



Business Finance
for the Poor
in Bangladesh



Diagnostics of Micro-enterprise Lending by MFIs in Bangladesh:

Opportunities and Challenges

February 2017

Key Policy Recommendations suggested in this Policy Brief

Policy options	Suggested action	Possible Impact	Time frame	Lead institution (s)
1. Support MFIs in mobilising financial resources through mobilising savings	Amendment of MRA Rules 28 (e) and 29 (e) and link voluntary and term deposit with total loan outstanding instead of total capital: MRA could amend rule 28(e) and 29 (e) to facilitate the process of savings mobilisation and ME financing. MRA Rules allow that an MFI can mobilise deposits equivalent to a maximum 80% of its total loan outstanding. So, MRA could link the voluntary and term deposit clause, already in their rules with the total loan outstanding. This could replace the total capital of a MFI requirement without amending other clauses of Rule 28 (e) and 29 (e). If MRA revise these clauses by explicitly indicating that the voluntary and term deposits will not be more than 25% of the total loan outstanding of the MFI, then MFIs could mobilise more deposits. If MRA thinks to impose further conditions, then it may consider some financial and operational ratios such as debt-equity ratio, current ratio, capital adequacy ratio, portfolio at risks, operational self-sufficiency and financial self-sufficiency etc.	<p>It is estimated that the total savings volume will increase by at least 80% and ME and Microcredit (MC) loan outstanding will increase by at least 35%. If this happens then average loan size will increase by at least 35% from BDT 24,000 to BDT 32,000. Both ME and MC clients would be benefited from increased loan size. The additional investment of ME borrowers would generate more revenue and employment. Livelihood and income opportunities from MC borrowers would also increase because of increased loan size.</p> <p>- The cost of funds that MFIs incur would reduce because the interest rate on client savings is less than the interest rate on borrowing from commercial sources.</p>	Short-term (within one year)	<p>a. Microcredit Regulatory Authority (MRA), and</p> <p>b. Bank and Financial Institutions Division (BFID) of Ministry of Finance</p>
2. ME loans / Expand Financing MEs	<p>Increase ME loan limit: The existing limit on 50 percent may be relaxed to 60 percent without affecting financing of income generating activities for poverty alleviation, as indicated in the BFP-B financed study.</p> <p>Redefine ME loan definition: MRA could amend the definition of an ME by increasing it from loan size BDT 50,000 to BDT 75,000.</p>	The additional loan demand of ME borrowers would be met, which will increase their revenue and generate employment. By increasing the loan size, transaction costs of MFIs would be reduced which could be used to subsidise MC programmes for the very poorest or other poverty alleviation programmes.	Short-term (within one year)	<p>a. Microcredit Regulatory Authority (MRA), and</p> <p>b. Bank and Financial Institutions Division (BFID) of Ministry of Finance</p>

3. Systematic Risk Reduction through establishing Credit Information Bureau (CIB) for Microfinance sector	<p>Establish CIB for Microfinance based on DFID feasibility study report findings. There are three options to establish CIB-MF:</p> <p>i. MRA-BB; ii. independent MRA; and iii. PKSf. The least cost option is MRA-BB, and the highest cost option is MRA. PKSf has marginally higher cost than MRA-BB, but lower cost than MRA. It has the least establishment time and also financially sustainable.</p>	<ul style="list-style-type: none"> - Reduce systematic risks of MFIs as well as banks. - MFIs will disburse more loans to ME and MC clients. - Portfolio at risks would reduce. 	Short-term (within one year)	<p>a. Microcredit Regulatory Authority (MRA), and</p> <p>b. Bank and Financial Institutions Division (BFID) of Ministry of Finance.</p> <p>c. Bangladesh Bank</p>
4. Increase flow of fund for ME investment through banking system	<p>a. Set a credit floor (for example 40 percent) for financing cottage and micro enterprises (CMEs) each year.</p> <p>b. A minimum of 40 percent of the SME refinancing may be set for CMEs.</p> <p>c. Bangladesh Bank might issue a circular mentioning that the commercial banks would disburse a given percentage of their SME loans to MEs through partnership with MFIs.</p>	<ul style="list-style-type: none"> - CME finance through banks will increase. - Banks and NBFIs would be interested to disburse CMEs loans. - ME lending will increase by the MFIs because of bank-MFI linkage. 	Short-term (within one year)	Bangladesh Bank
5. Increase flow of fund for financing CMEs through PKSf	<p>a. PKSf may open a special window for financing MEs. This window may be a subsidiary organisation of PKSf or may be a specialised ME Fund within PKSf.</p> <p>b. The government could allocate a certain amount in the budget for ME financing every financial year, which could be channelised through PKSf.</p>	The ME lending of MFIs will increase because of available low cost fund from PKSf.	Short-term (within one year)	<p>a. Palli Karma-Sahayak Foundation (PKSF).</p> <p>b. Bank and Financial Institutions Division (BFID) of Ministry of Finance.</p>

In recent years, policymakers have shown keen interest in micro–enterprises (MEs) for accelerating poverty alleviation and growth.

