COMMERCIALIZATION OF MICROFINANCE

BANGLADESH

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FOREWORD

The microfinance industry landscape has begun to change significantly in recent years. Yet, the outreach of the industry remains well below its potential in the Asia and Pacific region. If the full potential of microfinance for poverty reduction is to be realized, it is essential to expand its outreach substantially. It is in this context that commercialization of the industry has become a subject of in-depth study. Although many industry stakeholders appear to believe firmly that commercialization is necessary, there is inadequate understanding of the complex process of moving toward a sustainable microfinance industry with a massive outreach.

The Microfinance Development Strategy of the Asian Development Bank (ADB), approved in June 2000, provides a framework for supporting the development of sustainable microfinance systems that provide diverse high-quality services to traditionally underserved low-income or poor households and their microenterprises. One element of this strategy is support for development of viable microfinance institutions that can set in motion a process of commercialization of microfinance services. As a first step, ADB approved in November 2000 a regional technical assistance project on Commercialization of Microfinance, to improve understanding of the process of microfinance commercialization as well as its challenges, implications, and prospects. The project, which was financed from the Japan Special Fund, has three components: country studies on microfinance commercialization; in-country workshops to discuss the country studies and specific institutional experiences; and a regional workshop to discuss each country study and institutional experiences in a comparative context.

The countries chosen for study–Bangladesh, Indonesia, Philippines, and Sri Lanka–represent different stages of development and commercialization of the microfinance industry.

The Bangladesh country study was carried out by Stephanie Charitonenko of Chemonics International Inc. and S. M. Rahman, an independent consultant. Their report, presented here, was first presented at the Country Workshop on Commercialization of Microfinance, held at the Bangladesh Rural Advancement Committee (BRAC) Centre for Development Management, Rajendrapur, Gazipur, Bangladesh, 2–4 April 2002. Workshop participants provided valuable input to refine the report and improve its relevance.

This publication is one of a series of papers resulting from the project. The series comprises four country reports (on Bangladesh, Indonesia, Philippines, and Sri Lanka, respectively) and a regional report covering these countries.

It is hoped that this publication series will contribute to a better understanding of the issues involved in commercialization of microfinance and lead to better approaches toward a sustainable microfinance industry that will provide a wide range of services to poor and low-income households not only in the Asia and Pacific region but also in other regions.

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ABBREVIATIONS

ADB	Asian Development Bank
ASA	Association for Social Advancement
BRAC	Bangladesh Rural Advancement Committee
BRDB	Bangladesh Rural Development Board
BURO	Bangladesh Unemployed Rehabilitation Organization
CDF	Credit and Development Forum
CGAP	Consultative Group to Assist the Poorest
CIB	credit information bureau
FSS	financial self-sufficiency
FY	fiscal year
GDP	gross domestic product
GNP	gross national product
MFI	microfinance institution
NGO	nongovernment organization
OSS	operational self-sufficiency
PKSF	*Palli Karma-Sahayak* Foundation
RASUS	*Rupgonj Artha Samajik Unnayan Sangstha*
RLF	revolving loan fund
Tk	taka
TMSS	*Thengamara Mohila Sabuj Sangha*

CURRENCY EQUIVALENT

Currency Unit	–	taka (Tk)
Tk1.00	=	$0.0175
$1.00	=	Tk57.00

The value of the taka is fixed in relation to a basket of reference currencies with the US dollar as the intervention currency. For the purposes of calculations in this report, an exchange rate of $1.00 = Tk57.00 is used based on the mid-rate of buying and selling exchange rates on 31 December 2001, unless otherwise noted.

NOTES

(i) The fiscal year (FY) of the Government ends on 30 June. In this report, FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2000 ends on 30 June 2000. The FY of Sonali Bank ends on 31 December.

(ii) In this report, "$" refers to US dollars.

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]

1 Introduction

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

METHODOLOGY AND ORGANIZATION OF THE STUDY

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

Responses to questionnaires eliciting stakeholders' views on microfinance commercialization and their latest institutional and financial data have been incorporated where possible. In addition to collecting such data and holding a wide variety of stakeholder meetings in Dhaka, the study team gathered data during field visits to several other districts.[7] It is important to note that all institutional and financial data are based on self-reporting by the MFIs surveyed by the authors, unless otherwise noted. Readers should be mindful that these self-reported data provided by MFIs and included in this report are often based on estimates only. This is because of the widespread practice of MFIs in Bangladesh of not separating microfinance from other social programs (an issue in most medium and small microfinance NGOs) or from traditional financial intermediation (as in public sector banks).

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

UNDERSTANDING "COMMERCIALIZATION" OF MICROFINANCE

In Bangladesh, the term *commercialization* carries with it a negative connotation in that many people equate it with exploiting the poor. This may be because NGOs are the predominant institutional form of microfinance provider and that profit maximization (for the benefit of shareholders under most "commercial" enterprises) is seen as incompatible with the social missions of NGOs. Although NGOs are legally allowed to earn revenues in excess of expenses, any such "profits" are to be reinvested as operating capital (usually referred to as the NGO's "own funds" in Bangladesh).

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

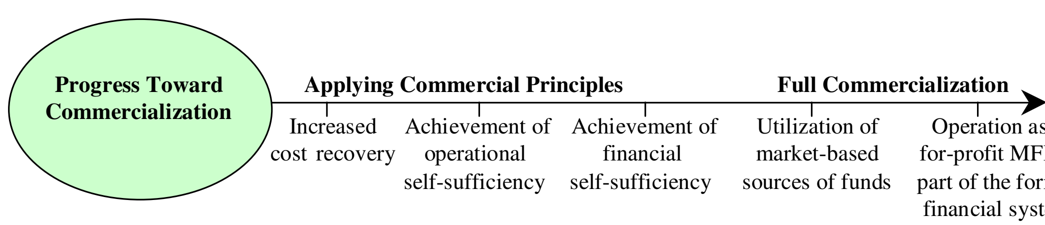
MFI Commercialization

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

- Adoption of a for-profit orientation in administration and operation, such as developing diversified, demand-driven financial products and applying cost-recovery interest rates.
- Progression toward operational and financial self-sufficiency by increasing cost recovery and cost efficiency, as well as expanding outreach.
- Use of market-based sources of funds, for example, loans from commercial banks, mobilization of voluntary savings, or other nonsubsidized sources.
- Operation as a for-profit, formal[10] financial institution that is subject to prudential regulation and supervision and able to attract equity investment.

