plus" activities that cloud their financial performance and hinder their ability to become financially viable. Given the level of subsidy dependence in microfinance, there is only a minute presence of private commercial banks in this field.

About 70% of poor households are currently reached by MFIs, based on the latest government estimate of 12.2 million poor families in the country and adjusting the active borrower data for client overlap (the proportion of clients borrowing from more than one MFI at the same time is widely believed to average about 15%) and membership by nonpoor households (usually estimated at 10%). Competition is increasing in many of the more populated rural areas. Most of the MFIs are not financially self-sufficient and there will likely be a reduction, especially of small and medium-sized NGOs, as competition increases and funding agencies tire of funding unsustainable institutions.

Recently, many MFIs in the country have begun to apply more commercial principles to their operations and have become more concerned about achieving financial self-sufficiency. However, there are still few commercial sources of funds and the legal and regulatory framework is not supportive of their movement toward commercialization. Nonetheless, as competition increases, MFIs are becoming more responsive to client demand by diversifying their product offerings to include larger individual loans, leasing, savings products, and microinsurance. Those that can best satisfy client demand while ensuring financial self-sufficiency will be the most likely to survive.

MICROFINANCE COMMERCIALIZATION CHALLENGES

Several challenges to microfinance commercialization exist at the micro (institutional) and macro (operational environment) levels. Below are a few of the most pressing challenges.

- **Widespread Negative Perceptions of Commercialization**

Perhaps the largest obstacle to commercialization of microfinance is that both MFI practitioners and government officials view the dual objectives of profitability and poverty alleviation as conflicting rather than mutually supportive.

- **Weak Institutional Capacity**

There are many small NGO microfinance institutions that lack the institutional capacity to manage a rapidly growing financial intermediary. In particular, many MFIs suffer from lack of clarity in their mission, weak governance, and low levels of technical skills in 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 service activities in their books. These weaknesses hinder these MFIs from achieving financial self-sufficiency and from progressing toward commercialization.

- **Lack of a Vision for the Microfinance Industry**

The political situation following the 2001 general elections has impeded the implementation of key policy reforms needed for faster economic growth and poverty reduction. Despite the importance of microfinance in Bangladesh, no comprehensive national policy for the continued development of the industry has been articulated. This is causing concerns about potential adverse government intervention in the sector, especially regarding regulation of MFIs.

- **Plethora of Poorly-performing Government Microcredit Programs**

At least 18 separate microcredit programs are carried out by as many as 13 government ministries and divisions. 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 Credit and Development Forum (CDF) statistics, however, reveals that repayment rates vary between 19.6% and 98.6%. Special, rural microlending programs in several state-owned commercial banks have been estimated to have collection rates below 20%, according to a World Bank analysis.[2]

- **Inadequate Secured Transactions Framework**

Virtually no current or potential microcredit clients are able to take advantage of immovable property laws to collateralize their loan request because of their lack of real assets. 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.

- **Absence of a Credit Information Bureau that Includes Information on Microcredit**

While there is a national credit information bureau, it contains information on commercial bank loans only. There is growing realization that the microfinance industry needs access to a credit information bureau that includes information on microcredit in order to mitigate the problem of client overlapping and to reduce the number of loan defaulters.

- **Lack of Supportive Legal and Regulatory Framework for Microfinance**

Bangladesh currently lacks a supportive legal and regulatory framework for commercial MFIs. This is likely to continue to be an obstacle to commercialization as the Bangladesh Bank has limited capacity to regulate and supervise the existing banks. This, along with other concerns about government intervention, has caused some of the largest MFIs to discourage any attempt to create a regulatory framework for microfinance within the Bangladesh Bank. However, given the large number of MFIs that mobilize client savings to onlend, international best practice suggests that some form of prudential regulation and supervision is necessary. MFIs are currently considering self-regulation as an alternative. The *Palli Karma-Sahayak* Foundation (PKSF) has devised a standard strategic policy package, which it offers to its partner organizations to ensure they are prudently managing their clients' savings.