The MEs play a crucial role in the Bangladesh economy, especially as key sources of growth and employment. Development of MEs contributes to poverty alleviation through creating self- and wage-employment opportunities; and promotes growth through forward linkages and developing factor and product markets. These enterprises show significant dynamism and flexibility, and they can adapt quickly to changing market demand and supply situations. The MEs are important vehicles for diversifying economic activity and have the ability to make a significant contribution to the economic well-being of the people. These enterprises also contribute to enhancing competition and entrepreneurship and have benefits on economy-wide efficiency, innovation, and aggregate productivity growth.

Although average employment in micro and cottage enterprises (MCEs) is low as these are mostly operated by family labour or the entrepreneur himself/herself, the total number of people engaged in MCEs is much higher than people involved in large, medium and small enterprises.

In Bangladesh, around 89 percent of all economic establishments are MCEs (BBS 2013). More than 7.8 million economic establishments operate in Bangladesh (see Box 1). Average employment per MCE is 1.98 persons. This means that the MCEs have created employment for 13.73 million persons, 56 percent of total employment in all enterprises. These enterprises have significant potential for future growth and are currently poised to become the emerging drivers of inclusive growth in Bangladesh. The MCEs are the pioneers of diversification of the rural economy and its transformation towards modernisation. For unleashing the potential, the critical questions are: What constraints do the MCEs face? What are the appropriate policy responses?

BOX 1: Definition and Number of Enterprises in Bangladesh

Until 2010, MCEs were not part of the country's industrial policy. Cottage and micro industries were added in the industry classification for the first time under the 2010 Industrial Policy. The 2010 Policy defines enterprises based on the sector (i.e. trade, industry or services) and employment size (or asset value).

In the 2013 Economic Census, BBS has followed the same classification as in the 2010 Industrial Policy. Based on this definition, total number of enterprises in 2013 is 7.82 million of which 6.95 million are MCEs.

Palli Karma Sahayak Foundation (PKSF) identifies an enterprise as ME if the owner's equity lies between Tk. 40 thousand to Tk. 1.5 million. However, micro finance institutions (MFIs) in Bangladesh do not practice any universal definition for identifying MEs. The MFIs usually identify them by loan size.

Type of enterprise	Number (million)	% of total
Cottage	6.843	87.52
Micro	0.104	1.33
Small	0.859	10.99
Medium	0.008	0.09
Large	0.005	0.07
Total	7.819	100

This policy brief identifies constraints to developing MEs especially relating to financing issues, and outlines different strategies for promoting and developing MEs based on the findings of the InM¹ study. It identifies constraints faced by MEs, their current financial and capital structure and intensity of access to different credit markets, provides estimates of projected demand for ME credit and suggests policy options for improving accessibility of MEs to credit markets. Exploring the potentiality of banks and MFIs in financing of MEs has particularly been examined in the study.

¹ Institute for Inclusive Finance and Development (InM) conducted a study in 2016 to identify constraints and opportunities for developing MEs, and suggest strategies for removing the bottlenecks with financial support from DFID under its Business Finance for the Poor in Bangladesh (BFP-B) project.

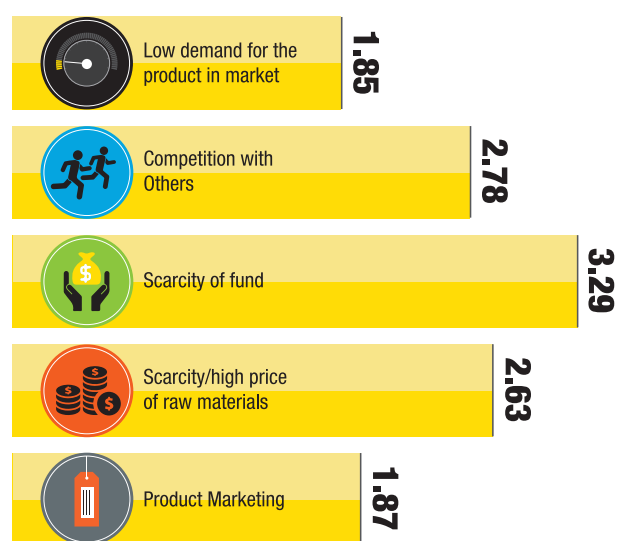
It is evident from available statistics on intensity of ME financing that market failure exists for MEs in the formal bank-credit market. The MFIs have advantages over banks in financing because of their network and simplicity of operation. In terms of intensity of access to ME loans, measured by the number of ME borrowers, MFIs have great opportunities for both graduating MFI members and lateral entrants. As such, this policy brief focuses on ME financing through the microcredit market. The analysis is based on primary data collected from 600 MEs selected randomly from different districts and information gathered from secondary sources and discussion with bank and MFI officials.² The secondary sources include publications and reports of Bangladesh Bank (BB), Microcredit Regulatory Authority (MRA) and various MFIs.

1. Constraints to ME development

Constraints faced by MEs are broadly categorized as: (i) non-financial and (ii) financial constraints. Non-financial constraints include, but not limited to, lack of infrastructural facilities and utilities, time-consuming regulations, corruption, and political instability. However, financial constraint – in the form of inadequate sources of funds – is the major constraint in developing MEs in Bangladesh. This is also well documented in the literature as. In Bangladesh, finance is identified as the dominating constraint for micro, small and medium enterprises (MSMEs). This is also evident from the share of MCE credit. In 2015, banks disbursed only 11 percent of SME credit to MCEs. In 2014, the share of MCE credit was 28 percent of both total loans disbursement and outstanding, corresponding to 8 percent of total borrowers. The financial constraint is further exemplified by the financial structure of MEs.