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

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



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

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

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

Commercialization of the Industry

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

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

1. Policy Environment

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

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

2. Legal and Regulatory Framework

• The legal environment for secured transactions–the creation (legal definition), perfection (registration), and repossession (enforcement) of claims–as well as that for microenterprise formation and growth.[12]

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

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

3. Money Markets and Capital Markets

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

SOCIAL AND MACROECONOMIC ENVIRONMENT

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

Socioeconomic Factors

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

Bangladesh's economic growth performance has been relatively robust during the last several years, with average annual GDP per capita growth during 1996–2000 of 3.5% compared to 2.3% during the preceding five-year (1991–1995) period.[15] During FY2001, Bangladesh posted strong macroeconomic performance with increased economic growth, low inflation, and improvement in the current account balance of payments (Table 1.2). Growth of the gross domestic product (GDP) rose from 4.9% in FY1999 to 5.9% in FY2000, and to 6.0% in FY2001,[16] largely because of successive record crop harvests and recent rebounds in the industrial sector. The reported inflation rate declined to 3.4% in FY2000 and remains low, only 1.7% in October 2001 on a year-on-year basis.[17] Export growth recovered in FY2000, increasing from previous years to 8.2%, and the current account deficit declined to 1.0% of GDP. This has enabled microfinance activities in an atmosphere of economic stability, facilitating financial planning by MFIs and protecting the value of the savings of the millions of poor clients that MFIs serve.[18]

The structure of Bangladesh's economy shifted substantially during 1980–2001. The contribution of agriculture to GDP declined from as much as 50% to just 30%, while the share of services increased from 34% to 53%, and that of industry remained virtually unchanged at just under 20%. The shift from agriculture to services may be partly attributed to a high rate of rural-urban migration and the relatively easy availability of microfinance to landless poor families for undertaking small trading, repair, and other service sector activities in urban areas.[19] Despite rural-urban migration, high population growth rates have increased population density in rural areas as well and heightened the reliance of the rural poor on the service sector of the economy. This, in turn, has also contributed to the high demand for microfinance.

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

Table 1.1: Bangladesh Social Indicators

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

[a] Refers to expenditure ratio.
[b] Proportion of households with either tap or tubewell source.
[c] Refers to proportion of households.

Source: ADB 2001b, p.11.

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

Prudent macroeconomic management is essential for implementing the country strategy and programs. Slippage in macroeconomic performance could seriously strain economic growth and poverty reduction efforts. For example, high inflation would be detrimental to MFIs, most of which are reluctant to increase interest rates to ensure financial self-sufficiency. The Government needs to address the macroeconomic strains to sustain high rates of pro-poor growth, allocate additional funds for social sector investment, and improve the delivery and quality of social sector services. In particular, the Government needs to improve fiscal management by further strengthening revenue mobilization and containing unproductive expenditure, improving the utilization of external assistance, increasing foreign exchange reserves, and diversifying the export base, especially in light of the planned phase-out of the Multi-Fibre Arrangement (MFA) by the end of 2004.[22]

Table 1.2: Bangladesh Economic Indicators

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

[a] Excludes food subsidies.
[b] Defined as the difference between the expenditure GDP and revenue GDP ratios, adjusted to reflect the difference between fiscal accounts and estimates of total government financing.
[c] Exports imply merchandise exports only.
[d] Imports imply merchandise imports only.
[e] Represents the ratio of debt to total foreign exchange from exports of goods and nonfactor services, plus workers' remittances.
[f] Based on national consumer price index (using 1985/86 base).

Source: ADB 2001b, p.10.

Agricultural Development

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

The Formal Financial Sector

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

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

At the same time, as is well known, a strong semiformal NGO microfinance system has emerged in the country. The Grameen Bank and hundreds of microfinance NGOs that predominantly follow the Grameen model operate in rural areas, small towns, peri-urban areas, and increasingly, urban neighborhoods as well. Neither the Grameen Bank nor microfinance NGOs are subject to the Banking Companies Ordinance or any other law related to financial institutions.[28] These MFIs mainly undertake nontraditional lending to poor clients for service sector trading, vending, and small production activities. Lending by not-for-profit microfinance NGOs takes place on a scale unparalleled anywhere in the world and more than matches the combined efforts of the formal financial sector, including the banks and the cooperatives.[29]

2 Progress Toward Microfinance Commercialization

Social visionaries have led the rapid expansion of microcredit in Bangladesh, which began and continues to be strongly oriented toward serving the unmet or underserved demand of the poor for financial services. Dominated by the Grameen Bank and NGOs, microfinance has historically operated largely on a noncommercial basis, although two of the largest microfinance NGOs are commercially viable and currently reach about half the market. In addition, there are numerous poorly performing, subsidy-dependent microfinance NGOs and government microcredit programs. 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 as providers of microcredit.

Most of the MFIs are not financially self-sufficient and there will likely be a reduction, especially of small and medium-sized microfinance NGOs as competition increases and funding agencies tire of funding unsustainable institutions. Recently, many microfinance NGOs 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. Also, the legal and regulatory framework is not supportive of movement toward greater levels of commercialization by microfinance NGOs. 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.

This chapter discusses the historical development of the microfinance industry and evaluates its performance in terms of outreach and progress toward commercialization.

DEVELOPMENT OF THE INDUSTRY

The earliest providers of microfinance were cooperative societies that spread throughout the country before it gained independence in 1971 and that rapidly expanded into a nationwide network during the late 1970s and early 1980s.[30] The Bangladesh Rural Development Board (BRDB) promoted this growth by organizing the cooperative societies into a two-tier structure, with primary cooperatives at the local level and others at the subdistrict (*thana*) level. The BRDB helped to spread the cooperatives to most of the 460 *thanas* throughout Bangladesh but did not achieve the goal of making them self-sufficient. Although BRDB tried several ways to improve the financial performance of the cooperatives, the effort ultimately failed because of (i) inconsistent government policies that led to reduced support to the cooperatives; (ii) loss of traditional business, such as input supply and marketing, to the private sector because of the liberalization of agricultural markets; and (iii) tarnished reputation of cooperatives because of weak leadership, lack of appropriate staff incentives, staff disincentives, lack of internal controls, and massive deposit losses and loan defaults.[31]

Continued Influence of the Grameen Model

The institution that has shaped much of modern-day microfinance is the Grameen Bank, which Professor Muhammad Yunus began as an experimental project in 1976 to increase access of mainly poor rural women to microcredit. What has become well known as the Grameen model demonstrated that lending to the poor could be an economically viable activity. Its success led to the early establishment of other, similar microfinance programs by several other large multisectoral NGOs, such as the Bangladesh Rural Advancement Committee (BRAC) in 1972, Proshika in 1976, and the Association for Social Advancement (ASA) in 1978. Over the next 20 years, hundreds of specialized microfinance NGOs were created based on the Grameen model, either to provide microfinance services exclusively or to add microfinance to their menu of social services. Strong competition among microfinance NGOs has helped fuel growth in client outreach, especially in recent years (Table 2.1).