- **Prevalence of Grants and Soft Loan Funds**

Although savings are the major source of funds for many MFIs, there is still high reliance on grants and concessional funds for onlending. At the end of 2000, such funds accounted for about 41% of the loanable funds for the microfinance industry. Contrary to popular opinion, donor funding to the microfinance sector has been rising in absolute terms. On the positive side, soft loan funds have partially replaced funding agencies' grants to MFIs, suggesting some movement toward commercialization. In addition, past grants and soft loans have helped the NGOs to develop their own capital base and to benefit from economies of scale as they expanded rapidly.

IMPLICATIONS OF COMMERCIALIZATION

While this report discusses microfinance commercialization from the perspective that commercialization would have a positive impact on microfinance as a whole, including increased outreach and long-term viability, many Bangladeshis are concerned that further commercialization could have negative social impact or result in "mission drift,"[3] such as a reduced focus on reaching the poorest. In addition, some fear that microfinance commercialization could shift the target market of MFIs from women to men, and lead to increased loan sizes and higher interest rates. These perceived implications are discussed below.

- **Many Poor Households Could Remain Unserved**

While some worry that the commercialization of microfinance could cause mission drift, in fact, the poorest are not currently being served well by the many noncommercial MFIs. 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. Microcredit is not necessarily the way out of poverty for all poor, and perhaps especially the poorest. Indeed, the results of one study[4] contend that targeting MFI support at the very poorest is, in many instances, harmful for them, suggesting that for the "hard-core" poor, access to microenterprise finance is not the first priority. New programs targeting the hard-core poor are needed to address the issue. Profitable MFIs with a social mission might be the best suited for this task, as they would have the funds to diversify and to cover the investment in reaching these markets.

- **MFIs Might Target Women Less**

Women currently account for as much as 90% of total MFI clientele. There is concern that commercialization of microfinance could lead to reductions in lending to women. While studies show that access to loans has raised women's standing in the household and the community, there are also findings that many loans to women are used or controlled by men. Nonetheless, increased competition has led MFIs to increase their direct lending to men. This has not come at the exclusion of women but rather as an expansion of MFI operations. While increased commercialization of the microfinance industry could contribute to more men being served, resulting in a lower percentage of female clients, women would continue to be a key target market for MFIs, especially given historical evidence of their lower risk profile.

- **Average Microloan Sizes Will Likely Increase**

The results of institutional interviews conducted for this report indicate that average loan sizes of the nongovernment MFIs has indeed been rising, from Tk2,500 in 1998 to Tk2,800 in 2000. Although these institutions may be increasing loan sizes as they offer more individual loans to "graduated" clients, this is also a trend in more established organizations that have had the opportunity to build up a mature client base. It is not yet a sign of mission drift because the client base remains the same (i.e., poor households); only the loan amounts are increasing. Mission drift in the industry will become more evident in coming years if increasing numbers of small NGOs engage more in individual lending, since most of them 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 clients.

- **Interest Rates Could Keep Rising**

Despite the fact that the vast majority of microfinance NGOs charge lending interest rates of 11% to 15% (on a flat basis) per annum, which do not cover their costs, recent trends show that interest rates are rising. Microfinance NGOs have been raising their nominal interest rates over the last few years, changing the mode of calculation from a declining balance basis of interest accrual to a flat method, which has increased the effective lending rate. In addition, they have incorporated service charges and used other indirect means to improve cost recovery. 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.

POSITIVE APPROACHES TO COMMERCIALIZATION

The array of factors inhibiting the commercialization of microfinance implies specific roles for major stakeholders such as the Government, funding agencies, MFIs themselves, and microfinance support institutions such as PKSF and CDF. General responsibilities and specific approaches to move commercialization forward are highlighted below for these stakeholders.

Roles of the Government

Action by the Government of Bangladesh is pivotal to the successful advancement of microfinance commercialization, which requires the following changes.