The InM Micro-enterprise Survey (2016) shows that the share of own fund in total capital investment is around 85 percent. The share of bank credit is 4 percent while MFIs contribute about 12 percent of capital structure of the surveyed MEs. The important issue is: Does it reflect financial constraint? More than 90 percent of the MEs recognise finance as the dominant constraint. This is followed by other major constraints: (i) product marketing, (ii) scarcity/high price of raw materials, (iii) competition with others, and (iv) low demand for the product in the market. Since MEs mostly operate in the local economy, product marketing or low demand for output is a lesser constraint. Based on ranking of the constraints faced by the sample MEs, weighted scores of intensity of the constraints are calculated (Figure 1). Scarcity of funds appears as the major constraint. The survey clearly shows that MEs are subject to severe financial constraint.

Figure 1:
Weighted Score of Constraints Identified by MEs



Note: Sample enterprises are assigned a score of 1 to 5 for each constraint. Higher value denote higher level of constraint. Numbers reported in the figure are the average value of the score assigned to each constraint.

Source: InM Micro-enterprise Survey 2016

² To find out unmet demand for ME credit (gap between demand for and supply of ME credit), information on total number of MEs based on uniform definition, number of ME borrowers, demand for and supply of ME credit are needed. For number of MEs, data from 2013 Economic Census is used. The population of ME borrowers is defined by collecting information on the number of ME borrowers. The Bangladesh Microfinance Statistics 2014 shows that there are 2.6 million ME borrowers in Bangladesh. Finally, considering the criteria that (i) sample should cover diversified providers of ME loans e.g. large, medium and small ME loan providers; (ii) sample should cover regional differentiation; (iii) sample should cover diversified ME sector/subsector activities like agriculture, trade, manufacturing etc., and (iv) sample should cover both ME borrowers and non-borrowers; ME borrowers and non-borrowers are selected using stratified sampling technique. In the first stratum, one district from each of the six divisions (Rangpur included in Rajshahi division) was selected. In the second stratum, we randomly selected two upazilas from each selected district with the exception of Sylhet and Habiganj where selection was based on concentration of MEs. The total number of upazilas is 22. For selecting ME borrowers, relevant MFIs are classified into three groups—small, medium and large-- as MEs are financed by different sized MFIs. A total of 19 MFIs were selected from different stratum. In the third stratum, MEs financed by different MFIs were selected. A total of 22 branches were selected from the sample MFIs. From each branch, information was collected on the number of ME borrowers. A total of 600 MEs including 490 ME borrowers and 110 ME non-borrowers were selected including five non-borrowers from each branch.

In this context, the critical question is: Is aggregate demand for ME credit sufficiently high for the lenders? If the aggregate demand for ME credit is high, only then the issue of why do MEs have such negligible access to bank and microfinance markets becomes relevant. This will also have implications for lenders, both MFIs and banks.

2. Demand for ME loan: Demand–supply gap

The MEs overwhelmingly identify shortage of funds as the major constraint to enterprise development. This implies that MEs have a higher demand for loans than what they receive from various suppliers. The demand for loans has been measured from the sample survey. The following assumptions are made for estimating the loan demand of MEs:

- Since the survey coverage is for cottage (95 percent) and micro-enterprises (4 percent), loan demand of small, medium and large enterprises is not estimated.
- The total number of MCEs is 6.95 million in 2013 Economic Census conducted by BBS. The number is taken as constant in the loan demand projection. Hence, there could be downward bias indicating that the actual loan demand is likely to be higher than the projected amount.

BOX 2:

Average Loan Demand by MEs—Key Findings

- Average loan demand of surveyed enterprises is Tk. 114.8 thousand. Average loan demand of borrower entrepreneurs is Tk. 141 thousand, much higher than non-borrower entrepreneurs. The borrower entrepreneurs actually received on average Tk. 119.6 thousand as loan. So, 15 percent of the loan demand of the borrower entrepreneurs remains unmet.
- Average loan demand is primarily determined by status relating to access to finance and the size of the enterprise. Enterprises with membership of MFIs have much higher loan demand than those who are not members. Also, large enterprises have a higher demand for loans.
- Loan demand is highly responsive to changes in interest rate. Demand for loans increases by 18 percent if the interest rate falls by 1 percent. Loan demand will fall if the interest rate rises, but at a lower rate –demand will fall by 1.8 percent if the interest rate increases by 1 percent.
- The demand for loans would have been 240 percent higher than what they have actually received if no institutional loan ceiling existed.

Source: InM Micro-enterprise Survey 2016

further classified into urban and rural. Average loan demand is projected for all these groups separately. Multiplying average loan demand by the number of total enterprises in each group gives the total demand for loans.