Two important lessons learned from the success of the Grameen model are that large numbers of poor can and will pay high interest rates (compared to the lending interest rates charged by private commercial banks) for access to timely and reliable sources of microcredit and that alternatives to traditional collateral, such as group liability and mandatory savings, can ensure high repayment rates. Participants at a March 2002 Women's World Banking consensus building seminar in Dhaka judged that successful development of the microfinance industry has also been because of the ability of MFIs to operate outside the strictures and traditional notions of the Government and international aid agencies. Over the last 20 years, Bangladesh government policymakers and regulators have allowed MFIs to grow, flourish, and innovate without government restrictions. The international development community has provided substantial support to microfinance, which in the early years was emphasized as a new approach to poverty alleviation.[32]

The success of the Grameen model and these external factors have led to outstanding achievements in outreach and consistently high repayment rates among the main providers. However, the approach has also led to a dearth of commercially viable MFIs and a lack of transparency in the microfinance industry because a high loan recovery rate has generally been treated as an adequate indicator of operational efficiency.

Evidence of Market Saturation

The best available data on the current supply of microfinance are compiled by the Credit and Development Forum (CDF), a Dhaka-based microfinance NGO network. It produces a "CDF

Table 2.1: Growth of Microfinance NGOs, 1996–2001

Period	No. NGOs Reporting	No. Active Members (million)	No. Active Borrowers (million)	Outstanding Loan Portfolio (Tk million)	Cumulative Loan Recovery Rate (%)	Net Savings (Tk million)
end-1996	351	6.0	3.12	6,952	-	2,391
end-1997	380	6.7	4.26	9,564	-	3,382
end-1998	495	8.0	5.42	13,737	93.2	5,216
end-1999	533	9.4	6.89	18,692	95.0	6,922
end-2000	585	11.0	7.99	21,903	95.6	8,866
mid-2001	601	11.6	8.32	23,983	95.4	9,591

Note: Net savings is total savings deposited less withdrawals.
Source: Credit and Development Forum 2001b.

Statistics" booklet that presents self-reported and partially verified data from 585 microfinance NGOs.[33] The CDF Statistics include summary data for the three main types of microfinance providers–the well-known, large microfinance NGOs as well as data highlights for the Grameen Bank, hundreds of lesser-known small NGOs, and all government microfinance programs. As such, the CDF Statistics provide information on virtually all microfinance activity in the country.

Total membership of microfinance NGOs at the end of 2000 was 11 million, of whom 90% were women. The Grameen Bank has 2.4 million members. Also, there are 2.1 million members of five ongoing BRDB projects, many members of the Ministry of Youth and Sport's TharDEP project, and other government microfinance programs.[34] Total microcredit coverage appears to be about 15.5 million families (Table 2.2). However, as even casual observation in some of the more accessible and populated areas of Bangladesh shows, there is considerable double counting of membership (of the poor) in multiple organizations. Based on this and using the generally held assumption that only 70% of reported membership figures reflect active membership, it is unlikely that actual microcredit coverage is in excess of 10.8 million families.

Related to the issue of client double counting is the problem of client overlap (client borrowing from more than one creditor at the same time), particularly among the large NGOs and the Grameen Bank. Although the exact extent cannot be ascertained, overlap is seen by several leading practitioners to be a significant and a potentially dangerous trend for the microfinance industry. The general consensus from a March 2002 gathering of microfinance industry leaders in Dhaka sponsored by Women's World Banking was that the national average for overlapping was

Table 2.2: Microfinance Supply as of 31 December 2000

Large NGOs	No. Members ('000)	No. Active Borrowers ('000)	Outstanding Loans (Tk million)	Average Outstanding Loan per Member (Tk)	Net Savings (Tk million)
BRAC	3,410	2,993	7,706	2,575	3,538
ASA	1,205	1,129	3,986	3,531	1,607
Proshika	2,151	1,123	3,811	3,394	997
Subtotal of Large NGOs	**6,766**	**5,245**	**15,503**	**2,956**	**6,142**
Medium-sized NGOs[a]	2,025	1,465	3,198	2,183	1,161
Small NGOs	2,231	1,279	3,202	2,504	1,563
Subtotal of All NGOs	**11,022**	**7,989**	**21,903**	**2,742**	**8,866**
Grameen Bank	2,379	2,057	12,606	6,128	4,339
BRDB	1,243		1,659		
Ministry of Youth and Sports	318		310		
PDBF	330		816		
WEDP	177		130		
Total	**15,469**	**10,046**	**37,425**	**3,725**	**13,205**

BRDB = Bangladesh Rural Development Board; PDBF = *Palli Daridro Bimochon* Foundation; WEDP = Women Entrepreneurship Development Programme.

[a] Medium microfinance NGOs include the remaining "top 20" microfinance NGOs in terms of membership and more than Tk85 million ($1.5 million) in outstanding loans as of 31 December 2000.

Source: Credit and Development Forum 2001b.

about 15%, with much higher overlap in some rural areas (such as Tangail), ranging from 25% to 40%.[35]

The number of active borrowers gives a better estimate of market penetration. Adding 70% of the government microcredit program membership to the number of active borrowers of the microfinance NGOs and the Grameen Bank yields an approximate total of 11.5 million active borrowers. Reducing this figure by the estimated 15% incidence of overlapping yields 9.8 million active borrowers.

The Government estimates that approximately 45% of the population, or some 12.2 million families, are poor[36] (based on a total population of 130.2 million, comprising about 27.1 million families with an average 4.8 persons per family).[37] If this estimate is correct, the microcredit market is largely saturated, with MFIs reaching slightly more than 70% of poor households (incorporating also the usual assumption that 10% of microcredit is borrowed by nonpoor clients).[38]

Saturation of the microcredit market "has led to many cases of over-indebtedness and appears to be undermining the primary incentive to repay … Increasingly, clients appear willing to default with one MFI safe in the knowledge that they can access financial services from one of its competitors if follow-on loans are not made available."[39] Indeed, for the first time in at least four years, repayment rates for microfinance NGOs are potentially declining (Table 2.1), and there have been recent repayment problems in several of the major MFIs. Switching costs incurred by clients when changing providers appear set to decline as competition increases and MFIs vie for clients by reducing the transaction costs of participation. While it is impossible to know how accurate the estimates of double counting and overlapping are, it is clear that these two factors are causing overstatement of total microcredit outreach figures.

It is important to note, however, that the high level of market saturation relates mainly to households with access to traditional Grameen-style microcredit and reflects the limited scope and provision of microfinance services, including microcredit (Box 2.1). The degree of market saturation noted in no way indicates fulfillment of the potential demand for microcredit on other terms (for example, individual lending, lending to men, or lending that is not tied to mandatory savings) or for other microfinance products, such as leasing, savings, and insurance. While the relative emphasis on credit and nonlending activities offered by each MFI varies, the key operational and financial features of the microcredit programs are generally quite similar.[40]

The present coverage of MFIs, about 70% of poor households, suggests little room for further growth in market depth through Grameen-style microcredit. However, there is potential to fuel further expansion of the microfinance industry by increasing the breadth of outreach, and by expanding areas of service and types of products and services offered. These approaches may be especially important for MFIs trying to make their operations commercially viable by exploring profitable market niches.