- **Providing an Enabling Policy Environment**

The main role of the Government should be to create and maintain an enabling macroeconomic and sectoral policy environment and an appropriate legal and regulatory framework for microfinance. Low levels of political consensus on major national issues have impeded the implementation of key policy reforms needed for faster economic growth and poverty reduction that may also serve to boost effective demand for microfinance. Key public and private stakeholders need to come together to develop a comprehensive vision for the commercialization of the microfinance industry and to push for the necessary policy, legal, and regulatory changes. The Government should focus on maintaining stable economic growth and containing inflation at current levels. Thus far, macroeconomic growth has boosted the effective demand for microfinance, especially in the service sector. Weaknesses, however, in physical infrastructure (power, telecommunications, water, etc.) as well as basic human services will continue to constrain further demand for microfinance. Introduction of a national identification system would provide an institutional basis for many public services, including providing the necessary support for a private, national credit bureau.

- **Phase out Direct Interventions that Distort the Market for Microfinance**

Several major, direct government interventions in microfinance that have experienced poor performance should be phased out in favor of more indirect support of the microfinance sector. Direct financial sector interventions should be minimized to prevent market distortions and to allow private sector provision of microfinance services using proven methodologies for sustainable microfinance delivery. The special licensing of the Grameen Bank and more recent indirect interventions, such as the licensing of the BRAC Bank to provide commercial financial services to the so called "missing middle" operators of small businesses that are not served by traditional banks or MFIs, are positive signs that the Government may be willing to support a commercial approach to microfinance.

- **Focus on Grant-based Approaches to Assist the Poorest**

The government should also consider complementary grant-based approaches, such as social services or business development services and training, to reach certain sectors of the microenterprise market (for example, the lowest rung of the working poor as well as the hard-core poor). Investments in physical infrastructure and provision of human services, particularly in rural areas, have the potential to boost effective demand for microfinance.

- **Create a New Legal Structure for Commercial MFIs**

Consideration should be given to developing a new tier of regulation for financial intermediaries specializing in microfinance operations, including mobilization of voluntary deposits from the general public. Such regulation and supervision should be tailored to the respective microfinance operations and reinforce sustainable growth, drawing from recent positive international experiences in Africa and Latin America. Strengthening the Bangladesh Bank to be able to regulate and supervise the handful of NGOs suited to such a transformation would be a necessary prerequisite and should be a priority of the Government and funding agencies.

- **Adopt Appropriate Regulation and Supervision for Microfinance**

Once the Bangladesh Bank's capacity to regulate and supervise traditional financial institutions is developed, it should take on the role of supervising the few MFIs that might come under the proposed tier of regulation that would allow them to mobilize voluntary deposits from the public. The regulatory structure should ensure that deposit-mobilizing MFIs have strong governance structures, qualified and active board members, effective internal control and risk management systems, and thorough auditing by an independent third party at least annually. In addition, the Bangladesh Bank should adopt stricter risk classification criteria, requiring higher levels of loan provisioning and faster write-offs. For supervision, the Bangladesh 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 as well as establishment of registries appropriate for such a purpose. 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. These are discussed below.

- **Support an Effective Policy, Legal, and Regulatory Environment**

Funding agencies should work with the Government to ensure an environment conducive to MFI progress toward commercialization. This includes advising on macroeconomic and sectoral policies, as well as a legal, regulatory, and supervisory framework (specific areas of emphasis are mentioned above). It also entails encouraging the Government to phase out poorly performing, subsidized direct credit programs and to stop supporting refinancing schemes with subsidized interest rates.

- **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. This will help MFIs to expand their outreach and develop cost-effective sustainable operations (through the use of so-called "smart subsidies"). If onlending funds are provided at all, 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 2- to 3-year time horizon on continued funding access. It will be important for funding agencies to focus also on increasing the local availability of microfinance training courses and programs. Expansion of CDF in this regard would be a useful starting point. In addition, opportunities should be provided for senior managers of MFIs to be exposed to successful microfinance programs in other leading countries, such as Indonesia and the Philippines. An integral part of this second major role for funding agencies is assistance in the development of commonly accepted microfinance industry operating, financial, and reporting standards.