Table 1: Aggregate Demand for ME Loan, 2015

	Total number of enterprises		Average loan demand (Tk.)		Total loan demand (Tk. in billion)		
	Urban	Rural	Urban	Rural	Urban	Rural	Total
Cottage (total number of employment:1-9)	1,730,150	5,112,734	107,710	104,283	186.35	533.17	719.52
Micro (total number of employment:10-24)	41,112	62,895	228,750	133,333	9.40	8.39	17.79
Total							737.31

Source: InM Micro-enterprise Survey 2016 and BBS, Economic Census 2013

For total loan demand projection, the sample enterprises are classified into two categories: (i) cottage enterprises (total employment between 1 and 9) and (ii) micro enterprises (total employment between 10 and 24). These two groups are

The study estimates that total demand for ME loans in 2015 is Tk. 737 billion. Total ME loan outstanding by MFIs is Tk. 123.27 billion and that of banks is Tk. 176.65 billion. So, total loan supply to MEs is Tk.299.92 billion and therefore the

demand-supply gap is Tk. 437.39 billion in 2015. Despite the existence of such a high demand, why do the lenders fail to meet the demand for ME loans?

Why do MEs have limited access to bank and microcredit markets?

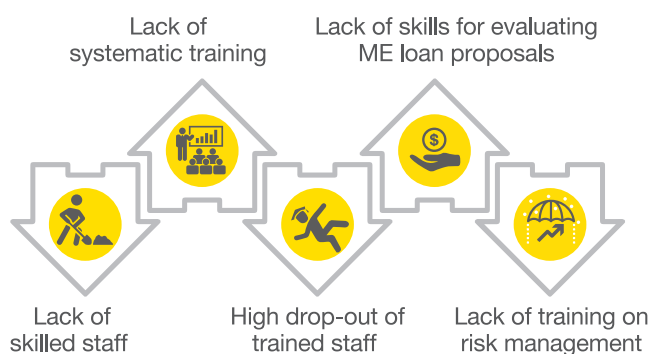
The bank officials identify several factors: (i) branch network is limited; (ii) existing collateral-based lending practice is not suitable; (iii) ME lending is costly and risky; and (iv) large and medium loans are profitable. However, they recognise that services of NGO-MFIs can be used to channel loans to MEs provided MRA publishes rankings of MFIs and a CIB is available for MEs.

MFIs disburse ME loans, and they are willing to expand loan intensity. Their critical argument is financial constraint. They also consider MRA rules as restrictive. They argue that relaxation of the regulatory restriction would not solely be sufficient to meet additional demand for credit. MFIs require more funds.

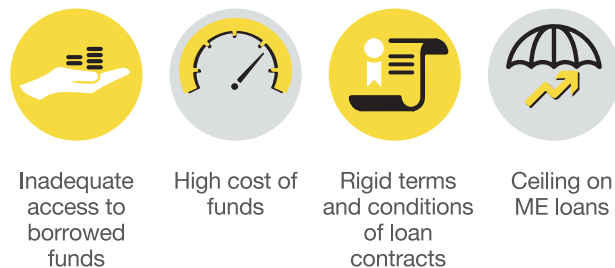
Considering the characteristics of the MEs, MFIs are probably the right vehicles for financing MEs. Banks have larger portfolio for maximising profit through reducing transaction and default costs. As such, we may presume that banks and non-bank financial institutions have a limited role in financing cottage and MEs. Within such a caveat, future policy implications may be drawn.

MFIs identify three types of constraints in financing MEs – operational constraints, financial constraints, and regulatory constraints. More than 72 percent of participants and MFIs identify operational and financial constraints as the major ones.

The operational constraints relate to:



The identified financial constraints are:



Financial constraints are also created by regulatory constraints. Around 45 percent of the MFI-participants hold that financial constraints are at least partly created by regulatory restrictions on ME loan volume. The regulatory constraint arises from three provisions of MRA Rules 2010:

- i. Rule 34 requires that MFIs maintain 15 percent of member deposits as liquidity reserve requirement;
- ii. Rule 20 requires that MFIs should maintain 10 percent of Reserve Fund as deposits;
- iii. Rule 24(3) requires that ME loans should not exceed 50 percent of total loans outstanding.

Although MFIs argue that relaxation of regulatory restrictions will contribute to increasing supply of funds for ME financing, we consider that Rule 20 and Rule 34 are required for liquidity requirements and financial stability. There is an opportunity to relax rule 24(3). But this may not be adequate. MFIs require access to additional funds. These can be mobilised through member or public deposits. MFIs consider that Rule 27(2) and Rule 28(e) restrict mobilisation of savings. These MRA rules are as follows:

- i. Rule 27 (2) requires that the total deposit balance of any Microcredit Organisation will not exceed 80 percent of principal loans outstanding at any given time.
- ii. Rule 28 (e) requires that total voluntary deposits will not be more than 25 percent of the total capital of the organisation.
- iii. Rule 29 (e) requires that total term deposits will not be more than 25 percent of total capital of the organisation.

MFIs are unable to mobilise funds through offering different savings products because of the above regulatory restrictions in 2010 MRA Rules. They also argue that skill development training for ME loan-related staff will strengthen implementation of ME lending programmes. The question is: What can be done to remove the constraints on the lenders?

Why financing through MFIs?

In practice, MEs can have access to borrowing from both banks and MFIs. The 2016 InM ME Survey also focuses on the preference of the lenders by MEs. Low transaction costs of

borrowing as reflected in ease to get loans and ease to repay instalments and less time required to get loans appear to be the dominating advantage of MEs borrowing from MFIs (Box 3). Lower transaction cost is further exemplified by the fact that MFIs operate at the doorsteps of the MEs. In contrast, major disadvantages of borrowing from banks are difficult access to bank branches with no branch nearby and lengthy procedures involving too much paperwork. However, in order to increase intensity of coverage, MFIs need to tackle the problem of high lending interest rates, the lack of diversified loan portfolios and high credit rationing, as perceived by the MEs.