Opportunities for Expansion

While sustainability is an important goal, it depends on low overhead, adequate return on the loan portfolio, and high loan repayment rates, among other factors. This means that MFIs with a goal of sustainability would serve areas that are relatively easy and cheap to reach and would lend to sufficient numbers of clients having good repayment prospects. This would be the case at least until an MFI achieves full financial self-sufficiency, after which it may choose to cross-subsidize services to poorer people living in isolated areas and more vulnerable groups that are seen as more expensive to serve and pose greater credit risks. The costs of reaching more remote or poorer clients may exceed possible revenues. As such, complementary grant-based approaches or (cross-) subsidized microfinance services may be needed to reach much deeper, in terms of expanding the depth of outreach.

There may be viable options for increasing the breadth of outreach. There are still pockets of easily accessible, densely populated areas in

Box 2.1:

Elements of Traditional Grameen-style Microcredit

Typical microcredit lending in Bangladesh follows the traditional Grameen model: it is targeted at the landless/assetless; borrowers are part of a 15–20 person group, which meets regularly; women are given preference and make up 90% of the total borrowers; loans are collateral free and usually have a maturity of 50 weeks with weekly repayments; mandatory saving is an integral part of the program; and financial transactions are recorded in individual passbooks in the presence of the entire group to enhance transparency and self-monitoring. Microfinance institutions (MFIs) provide initially a small loan (about $25–75) and then follow-on loans of increasing amounts as long as repayment of the earlier loan is satisfactory. This stepped lending feature is essential to the excellent repayment performance (most MFIs report more than 95% cumulative repayment rates). The basic premise is that the poor need continuous access to credit for 8–10 years to accumulate enough savings/assets to escape poverty. MFIs usually have upper loan limits, but a few have a policy of "graduating" borrowers from their microfinance program to individual microenterprise loans, because clients who have been in the system for several years represent better credit risks despite the larger loan sizes. Borrowers are free to choose the activity financed by the loan. Activities are mostly rural and nonfarm in nature with short duration and daily sales, such as poultry farming, petty trade and shop keeping, cattle rearing, or handicrafts.

Source: World Bank 1999, p. 1.

rural Bangladesh where demand for more microfinance products may exist. These areas include the more remote tribal belts of Sylhet and Rajshahi, and the hill tract areas around Chittagong, where coverage is still relatively low in relation to estimates of the potential effective demand for microcredit.[41] There also may be market niches in urban areas, such as the smaller urban centers like Rajshahi, Jessore, and Comilla. Market penetration is lower in cities and towns; it is estimated that less than 25% of poor households in urban areas access credit services from MFIs.[42]

New Product Potential

There has been positive response to several recent innovations in tailoring various types of microfinance products and services to client needs, pointing to substantial potential demand that will enable further growth of the microfinance industry. Competition has arguably prompted the relatively recent tailoring of credit, leasing, savings, and insurance products to demand, as described below. Such developments also have the potential to expand access and relevance of microfinance to far greater numbers of poor and near-poor clients.

Breaking Away from the Traditional Grameen Model

Microcredit innovations through promotion of individual lending, expanding lending to men, and increasing access to those clients caught in the "missing middle"[43] hold promise to be the largest areas of potential demand. Over time, credit products have diversified. Today, there exist more than 15 credit products including daily credit, leasing loans, and housing loans. Normally, the loan ranges from Tk1,000 to Tk15,000 for one year. The average loan size is Tk3,500 ($70). Organizations providing loans higher than Tk3,000 are very few. Only a handful of MFIs can adequately support the real needs of their clients. The clients opine that the credit given falls far short of actual needs. This means that the market can absorb more .[44]

Introducing Leasing Services

Leasing was first introduced by Grameen Bank in 1992 on an experimental basis by leasing power looms to weavers in the Ariahazar area of Dhaka District. Now, most of the activities funded by Grameen's leasing programs are related to the small manufacturing and service industries. One of Grameen's most successful leasing programs has been the Village Phone (Box 2.2). Most of Grameen's leasing programs target experienced borrowers, who can handle loan sizes larger than Grameen's traditional microcredit products, and their family members. A member who possesses some skill in a certain technology for production of goods and services can buy the required equipment or any other items under this program. The rate of interest or leasing fee is 20% (on a declining basis), the same as in Grameen's basic loan product. There is no upper limit on size. Grameen has leased items as high as Tk1.2 million, such as a transport vehicle. The lease period is a maximum of three years. By December 2000, Grameen had provided 21,973 leasing loans totaling Tk33.54 million. The activities included services (67%), processing and manufacturing (21%), livestock and fisheries (12%), and trading (just under 1%).

Leasing, however, is yet to become popular in the sector. The Shakti Foundation for Disadvantaged Women (SHAKTI) is the only microfinance NGO that has developed substantial leasing operations. SHAKTI introduced equipment leasing in December 1999. Members in their third general loan cycle can access this service. A maximum of Tk30,000 is provided with 15% interest (flat) per year. The lease period is a minimum of 100 weeks.

Leasing (including both financial and operating leases) appears to have good market potential as evidenced by the Grameen Bank experience. The more established large and medium-sized microfinance NGOs may consider offering this product as their clients gain more experience handling loans and their businesses require larger amounts of credit.

Box 2.2:

Grameen Bank's Village Phone Leasing Product

Grameen Bank began its cellular phone leasing program in 1997 in response to high demand stemming from low telephone density in Bangladesh. Bank members leasing the phone, popularly known as "telephone ladies," sell services to earn additional income, which Grameen estimates is almost four times higher than the national average per capita income. In collaboration with Grameen Telecom, the Bank had disbursed 3,085 cellular leasing loans by the end of 2000, amounting to Tk55.53 million, with an average loan size of Tk18,000. During 2000 alone, 823 leasing loans were made, totaling Tk16.6 million.

Source: Grameen Bank 2000, p. 22.

Mobilizing Voluntary Savings

The microfinance market is largely oriented toward microcredit. Practically all clients have taken loans; savings are often on a forced rather than a voluntary basis, following the Grameen model. Nevertheless, savings play a central role in the economic lives of all households and microenterprises. Whether families use traditional assets (such as livestock or gold) or bank accounts, the purpose is the same: to build a material cushion of security. These savings are perhaps the most important factor in creating the domestic investment needed for sustainable economic growth. As indicated in Table 2.3, the savings market is virtually captured by the top 20 microfinance NGOs. Given the large number of microfinance NGOs in the country, growth in savings mobilization points to the potential for mobilizing massive amounts, should the legal framework allow this in the future.

