Business Finance for the Poor in Bangladesh

POLICY BRIEF

INNOVATIVE MSE FINANCING PRODUCTS AND DELIVERY CHANNELS IN BANGLADESH: OPPORTUNITIES & CHALLENGES

March 2019

Executing Agency
MoF FID

Implemented by
Microcredit Regulatory Authority

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About BFP-B Project

Business Finance for the Poor in Bangladesh (BFP-B) is a £25m facility to create economic opportunities for small businesses by changing the behaviour of market actors in the financial sector. BFP-B is improving the policy and regulatory environment for financial institutions, inducing private sector investment in expanding the frontiers of finance, and enhancing the credit worthiness of small businesses.

BFP-B programme funded by UKaid from the British Government. The Bangladesh Bank and Microcredit Regulatory Authority (MRA) are the implementing agencies, while the Financial Institutions Division, Ministry of Finance and the Government of Bangladesh are the executing agencies of the programme. Nathan Associates London Ltd, the management agency for the programme.

BFP-B Partners

Bangladesh Bank

Bangladesh Bank, is 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

Microcredit Regulatory Authority (MRA)

The Microcredit Regulatory Authority (MRA) was established by the Government of the People's Republic of Bangladesh under the "Microcredit Regulatory Authority Act 2006" to promote and foster sustainable development of microfinance sector through creating an enabling environment for NGO-MFIs in Bangladesh. MRA is the central body to monitor and supervise microfinance operations of NGO-MFIs.

www.mra.gov.bd

UKaid

BFP-B Project is funded by UKaid from the UK government through the Department for International Development (DFID) which leads the UK's work/mission to end extreme poverty which includes job creation, 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 development partners to Bangladesh.

www.gov.uk

Management Agency

Nathan Associates London Ltd.

Nathan Associates is a private international economic and analytics consulting firm established in 1946 that works with the government/ governmental clients' and commercial clients around the globe to deliver practical solutions through building frameworks for economic growth by navigating regulatory hurdles, securing infrastructure financing and evaluating and assessing disputes. 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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DISCLAIMER

This policy brief has been prepared by extracting the findings of the study on "Innovative MSE Financing Products and Delivery Channels: Opportunities and Challenges". Business Finance for the Poor in Bangladesh (BFP-B) Project commissioned Economic Research Group (ERG) to conduct this study. The views expressed in this policy brief are entirely those of the authors and do not reflect commitment of UK Aid, executing agency or implementing agencies.

Innovative MSE Financing Products and Delivery Channels in Bangladesh:

Opportunities and Challenges

Innovative Financing in Bangladesh

Micro and Small Enterprises (MSEs) play an important role in Bangladesh's quest for achieving inclusive economic growth. Financial innovations facilitated by wider application of information & communication technology have opened up new avenues for delivering various types of financial service to the MSEs. If rightly regulated, such innovations can foster economic growth by ensuring more efficient allocations of financial resources and can reduce inequity in access to finance as well. It is therefore desirable to have a regulatory environment, where financial innovations can flourish and contribute to growth and equity, while at the same time, preserve investors' rights, safety and interests.

Primary objectives of this study was to understand the regulatory barriers in launching, operationalising, pilot-testing and up-scaling of innovative financing products and delivery channels, by considering the regulator's views on the sustaining or lacking of new or existing regulations. The study reviewed the experiences of the awardees of Challenge Fund (CF), and identified regulatory barriers some of the awrdess are facing to implement and conduct business.

Rationale for Innovation

Financial inclusion needed for inclusive growth;

Innovations in delivery and product designs expand scope for financial inclusion;

MSEs are important for achieving inclusive economic growth; and application of ICT help in delivering financial service to the mSEs;

If rightly regulated, innovations can contribute to growth and equity, without adversely affecting investors' rights, safety and interests;

Challenges

The recommendations for regulatory changes were structured after consultations with relevant stakeholders. While the consultations followed broad areas of engagements in projects financed by BFP-B's Challenge Fund (CF), engagements with regulators leading to a convergence of ideas resulting in important recommendations to eight different challenge areas.

Consultations focused on following Topics

- Insurance-linked financing
- Agent Banking
- Alternative Investment
- Digitisation of Financial Transfers, including Payment Digitisation
- Other issues, including data storage and coordination between regulatory agencies

Theme I:
Financial Intermediation

CHALLENGE 1

Absence of appropriate insurance contracts between insurance companies and MFIs

Issue 1.1 Life insurance companies cannot offer non-life product and vice-versa

Concerned regulatory bodies: IDRA; MRA; and EDPs

Recommendation:
Composite insurance Products tied to financing, particularly those by MFIs, may be piloted within a regulatory sandbox approach and the new guideline which is under process may include such provision. In order to facilitate experimentation with alternative products linking finance and insurance, capacity building within the regulatory authorities is needed (IDRA and MRA).