Box 3: Entrepreneurs' perception on ME loan from alternative sources

Advantages of ME loans from MFIs

	% of respondents			
	Reason 1	Reason 2	Reason 3	Total
Ease of obtaining loan	62.48	15.47	12.38	90.33
Ease of repaying instalments	25.15	52.22	12.96	90.33
Requiring less time to get loan	10.83	25.53	46.42	82.79
Interest rate is comparatively low	0.39	3.09	9.67	13.15
Limited loan-amount of microcredit	0.19	0.77	3.87	4.84
Others	0.97	0.19	0.00	1.16

Disadvantages of ME loans from MFIs

	% of respondents			
	Reason 1	Reason 2	Reason 3	Total
Not meeting the quantity demanded	23.65	7.50	6.92	38.08
Interest rate is high	57.88	23.27	4.81	85.96
Having to mortgage assets	3.08	7.50	8.27	18.85
Requiring more time to get loan	2.50	2.88	2.50	7.88
Do not have long term loan	9.81	32.12	20.77	62.69
Cannot fulfil the demand for upper ceiling of loan	2.31	2.88	6.54	11.73
Others	0.77	0.38	0.77	1.92

Disadvantages of ME loans from banks

	% of respondents			
	Reason 1	Reason 2	Reason 3	Total
No bank in the near vicinity	16.79	3.69	2.95	23.43
Need much paperwork	75.46	16.24	4.24	95.94
Banks do not want to provide ME loans	3.69	35.06	16.42	55.17
Loan conditions are not business friendly	2.77	27.86	23.62	54.24
Do not have the ability to provide mortgage	0.55	8.86	18.45	27.86
Others	0.55	0.18	0.92	1.66

The disadvantages of MFIs and banks require several institutional changes for these two groups of institutions. The MFIs need to change their ME loan products by adjusting interest rate, introducing longer term loan and increasing loan size. On the other hand, banks should have strong willingness to lend to MEs. Secondly, banks should introduce easier ways to apply for ME loan by reducing paper works to the minimal.

3. Policy Strategies for ME Financing

The present analysis shows that banks have limited scope for financing MEs mainly because of their loan product approach. They are more inclined towards financing large and medium enterprises and, when they do, it is largely for working capital financing. Even when banks are financing MEs, they are basically serving the upper strata of MEs that are closer to graduation to small enterprises. Moreover, their operations are limited mostly to urban areas. In such a situation, it becomes quite difficult for banks to finance rural MEs. Specialised agricultural development banks with their specific portfolios are more engaged in financing the agriculture sector.

Policy options are proposed under different scenarios. Moreover, not all suggested policy options are mutually exclusive. The options also need deeper critical examination and proposed changes need a comprehensive approach to implementation, as these will have different implications for various stakeholders having their own perspectives. In the case of financial market-related policies, these should be evaluated both from micro and macro perspectives; from both firm and market perspectives.

STRATEGY ONE:

Increase flow through the banking system

Banks have a higher ability to mobilise financial resources and act as intermediaries to invest in the portfolio of firms and individuals. The analysis shows that banks have not been able to finance cottage and small enterprises directly; only around 11 percent of MSME loans outstanding are cottage and micro-enterprise credit. Despite such a limited role at present, given the advantages of banks, increasing funds flow to cottage and micro-enterprises is important. The suggested policies are as follows:

- **Bring changes in BB credit and refinancing policies.** Bangladesh Bank needs to bring some changes in its credit and refinancing policies to make it more MCEs-friendly. Following measures can be taken:

- Set a credit floor for financing MCEs for each year;*
- Although 100 percent refinancing of SME loans are available, such refinancing facilities should be made a priority for MCE loans in rural areas, in particular. A minimum of forty percent of the SME refinancing shall be set for MCEs.*
- Preferential lending interest rates for MCE loans in rural areas should be introduced as most rural employment is created in the MCE sector and more than 90 percent of the economic establishments are MCEs in nature. It will be socially justified as net social benefits are expected to be positive.*

- **Ensure investment of rural deposits in rural areas:** Bank deposits are the source of funds for investment. The rural advance-deposit ratio shows a declining trend. In June 2015, the ratio of rural advances and deposits is 0.39. Such trends are counter-productive. This needs to be reversed in order to increase investment in rural areas. Bangladesh Bank can suggest the following policy measures to ensure an increase in rural investment of rural deposits:

- set a clear policy of linking incentive-related policies like refinancing to rural advances out of rural deposits;*
- rural bank branches should be encouraged to use MFI branches for expanding credit facilities to both MEs and other economic activities in areas where banks cannot provide financial services directly.*

- **Strengthen 'agent banking' system.** The December 2015 amendments to Circular 4 of SMESPD require promotion of agent banking to provide financial services to cottage and micro enterprises. Though the policy is in effect, it is not as effective as it should have been. In the case of enterprise financing, NGO-MFIs are identified as agents. The principal-agent banking system should be specifically promoted and strengthened for financing MCEs. In the process of doing this, the following steps may be taken:

- i. *recognise licensed MFIs as a formal organ of the financial markets, particularly in rural financial markets. It is imperative that better collaboration between banks and NGO-MFIs exists. NGO-MFIs should not be treated as a 'client group' only. Such collaboration should start with recognition of licensed NGO-MFIs as a formal organ of the financial market. With such recognition and positive environment of collaboration, banks will be able to use the services of NGO-MFIs more effectively.*
- ii. *rural bank branches should be encouraged to provide financial services to MCEs through efficient and sound MFIs;*
- iii. *all commercial banks should be strongly encouraged to select some MFIs in rural financial markets as their agents. Bangladesh Bank should have specific policy guidelines for selecting MFIs under the principal-agent model of lending.*
- iv. *financial innovation and technology like mobile banking may be used to strengthen agent banking.*

Establishment of CIB for the microfinance sector will allow banks to lend with a higher level of confidence. At present the process is underway for establishing such a CIB.

STRATEGY TWO:

Increase flow of fund for financing MCEs through PKSF

PKSF is a major player in promoting and developing the microcredit market in Bangladesh. Over time, it has diversified its activities from pure finance to development finance. In recent years, PKSF has brought major changes in policy to promote MEs in Bangladesh through its partner organisations. In addition to banks, PKSF can be a major vehicle for increasing the flow of fund for financing MCEs as it has a higher capability to monitor MCEs and financing MFIs and has an established set of rules.

Considering the critical role that PKSF plays and the need for broad-based ME financing, PKSF may open a special window for financing MEs with financial support from government and international agencies. This window may be a subsidiary organisation of PKSF or may be a specialised ME Fund within PKSF. All licensed MFIs should have access to such specialised ME funds, if established.

STRATEGY THREE:

Support MFIs in mobilising financial resources

NGO-MFIs need to raise funds from all potential sources. A higher amount of funds is needed for expansion and scaling up financing for MCEs. The current state may be termed as a 'state of capital deficit'. In such a state, MFIs are confronted with two inter-related problems: (i) slower growth rate, less than the desired level, and (ii) operational deficit which limits MFIs' access to the capital market. In such a situation, based on cost of funds associated with each source of finance, NGO-MFIs may adopt a number of capital-raising or fund-raising approaches.

- **NGO-MFIs should finance lending activities more by savings.** Currently, MFIs are allowed only to mobilise member savings and term deposits subject to restrictions under rule 28(e) and 29(e). NGO-MFIs should mobilise more member savings and term deposits at a higher level. Several arguments are advanced to justify such a strategy. First, MFIs cannot sustain in the long run through financing MEs by borrowed fund. Second, MFIs will be able to reduce lending interest rates when cost of fund will be lower due to savings mobilisation. Third, it will enable MRA to design appropriate governance structure for better monitoring of the licensed MFIs. Fourth, it will facilitate MFIs to contribute to economic growth through up-streaming of their lending activities. Considering the arguments, we recommend the following measures:

- i. *MRA should amend rule 28(e) and 29(e) to hasten the process of savings mobilisation and ME financing. The present restriction of limiting voluntary deposits or term deposits to 25 percent of equity capital should be amended as "voluntary deposits or terms deposits will not be more than 25 percent of loans outstanding". Our estimates show that such amendment will contribute to mobilising member savings and term deposits and increasing ME financing by more than six times.*

- ii. *BB and MRA should examine the possibility of allowing MFIs to mobilise public deposits and treat MFIs as licensed financial institutions. This should be done in order to ensure financial stability and better monitoring of monetary policy.*
- iii. *Rule 24(3) may be amended to relax limit on ME financing as a ratio of loans outstanding. The existing limit of 50 percent may be relaxed to 60 percent without affecting financing of income-generating activities for poverty alleviation.*

- **Access to innovative financial instruments:**

Globally some innovative financial instruments are available for raising capital. The well-known instruments are: (a) Credit Guarantee Scheme; (b) Securitisation, and (c) Debt Instruments.

- (i) *NGO-MFIs can raise funds from financial institutions through a specially-designed Credit Guarantee Scheme for financing MCEs. Bangladesh Bank with assistance from the government may design such a specialised scheme. However, it is not only the product that has to be designed, but also the mechanism as well as terms and conditions that have to be properly defined so that they do not distort the behaviour of both lenders and borrowers.*
- (ii) *Securitisation is a well-discussed issue in the microcredit market. The issue of securitisation needs to be examined in the context of the relationship between microcredit market and formal bank credit market.*
- (iii) *There are other debt instruments like certificates of deposit or bonds/debentures that are issued to raise funds from the capital or money markets. These instruments can be used for raising capital for MFIs. The issue needs careful examination in the context of the state of capital and money markets in Bangladesh.*

STRATEGY FOUR:

Raise social equity fund (SEF)

NGO-MFIs in Bangladesh are 'not-for-profit' social entities. There is no privately-held equity, although the institutions are established and operated by social sponsors. In such a situation, they can raise social equity capital. There are several ways of raising social equity capital: (i) participation of donor agencies (firms or individuals) in social equity; (ii) participation of institutions like banks and PKSf in social equity; and (iii) access to the social capital market (which does not exist at present in Bangladesh).