Savings have shown spectacular growth both in absolute terms and share in the total revolving loan fund (RLF), which also rose over the last few years (Table 2.3). Yet, the scope of savings mobilization is very limited. A handful of organizations have introduced flexible savings among their members. ASA and the Bangladesh Unemployed Rehabilitation Organization (BURO) Tangail introduced flexible savings, term deposits, and time deposits among their "associate members" (nonmembers) with good

Table 2.3: Microfinance NGO Savings Mobilization

Period	Total Net Savings (Tk million)	Net Savings of Top 20 NGOs (Tk million)	Share of the Top 20 NGOs of Total Net Savings (%)	Total Revolving Loan Fund (RLF) (Tk million)	Share of Net Savings in the Total RLF (%)
end-1998	5,216	4,578	88	18,164	29
end-1999	6,922	5,941	86	24,096	29
end-2000	8,866	7,505	85	29,873	30

Source: Credit and Development Forum 2001b, p.5–12.

response, but these savings services to associate members were later discontinued following a notice by the Bangladesh Bank in the national daily newspapers in September 2000, prohibiting such services (Box 2.3). The notice reprimanded all organizations (not only NGOs) taking deposits without a license from the Bangladesh Bank. BURO Tangail has continued offering flexible savings services, but only within its membership.

Other regulatory issues related to savings mobilization by microfinance NGOs are discussed in Chapter 3.

Currently, the savings products available in the microfinance NGO sector (for members only) include mandatory savings, special savings, forced savings/group savings, contractual savings, time deposits, and daily savings. Very few organizations in urban areas are providing daily savings services. However, an experimental project operated by SafeSave since 1996 in the slums of Dhaka, demonstrates that strong demand exists for voluntary open-access savings among the very poor, and the poor are motivated and capable of saving when offered savings opportunities that feature safety and flexibility.[45]

The Grameen Bank has many savings products that include personal savings, special savings, Grameen Pension Scheme, time deposits, a savings scheme in which the amount deposited doubles in seven years, and fixed deposits with monthly income. As a bank, it is authorized to mobilize voluntary savings from the public (members and nonmembers alike). The Grameen Bank's total net savings now constitute 56% of total microfinance NGO net savings deposits (with 23% of Grameen Bank's net savings coming from nonmembers).

Box 2.3:

Bangladesh Bank Notice That Ended Voluntary Deposit Mobilization by NGOs from "Nonmembers"

Warning Notice

It has recently been observed that several unauthorized organizations/persons in different parts of the country are collecting money from the public in the name of savings/deposits/investment by alluring them with unrealistic and abnormally high interest rates. A good number of reports have appeared in the newspapers about persons who were cheated or adversely affected in the hope of making a large profit. The members of the general public are hereby advised to remain cautioned not to deposit any money with any such unauthorized organizations/persons. Bangladesh Bank is initiating legal steps against persons/organizations accepting savings/deposits as banks or financial institutions without being licensed by Bangladesh Bank.

Source: Published in Bangla in "The Daily Star" on 3 September 2000.

Experimenting with Insurance

Microfinance NGOs in Bangladesh are gradually becoming interested in offering insurance products, particularly life insurance, to their existing credit and savings clients. Interest has been generated following the successful microinsurance experiences of a private sector provider, Delta Insurance (Box 2.4). A sample of 528 microfinance NGOs by CDF in December 1999 showed that 76 (15%) had some kind of insurance products, indicating that MFIs could possibly serve this market.

To date, provision of insurance by NGOs may still be regarded as being experimental. The premiums are calculated using rule of thumb rather than actuarial data or financial analysis. Most of those sampled by CDF charged 1–2% of the original loan amount; others charged Tk1 per week; and still others charged on a monthly or yearly basis.

In introducing this practice, microfinance NGOs are presumably following both a social agenda and a commercial one. The social agenda shows increased recognition of poor households' needs for protection against risk. Insurance reduces the vulnerability of households and increases their ability to take advantage of economic opportunities. Also, insurance reduces the impact of households' losses that could exacerbate their poverty situation. The commercial agenda assumes that insurance enhances the stability and profitability of poor households. It reduces the impact of client risk on loan and savings portfolios, generates additional revenue, and enhances services. Insurance supports risk management, reducing clients' vulnerability to economic stresses. Additionally, insurance is helping to build up a source of funds for the microfinance NGOs–a zero cost funding source because pay-outs are still very rare. Overall, this concept is giving the providers of this service the opportunity to cross-sell their clients other services.

The Grameen Bank also has a quasi-insurance product for its members called a loan insurance savings account. On the last day of each year, the borrower is required to deposit a small amount of money, 2.5% of the outstanding loan, into this account. In event of the borrower's death, the outstanding loan is waived and the premium paid is returned along with savings.

Box 2.4:

Delta Insurance's Microinsurance Product

Gono Bima (Popular Insurance) is a subsidiary of Delta Insurance, a private insurance company in Bangladesh. It markets a life insurance product that has been designed to reach many of the poor and has clearly benefited from the experience of MFIs like the Grameen Bank. The product itself is simple. It is a 10-year contractual savings account with fixed monthly premium payments leading to a one-time lump sum payment at maturity, with accumulated interest. The insurance element is provided by the guarantee that a full pay-out will be made if the insured person dies during the term.

The delivery mechanism is equally simple. There are no medical examinations and only minimal application procedures. *Gono Bima* rents simple office space in rural and urban centers, staffed by field workers who collect premium payments from groups of customers in villages and slums. The smallest monthly premium accepted is about $2.00. The office then relends the premium income to its customers in microloans with terms similar to those of the Grameen Bank.

Started in 1994, the *Gono Bima* service had reached many villages by 1997, when its premium income topped $4 million, and represented more than one fifth of Delta's total premium income. At the end of 2001, there were more than half a million microinsurance clients and more than 100,000 microcredit clients in the program, more than 50% of whom were women. However, poor repayment rates experienced with their microlending program raise questions about its viability.

Sources: Women's World Banking 2001; Matin, Hulme, and Rutherford 1999, p. 20.

COMMERCIALIZATION OF MICROFINANCE PROVIDERS

Dominance of Microfinance NGOs

The microfinance market is dominated by three large NGOs–BRAC, ASA, and Proshika. They account for 71% of the total amount of outstanding loans made by all microfinance NGOs and 41% of the entire microfinance industry (Table 2.2). Also, although more than 585 microfinance NGOs report to CDF (as at the end of 2000), the top 20 institutions account for 87% of the total amount of outstanding loans made by all such NGOs and 51% of the total amount of outstanding loans in the microfinance market.

The Grameen Bank and government programs are the other two major suppliers of microfinance. The Grameen Bank alone provides about one third of the total amount of outstanding microloans. Established as a bank by special charter, Grameen enjoys the ability to mobilize deposits and accounts for around one third of total savings mobilized by microfinance providers. In addition, 18 separate microcredit programs are carried out by as many as 13 government ministries and divisions. Membership in these government microfinance programs is estimated at about 15% of the total.