- **Support Innovation in Enterprise Development**

Funding agencies should promote the development of innovative microfinance methodologies and products as well as complementary, grant-based social service programs. Responsibility for "credit plus" activities, such as business training, setting product standards, and marketing assistance, could be shifted to purely socially-oriented NGOs. This would allow microfinance NGOs reaching for sustainability to concentrate on satisfying the financial needs of their clients and not divert valuable time and resources to other activities. In addition, assistance from funding agencies will be vital in developing and piloting new or adapted delivery methods and products that can be used to increase access by underserved groups to financial services.

- **Promote Linkage Development**

Finally, funding agencies should promote linkages between commercial banks and microfinance NGOs to increase the latter's access to more commercial sources of funds. One component of the CARE INCOME project focuses on building financial linkages so that small and medium-sized microfinance NGOs in the country can access commercial funds and not be forever dependent on donor funds to support their ever-growing financial requirements. Additional donor efforts along these lines may assist in removing some of the obstacles between these 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 drift 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 these MFIs move toward financial self-sufficiency through a combination of strategic and business planning and adoption of cost-recovery interest rates. The large microfinance 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 their social objectives in that increases in cost efficiency allow for commensurate reductions in the interest rate. ASA's ability to reduce costs and keep interest rates low is proof that very high efficiencies can be attained, even when serving poor clients. While few MFIs would be willing and able to realize such an extreme level of efficiency, all MFIs have a responsibility to reduce costs in order to provide their clients with the most affordable, demand-driven microfinance services possible.

- **Improve Institutional Capacity**

Institutional capacity in the vast majority of microfinance NGOs is extremely weak. Improvements in several areas should take top priority. Missions should be clarified to incorporate a sustainable view of microfinance provision. Efficiency in operations should be made an institutional priority to enable accountability to owners/funders as well as clients. 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. Increased attention should be given to building human resource capacity in financial analysis and banking, in particular to improve strategic and business planning. Ensuring that board members understand business and finance is crucial. Charging nonsubsidized interest rates linked to competitive market rates is also essential. Interest rates should be high enough to sustain the MFI's operations. Further, because the administration of many small loans, including processing and tracking services, is a costly operation, MFIs need to charge interest rates higher than those of commercial banks, yet lower than those of money lenders. Preparing standard income statements and balance sheets and having them audited will increase the transparency of MFIs' operations and enable performance improvements. These improvements will help MFIs to access commercial sources of capital.

Roles of Microfinance Industry-support Organizations

PKSF and CDF are major microfinance-support organizations that can play a role in moving microfinance commercialization forward, as discussed below.

- **PKSF**

As the microfinance industry matures, PKSF should focus on improving its core business of onlending funds to its partner organizations and its monitoring efforts. To support microfinance commercialization, PKSF, with support from the Government, will need to eliminate its maximum onlending interest rate criterion. 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 for greater variation in the way MFIs carry out 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.

- **CDF**

In cooperation with PKSF and other microfinance stakeholders, CDF 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, and standard presentation of financial details with an eye toward eventual ratings) are commendable and should also be continued. Related to this, CDF should continue to play an important role in helping microfinance NGOs to understand the necessity and implications of regulation. CDF's capacity-building programs are consistent with commercialization of the industry and should be expanded because they stress operational and financial self-sustainability, product pricing/costing, cost efficiency, productivity, and linking its partners with commercial sources of funds. CDF should 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 support a credit information bureau for 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 such a pilot system, engaging several MFIs from one or two areas. Findings from this pilot could help industry leaders to understand better the incentives and disincentives to building a decentralized system for sharing information on borrowers in general.[5]