Raising social equity funds is an important policy issue. The policy should be examined from the perspective of (i) establishing a 'Social Capital Market (SCM) or Social Capital Exchange (SCE); and (ii) allowing individuals as well as national and international agencies to contribute to the Social Equity Fund (SEF). All relevant players e.g. BB, SEC, MRA, and PKSf along with relevant experts should examine the issue of establishing this specialised exchange for social institutions like NGO-MFIs. Implementing the second perspective of accepting contributions of individuals and organisations to SEF will be easy once a working policy is adopted by MRA in collaboration with BB. There is, however, another system called kiva micro-lending, quite well practised in some of the European countries. It is quite prominent in China as well. It is an on-line credit market where a platform is created for both potential lenders and borrowers. Both individuals and firms can participate. But unregulated kiva microlending may create financial instability as well. Such system may be examined by both MRA and BB.

STRATEGY FIVE:

Establish separate institutions for financing MCEs

Financing cottage, micro and small enterprises (CMSEs) requires 'up-streaming' of lending activities for NGO-MFIs and 'down-streaming' of lending activities of banks. Based on the limitations of both banks and MFIs, one may argue for establishing separate specialised financial institutions in rural financial markets (RFMs). Establishing such specialised financial institutions

in RFMs requires a serious policy review in the context of the expected role of NGO-MFIs, and the failure of specialised banks like Bangladesh Krishi Bank (BKB) and Rajshahi Krishi Unnayan Bank (RAKUB). Such specialised institutions may be termed as ‘community banks’ or ‘rural banks’. However, the targeted objective may be achieved through an alternate arrangement if PKSF is allowed to open a separate window for financing MCEs with capital contributions from the government, BB and low-cost funds from international agencies. BB and MRA may examine the proposal to improve the performance of RFMs.

STRATEGY SIX:

Transform MFIs into microfinance banks

About a decade ago, microfinance banks were unknown entities. At present, many microfinance banks operate in different countries. They operate even in several South Asian countries such as India, Nepal and Pakistan. In Africa, these are well spread. In Latin American countries like Bolivia, microfinance banks exist and have operated for over two decades. But not all these microfinance banks are social organisations. Some are commercial financial institutions with two modes of ownership – private equity and institutional equity. Although these are microfinance banks, their activities are spread over financing micro-enterprises to small and medium enterprises.

In Bangladesh, establishing microfinance banks may be considered as a policy option for ‘up-scaling’ activities of NGO-MFIs; financing MCEs, capacity improvements of NGO-MFIs, and strengthening rural financial markets. There are pros and cons for transforming MFIs into microfinance banks. In addition to scaling-up activities, transforming MFIs into microfinance banks will enable the banks to operate effectively in RFMs with available information. However, some critical issues need detailed examination:

- Should all MFIs be transformed into banks? (Probably not)
- What should be the ownership and governance structure?

- Should these banks be regulated by MRA? If not, what will be the future role of MRA?
- Should microfinance banks operate only in RFMs?
- Should microfinance banks be limited in number?
- Will transformation of selected number of MFIs into microfinance banks affect the targeted objective of financing IGAs and reducing poverty?

A clear policy needs to be formulated by BB and MRA. For example, State Bank of Pakistan has issued a set of detailed outlines or guidance for establishing separate microfinance banks or transforming MFIs into microfinance banks. These guidelines are quite extensive and address critical issues from ownership to governance.

STRATEGY SEVEN:

Remove non-financial barriers to developing MEs

The expansion and development of MEs cannot be done in isolation through making provision for finance only. It requires a holistic approach so that problems in credit markets, factor markets and product markets are simultaneously addressed. Otherwise, a piecemeal approach may create distortion in other markets and may contribute to inefficiency. Moreover, MEs are constrained by skills, market knowledge, product selection and infrastructure. In view of this, resolving the financial constraint will require creating an appropriate environment for ME development, defining MCEs in a uniform manner, identifying target groups, recognising heterogeneity of MEs, providing business support and other relevant services. Moreover, distortions in factor and product markets will undermine credit market liberalisation for the MEs.

Based on the above discussion, we have summarised in the following table the major policies to increase ME financing, how those policies could be implemented and the institution/ organisations that are primarily responsible for the implementations of these policies.

Key Policy Options for ME Financing

Policy options	Suggested action	Time frame	Lead institution (s)
1. Increase flow of fund for ME investment through banking system			
Bring changes in BB credit and refinancing policies	Set a credit floor for financing cottage and micro-enterprises (CMEs) each year. 20 percent of SME credit may be earmarked as credit floor.	Short term	Bangladesh Bank
	A minimum of 40 percent of the SME refinancing may be set for CMEs		
	Preferential lending interest rate for CME loans in rural areas may be introduced		
Ensure investment of rural deposits in rural areas	Set incentive-related policies, like refinancing, to encourage investment of rural deposit in rural areas		
	Rural bank branches could be directly encouraged to use MFI branches for expanding credit facilities to both MEs and other smaller economic activities		
Strengthen the 'agent banking' system	Recognise licensed MFIs as a formal part of the financial market		
	Rural bank branches could be encouraged to provide financial services to MEs		
	All commercial banks could be strongly encouraged to select some MFIs in rural financial markets as their agents		
	Financial innovation and technology like mobile banking may be used to strengthen agent banking		
	Establish CIB for the microfinance sector		
2. Increase flow of fund for financing CMEs through PKSF	PKSF may open a special window for financing MEs. This window may be a subsidiary organisation of PKSF or may be a specialised ME Fund within PKSF	Short term	PKSF, Ministry of Finance
	The government could allocate a certain amount in the budget for ME financing every financial year, which could be channelled to MFIs through PKSF.		
3. Support MFIs in mobilising financial resources			
NGO-MFIs could finance lending activities to MEs more using savings	MRA could amend rule 28(e) and 29(e) to facilitate the process of savings mobilisation and ME financing	Short term	MRA
	BB and MRA could examine the possibility of allowing MFIs to mobilise public deposits and treat MFIs as licensed financial institutions.		Bangladesh Bank and MRA
	Rule 24(3) may be amended to relax the limit on ME financing as a ratio of loans outstanding		MRA
Access to innovative financial instruments	NGO-MFIs may raise funds from financial institutions through a specially- designed Credit Guarantee Scheme for financing CMEs		MRA, Bangladesh Bank, Ministry of Finance
	The issue of securitisation may be reviewed in the context of the relationship between microcredit market and formal bank credit market.		
	Certificates of deposit or bonds/debentures may be used for raising capital for MFIs		