It is difficult to estimate the extent of private sector commercial bank involvement in microfinance but it is widely perceived to be quite low. Although a few banks may be anxious to reclassify much of their small loan portfolios as microfinance for public relations purposes, most would not qualify as such in the definition used in this report. Some short-term crop financing in amounts below Tk30,000 ($526) might qualify, but there are no reliable data on what proportion of such credit is accessed by the poor. For the most part, the banks shy away both from lending directly to the poor and from making wholesale loans to MFIs. The profit potential of microfinance is as yet unclear and the predominance of noncommercial MFIs undermines the incentives for private capital to enter the market. In addition, little competitive pressure exists in the formal banking sector for banks to begin microfinance operations. One exception is a microcredit program being run by the Islami Bank Bangladesh, Limited (Box 2.5).

Few Commercially Viable MFIs

Despite the outstanding achievements in outreach, few MFIs have achieved full sustainability, often equated with financial self-sufficiency. However, the two MFIs known to be financially self-sufficient have large outreach, totaling 4.6 million members and accounting for about one third of the total amount of outstanding microcredit. Based on year-end 2000 data compiled by the MicroBanking

Box 2.5:

Microcredit Program of Islami Bank Bangladesh, Limited

Islami Bank Bangladesh, Limited (IBBL) has a microcredit wing undertaking a rural development program for poverty alleviation. IBBL uses the basic Grameen model but, as its name implies, uses Islamic banking concepts that require it to invest through methods such as leasing and hire purchase rather than cash lending. There are mandatory savings of Tk5 per member per week. Loan repayments are in weekly installments, in terms of cost plus mark-up (12% on a declining basis, compared to the 14–16% declining rate of interest it charges on its more traditional loans), and the loan period is from one to three years. IBBL's microcredit lending program has grown rapidly in the last three years reaching 76,266 members (94% of whom are women) with outstanding loans of Tk332.0 million ($5.8 million) at the end of June 2001. The reported (cumulative) repayment rate on its microcredit program loans was 99%. However, it is unclear whether or not IBBL's microcredit activities are sustainable.

Source: Credit and Development Forum 2001a.

Bulletin and published by the MicroFinance Network with its members' permission, both ASA and BRAC have achieved full financial self-sufficiency (Table 2.4). The operational self-sufficiency (OSS)[46] and financial self-sufficiency (FSS)[47] ratios for ASA were steady at 134% and 120%, respectively (and expected to continue to rise, to 146% and 129%, respectively, by the end of 2001). Similarly, BRAC achieved an OSS of 111% and FSS of 104% (with both ratios expected to register 1–2% increases in 2001). Such achievements in sustainability are in large part the result of extreme cost efficiency and relative inflexibility with which both institutions operate. MicroBanking Bulletin data on BURO Tangail, a medium-sized NGO, indicate that for 2000 and several previous years, this institution has also been hovering around full OSS and about 80% FSS.

Grameen Bank performance details are indicative of most of the microfinance industry. At the end of 2000, the Grameen Bank had total outstanding loans of Tk12.6 billion (with 2.4 million members) and reported a profit of Tk11.1 million for the year, but only after taking into account grants worth Tk19.2 million. This suggests a net operating loss in 2000 of Tk8.2 million.[48]

Despite Grameen Bank's claims to the contrary, it is clear that if international accounting standards were applied, including adjusting for loan loss provisions and accounting for soft loans, the institution would be operating at a loss. As with most MFIs in the country, the Grameen Bank is dependent on foreign grants and soft loans and receives domestic subsidies (see also Table 2.5). In recent years, government-guaranteed bonds have become a relatively large share of its overall resources. These grants and soft loans include borrowings of Tk942.5 million from the International Fund for Agricultural Development at 2–3% interest per annum, and purchase by nationalized commercial banks of Tk6.5 billion and Tk2.0 billion worth of government-guaranteed, 4–10% interest-bearing bonds in 1994 and 1999, respectively. By imputing values to all the subsidies received by Grameen, it has been estimated that it would need to raise the nominal interest rate on its general loans from 20% per annum to 33% (both on a flat basis) in order to break free from subsidies.[49]

Despite widespread subsidy dependence of the microfinance industry, good performance by a few MFIs indicates the potential for a larger number of MFIs to move toward greater sustainability. The difficulty of raising lending interest rates in areas where competition for microcredit clients exists, however, means that most MFIs will need to find ways of improving operational efficiency in order to become more financially self-sufficient.

COMMERCIALIZATION OF FUNDING SOURCES

Increasing Reliance on Savings

The latest available data indicate that the largest sources of funds for microfinance NGOs are now member savings (25%), followed by soft loans from PKSF (23%), foreign donations (18%), service charges (16%), and local banks (10%) (Table 2.5).

The importance of savings is growing rapidly. Microfinance NGOs' income from interest included in service charges is also increasing and borrowing loan funds from commercial banks for onlending is also on the rise, albeit at a slower growth rate. These trends represent a shift away from grants to use of savings and other sources of funds, pointing to gradual commercialization of microfinance funding sources (Figure 2.1).

Limited Access to Commercial Funding Sources

There are few commercial sources of funds for MFIs other than client savings. Most MFIs are still heavily dependent on donor support. Neither the Grameen Bank nor the NGOs can access lines of credit from the central bank. Commercial banks are reluctant to lend to most microfinance NGOs mainly because of the latter's lack of a clear ownership structure, the perception that loans to the poor are inherently

Table 2.4: Selected MicroBanking Bulletin 2000 Indicators

	ASA	BRAC
OUTREACH AND INSTITUTIONAL INDICATORS		
Age of Institution (years)	22	26
Number of Offices	825	1029
Number of Active Borrowers	1,128,693	2,992,674
Women Borrowers (%)	94	100
PROFITABILITY		
Adjusted Return on Assets (AROA) (%)	3.7	0.9
Adjusted Return on Equity (AROE) (%)	10.5	2.6
Operational Self-Sufficiency (OSS) (%)	134.3	111.0
Financial Self-Sufficiency (FSS) (%)	120.4	104.3
EFFICIENCY		
Total Admin. Exp./Avg. Gross Loan Portfolio (%)	9.0	16.1
Salary Exp./Avg. Gross Loan Portfolio (%)	7.5	11.6
Other Admin. Exp./Avg. Gross Loan Portfolio (%)	1.5	4.5
PRODUCTIVITY		
Average Salary (multiple of GNP/Capita)	2.7	4.0
Cost per Borrower ($)	5.8	8.0
Staff Productivity	211.1	279.4
Loan Officer Productivity	323.4	336.3
PORTFOLIO		
Portfolio at Risk > 90 days (%)	0.5	2.0
Average Loan Balance ($)	65.0	49.0
Depth (Loans as a % of GNP/Capita)	17.6	13.2

Notes:

$$\text{Average Salary} = \frac{\text{Average Personnel Expenses + In-kind Donations}}{\text{GNP per Capita}}$$

$$\text{Cost per Borrower} = \frac{\text{Administrative Expenses + In-kind Donations}}{\text{Average No. Active Borrowers}}$$

$$\text{Staff Productivity} = \frac{\text{No. Active Borrowers}}{\text{No. Staff}}$$

$$\text{Loan Officer Productivity} = \frac{\text{No. Active Borrowers}}{\text{No. Loan Officers}}$$

Source: MicroBanking Bulletin 2000 Statistics shared by ASA and BRAC.

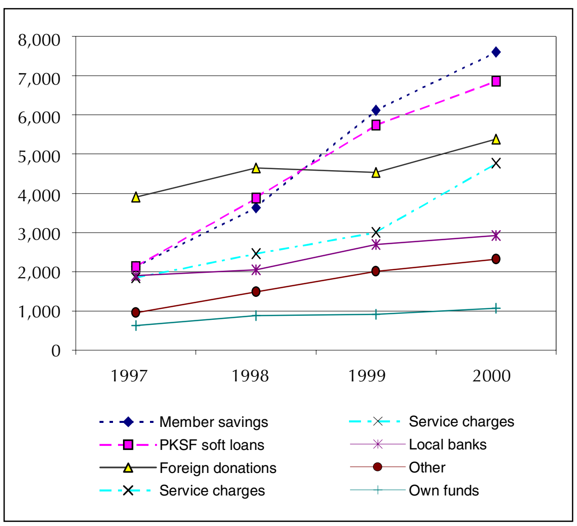
Table 2.5: Sources of Revolving Loan Funds[50] for Microfinance NGOs (Tk million)

Period	Number of NGOs	Grants	PKSF Soft Loans	Member Savings	Own Funds	Service Charges	Others[a]	Total RLF
end-1996	351	3,888	769	1,656			1,804	8,117
		(48)[b]	(10)	(20)			(22)	(100)
end-1997	380	3,907	2,128	2,126	627	1,853	2,228	12,869
		(30)	(17)	(17)	(5)	(14)	(17)	(100)
end-1998	495	4,644	3,83	3,637	888	2,48	2,654	18,164
		(26)	(21)	(20)	(5)	(13)	(15)	(100)
end-1999	533	4,534	5,738	6,114	913	3,004	3,793	24,096
		(19)	(24)	(25)	(4)	(12)	(16)	(100)
end-2000	585	5,384	6,863	7,607	1,067	4,768	4,184	29,873
		(18)	(23)	(25)	(4)	(16)	(14)	(100)

[a] Includes funds borrowed from commercial banks, ASA, BRAC, Proshika, and other sources.
[b] Numbers in parentheses are percentages representing the proportion of each type of source of revolving loan fund per year.

Source: Credit and Development Forum 2001b.

Figure 2.1. Trends in Sources of Revolving Loan Funds for Microfinance NGOs (Taka million)



Source: Credit and Development Forum 2001b, and previous years.

risky, and the lack of familiarity with NGOs' modes of operation. These factors result in banks' lack of confidence in assessing MFI creditworthiness.[51]

A few of the largest NGOs, however, have borrowed money from commercial banks at competitive interest rates and been able to run their microcredit programs at a profit. Enamul Haque, General Manager of ASA said that "Besides PKSF, we have also taken loans from other financial institutions like Agrani Bank and BASIC…We paid 9% interest to Agrani and 7% to BASIC. But this did not affect our financial health. This proves that it is sustainable to tap into the formal money market to help the poor." Agrani Bank is one of the seven national commercial banks. However, its Tk10 million loan to ASA was fully secured by ASA's headquarters building.[52] Aminul Alam, a Deputy Executive Director at BRAC, noted, "BRAC has also taken loans from banks. From Janata bank we had taken funds at 11% interest and from IFIC Bank at 9%. And we are planning to take fresh loans from AB Bank at a 9% interest rate. We have already repaid our loans to Janata." These statements indicate that perhaps with better MFI performance and greater transparency, commercial sources of funds for MFI onlending may become more available.

Support organizations such as CDF and the INCOME Project Phase III of CARE/ Bangladesh, are helping this trend through the development of formal-semiformal financial linkages. The CDF is very actively involved in the process of linking its partner microfinance NGOs with commercial bank credit. It also provides referral services by sending the names of capable NGOs to PKSF for financial assistance. The focus of CDF's capacity building is indeed commercialization; it stresses operational and financial sustainability, product pricing/costing, cost efficiency, productivity, and eventually linking its partners with commercial sources of funds. The CARE INCOME Project component on building financial linkages focuses on creating linkages between microfinance NGOs and the commercial banks so that small and medium-sized NGOs are not forever reliant on funding agencies. CARE INCOME attempts to remove the obstacles that prevent mutually beneficial business relationships between these NGOs and commercial banks. CARE has approached Sonali Bank, Janata Bank, and BASIC Bank regarding this linkage and all the banks have shown willingness to cooperate. A credit guarantee will be the core business under this component.

The Grameen Bank's access to commercial sources of funds is the result of a provision to the Grameen Bank Ordinance added by the Bangladesh Bank in 1990, allowing Grameen to issue bonds and debentures guaranteed by the Government of Bangladesh. In 1995, Grameen floated $1.25 million of bonds in 3-, 5- and 10-year tranches, which were sold to four commercial and two private banks and guaranteed by the Government.[53] As noted earlier, Grameen Bank's ability to mobilize voluntary deposits legally from nonmembers allows the institution to grow while reducing its dependence on grant and other subsidized funding sources.

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]

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" clients[71] 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 finding[74] 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 study[76] 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 Bangladesh[79] 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 Microenteprise 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		
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.

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].

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ENDNOTES

1 An MFI is defined herein as a single organization (for example, a nongovernment organization providing microfinance) or a unit whose primary business is microfinance within a diversified institution (for example, a microfinance unit within a commercial bank).

2 Carpenter 1997, p.17.

3 Similar to Christen's (2000, p.5) use of the term *mission drift* in this report refers to the shift in MFI focus from the poor or poorest to relatively higher-income clients.

4 Mosley and Hulme 1998.

5 Women's World Banking 2002, p.6.

6 The financial systems approach to microfinance considers microfinance as part of a country's general financial services market, focuses on the development of sustainable financial institutions, and recognizes that microfinance clients are willing to pay the full cost of these services, if they are designed and delivered consistent with their specific needs (Von Pischke 1988; Otero and Rhyne 1994).

7 These districts include Bogra, Brahmmanbaria, Gazipur, Manikigonj, Narayangonj, Tangail, (and Savar township within Dhaka District).

8 Similar to Christen's (2000, p.5) use of the term, *mission drift* in this study refers to the shift in MFI focus from the poor or poorest to relatively higher-income clients.

9 See for example, Poyo and Young 1999; Christen 2000.

10 "*Formal institutions* are defined as those that are subject not only to general laws and regulations, but also to banking regulation and supervision. *Semi-formal institutions* are those that are formal in the sense of being registered entities subject to all relevant general laws, including commercial laws, but informal insofar as they are, with few exceptions, not under banking regulation and supervision. *Informal providers* (generally not referred to as institutions), are those to which neither special banking law nor general commercial law applies and whose operations are such that disputes arising from contact with them, often cannot be settled by recourse to the legal system" (Ledgerwood 1999, p.12–13).