4. Raise social equity fund for NGO-MFIs	Examine the feasibility of establishing Social Capital Market (SCM) or Social Capital Exchange (SCE)	Medium term	Bangladesh Bank, Securities and Exchange Commission (SEC), MRA, PKSF
	Review the possibility for individuals as well as national and international agencies to contribute to the Social Equity Fund		
5. Establish separate institutions for financing CMEs in RFM	Examine the expected role of NGO-MFIs, specialised banks like Bangladesh Krishi Bank (BKB) and Rajshahi Krishi Unnayan Bank (RAKUB) in financing CMEs	Medium term	Bangladesh Bank, MRA, Ministry of Finance, SEC
6. Transform MFIs into microfinance banks	Explore the feasibility and identify potential MFIs which can be transformed into microfinance banks	Medium term	Bangladesh Bank, MRA
	Review alternative options and identify desirable ownership and governance structures		
	Identify the regulatory authority		
	Explore the area of operation: rural or urban or both		
	Identify the number of banks		
	Examine the effects of such transformation on social objectives of NGO-MFIs		
7.Non-financial Measures of ME development	Capacity of MFIs and micro-enterprise borrowers need to be enhanced through training and provision of market-related information.	Short Term	Government of Bangladesh, InM, BIBM
	Identify required non-financial services such as strengthening backward and forward linkages for MEs and adopt measures for delivery of comprehensive services.		
8.Defining Micro-enterprise	ME may be defined based on (i) loan size and (ii) employment size	Short Term	MRA
	Entities with full time employment size of 1 to 5 be defined as micro-enterprises		
	ME Loan size may be set at Tk.70,000		

The Way Forward

The study suggests two sets of strategies – one for improving access to ME credit market, and the other for creating an enabling environment for promoting and developing MEs. The policies, as suggested, are not mutually exclusive. All policies have advantages and can be implemented. What is necessary is a policy dialogue by BB, MRA, PKSF, MOF and other stakeholders. Each strategy needs to be examined with potential costs and benefits. The suggested strategies may be structured in terms of priority for implementation. Moreover, the implication of each of the strategies on the behaviour of the financial markets needs exploration. It needs to be emphasised that the micro-credit market cannot be separated from the

formal bank-credit market. These are inter-related. Any erroneous policy in one segment will have adverse impact on the behaviour of lenders as well as on the overall financial market. It is important to undertake critical analysis of all relevant issues along with effective coordination, especially among BB, MOF and MRA. Moreover, for increasing supply of funds for ME financing, it is necessary to pursue a comprehensive approach that combines all plausible instruments in a strategic fashion so that they become mutually reinforcing.



About BFP-B Project

BFP-B is a programme funded by UKaid from the British Government. The Bangladesh Bank is the implementing agency, and the Financial Institutions Division (FID) of the Ministry of Finance, Government of Bangladesh, the executing agency of this programme. Nathan Associates London Ltd. is the management agency. BFP-B is a multifaceted programme, aimed at bringing poor and marginalised people into the formal financial sector and promoting overall inclusive economic growth in Bangladesh. The programme targets 'access to finance' for Micro and Small Enterprises (MSEs) that are currently unserved / underserved by the formal financial sector.

BFP-B Partners

Bangladesh Bank

Bangladesh Bank, the central bank and apex regulatory body for the country's monetary and financial system. The key functions of Bangladesh Bank are formulation and implementation of monetary and credit policies, regulation and supervision of banks and non-bank financial institutions, promotion and development of domestic financial markets, management of the country's international reserves and issuance of currency notes.

www.bb.org.bd

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BFP-B Project is funded by UKaid from the UK government through the Department for International Development (DFID) which leads the UK's work to end extreme poverty that includes ending the need for aid by creating jobs, unlocking the potential of girls and women and helping to save lives when humanitarian emergencies hit. The UK government is currently among the largest bilateral donors to Bangladesh.

www.gov.uk

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Nathan Associates London Ltd. specialises in innovative programmes to reduce poverty, offering expertise in private sector development, trade policy, rural development, agriculture, and economic and financial sector development. Nathan Associates London has been awarded the contract by DFID to deliver technical and financial assistance under the BFP-B Project.

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