11 Internationale Projekt Consult GmbH 2002.

12 Fleisig 1996, p.45; Lyman 2000, p.39–41.

13 World Bank 2001, p.1.

14 The HDI measures a country's achievements in terms of life expectancy, educational attainment, and adjusted real income (UNDP 2001, p.3).

15 ADB 2001b, p.3.

16 FY2001 national accounts data are now under revision (ADB 2001a, p.1)

17 ADB 2001a, p.4.

18 ADB 2000b, p.18.

19 ADB 2000b, p.4.

20 ADB 2001a, p.5.

21 ADB 2001b, p.1

22 ADB 2001b, p.2. The MFA is a system of quotas that limits the importation to Bangladesh of many types of garments and textiles. These quotas are due to be removed on 1 January 2005 and this is expected to place the viability of some 1,500 factories in doubt because of their inability to compete with the quality or low cost of garment and textile exports from countries such as the Republic of China and India. Manufacturing of ready-made garments provides employment for more than 1.5 million people, many of whom are women, and generate nearly 80% of the export earnings of the country. Phase-out of the MFA implies a potentially significant economic loss of employment and income for mainly poor industry workers unless preventative measures are taken in the near future to boost the cost efficiency and quality of the Bangladeshi garment and textile industries.

23 USAID 2002.

24 World Bank 2002.

25 Bangladesh has a two-tier banking system comprising: i) Bangladesh Bank, fulfilling the functions of a central bank; and ii) 4 nationalized commercial banks (Agrani Bank, Janata Bank, Rupali Bank, and Sonali Bank), 5 public sector specialized banks, 25 private banks (domestically incorporated); 4 Islamic banks (domestically incorporated), and branches of 12 foreign banks. The nonbank financial institutions comprise 4 public development finance institutions, 8 private sector leasing companies, 2 government-controlled and 32 private insurance companies, several cooperative institutions, and 2 investment companies (ADB 1998, p.5).

26 Rahman 2000a, p.16.

27 McGuire, Conroy, and Thapa 1998.

28 Yaron, Benjamin, and Piprek 1997, p.142.

29 ADB 2000b, p.6.

30 ADB 2000b, p.6.

31 ADB 1998, p.7.

32 Women's World Banking 2002, p.4.

33 Credit and Development Forum 2001b, p.ii.

34 Only the government microcredit programs with outstanding loan information available in the CDF Statistics are included in Table 2.2.

35 Women's World Banking 2002, p.2.

36 In the context of Bangladesh, being "poor" means being unable to afford the basic dietary requirement of 2,122 calories per day. More than half of the rural poor consume less than 1,805 per day (referred to as "hard-core" poor); they belong primary to wage labor households and have little or no cultivated land (less than 0.2 hectares).

37 The government estimate is from the "Preliminary Report" of a population census of the Bangladesh Bureau of Statistics, August 2001.

38 The numerical basis of this calculation is that there are 8.82 poor households served

(90% of the 9.8 million active borrowers) or about 70% of the 12.2 million poor households.

39 Wright et al. 2001, p.34.

40 World Bank 1999, p.1.

41 ADB 2000b, p.13.

42 Women's World Banking 2002, p.1.

43 The "missing middle" refers to those clients who are too (asset) rich to qualify for most microcredit offered yet too poor to qualify for traditional commercial bank credit.

44 Rahman 2000a, p.16.

45 Meyer 2001, p.20.

46 OSS is calculated by dividing operating income by the sum of operational expenses (loan losses, and personnel and administrative expenses).

47 FSS is calculated by dividing operating income by operating expenses adjusted for inflation and subsidies.

48 Grameen Bank 2000, p.43, 53, 65.

49 Morduch 1998, as cited in ADB 2000b, p.8.

50 RLF is the common term used in Bangladesh to refer to the total amount of funds that MFIs have from which to make loans.

51 Goodwin-Groen 1998; Sinha 1999, as cited in ADB 2000b, p.11.

52 Carpenter 1997, p.17.

53 Carpenter 1997, p.22.

54 TMSS Case Study (ADB 2002, p.14.)

55 Grameen maintains, however, exceptionally liberal (nonstandard) provisioning and write-off policies. Provisioning of 100% is made for overdue loans of more than two years and loans are only written off once they are four years past due (*Source*: Annual Reports of the Grameen Bank).

56 Credit and Development Forum 2001b, p.168.

57 Carpenter 1997, p.17.

58 ADB 1998.

59 Fleisig 1996.

60 Women's World Banking 2002, p.6.

61 ADB 2000b, p.18.

62 The NGOs and cooperatives are registered under six different Acts. Most are registered under the Societies Registration Act, 1860, which is administered by the Department of Social Welfare. Others are registered under any of the following: (i) as voluntary social welfare agencies (under the Registration and Control Ordinance, 1961); (ii) as nonprofit companies limited by guarantee and licensed under Section 28 of the Companies Act, 1984); (iii) as trusts under the Trust Act, 1882, or the Charitable and

Religious Trust Act, 1920; or as (iv) cooperatives under the Cooperative Societies Ordinance, 1984 (ordinance No. 1 of 1985). In the case of MFIs receiving foreign grants, the NGO Affairs Bureau, established under the Foreign Donations (Voluntary Activities) Regulation Ordinance, 1978, has to be informed and clearance given to receive the funds.

63 McGuire, Conroy, and Thapa 1998.

64 ADB 1998, p.21.

65 PKSF 2000, p.7.

66 ADB 1997, p.21.

67 Cited by Rosenberg 1998.

68 MicroBanking Bulletin 1997.

69 World Bank 1999, p.19.

70 As mentioned at the beginning of this report, *mission drift* refers to the shift in MFI focus from the poor or poorest to relatively higher-income clients (Christen 2000, p.5).

71 "Bankable" clients are those having effective demand for microcredit with the opportunity to invest such funds profitably.

72 Hashemi 1997.

73 Wright 2000, as cited by Meyer 2001, p.4.

74 Cited by Zaman, in Wood and Sharif 1997, p.253.

75 Meyer 2001, p.4.

76 Mosley and Hulme 1998.

77 ADB 2000b, p.10.

78 Hulme and Mosley 1996.

79 Goetz and Sen Gupta 1996.

80 Marcus, Porter, and Harper 1999, p.27–29.

81 New loan size may be a more effective summary statistic than average loan size of the target audience of an MFI. While average loan size will increase with borrower exposure to MFI lending, new loan size will not. However, data constraints have necessitated consideration of average outstanding loan sizes only.

82 Alamgir 1999.

83 Cracknell 2000, p.49.

84 Abbey, E.M. 2002. E-mail correspondence with the authors, 4–5 April 2002.

85 ADB 2000b, p.23.

86 Rahman 2000b, p.55.

87 Lyman 2000, p.4–6.

88 Women's World Banking 2002, p.6.