Action required:
Revise Insurance Act 2010, Chapter 2, Section 5, clause (1) (2) to allow inclusion of composite insurance products (life and non-life). Develop a separate guideline to allow MFIs to engage in linking lending with insurance.

Issue 1.2 Alleged strict actuary requirements especially in case of residency of a hired actuary

Concerned regulatory bodies: IDRA, BIA; WB and other EDPs

Recommendation:

Regulators may consider relaxing requirements on residency of an actuary, at least, until there is adequate number of in-country certified actuaries practicing to provide the service.

Action required:

The stringent requirements in IDRA guideline clause 3, for an actuary may be relaxed in light of an inadequate number of certified actuaries in practice in order to support academic link programmes.

Issue 1.3 Financial inclusion through MFIs and problems of formally linking lending with insurance

Concerned regulatory bodies: IDRA & MRA

Recommendation:

To facilitate partnerships among MFIs and insurance companies, win-win space may be created by allowing rechanneling of insurance companies' funds to MFIs.However, in order to avoid uncertainty in procuring NOCs for every innovative insurance-linked financial product, a separate regulatory framework is needed for facilitating wider adaption of micro insurance. This should require less stringent compliance compared to regular insurance.

Action required:

In the short term, IDRA may allow insurance companies to include funds to MFIs in their investment portfolio, with the provision to review after a finite period of piloting. For resolving apparent inconsistencies between MRA Act 2006, Chapter 5, clause 24 (h) and MRA Rules 2013, clause 16 (a), which allows MFIs to provide insurance, and the Insurance Act, both IDRA and MRA need to collaborate to develop a guideline for 'microinsurance' with provisions to allow MFIs (and/or, separately registered agencies) to engage in issuing composite insurance without having to follow the stringent rules applicable for insurance companies.

Issue 1.4 Opening up access to finance for micro-enterprises groomed by MFIs

Concerned regulatory bodies: MRA, PKSF & commercial banks under BB guidance

Recommendation:

Promote sub-contracting in the value chain and enhance financing scopes by (i) supporting trade finance facilitated by IT platforms; and (ii) pilot work order financing in a secured manner.

Action required:

Seek proposals from MFIs, MRA, PKSF and commercial banks to pilot projects on work-order financing, within an institutional arrangement whereby respective departments in Bangladesh Bank (FID or BRPD) can monitor and assess to develop a feasible roadmap for future engagements.

CHALLENGE 2

Potential for financial inclusion through Agent Banking may be restricted by stringent rules and regulations

Issue 2.1 Agent cannot open accounts; complex licensing procedure for agents; the requirement of dedicated premises

Concerned regulatory body: BB (BRPD)

Recommendation:

Based on the interviews and FGDs with the stakeholders, it is understood that the initial practice of bulk licensing was not an ideal policy. With current regulators being responsive to changes, current regulations are not too constraining for the expansion of agent banking, and changes at the margin can be negotiated.

Action required:

No change in regulation to be initiated. However, constant dialogue to share experiences of agent banking with the regulators, the monitoring through systematic data collection and their meaningful analysis to feed into policies should continue.

CHALLENGE 3

Bank finance is either inaccessible or too costly for MSEs

Issue 3.1. Except venture capital, equity financing and impact investment, the SBSEC Alternative Investment Rules, 2015 precludes any other form of alternative investment.

Concerned regulatory body: BSEC

Recommendation:

Given the debacles in the capital market, there is good case for finding alternative routes to mobilise small savings targeted to finance specific MSE. ''Crowdfunding' maybe an alternative investment tool to mobilise small savings to finance specific MSEs. However, current BSEC Alternative Investment Rules, 2015 do not permit such alternative tools. A regulatory sandbox approach may be undertaken to test the viability of crowdfunding.

Action required:

Amend existing BSEC Alternative Investment Rules, 2015 to introduce crowdfunding as an alternative investment tool and mobilise small savings to finance specific MSEs. A regulatory sandbox approach maybe undertaken to test feasibility of crowdfunding.

Issue 3.2 Enhance opportunities of equity and bond financing by small enterprises, availing the new BSEC rules

Concerned regulatory bodies: BSEC and DSE

Recommendation:

Ensure that the rules on small cap platforms at DSE are producer-friendly; develop an eco-system to reduce cost of small capital companies for engaging in capital market.

Action required:

Ensure that the rules on small cap platforms at DSE are producer-friendly; develop an eco-system to reduce cost of small capital companies for engaging in capital market. If there are scopesis a possibility to include new provisions in the Act, organise open consultations on the rules; support initiatives to develop the financial eco-system to make participation from small enterprises smoother. More importantly, the ceiling on equity share of the original owners may be relaxed to encourage family-owned micro and small enterprises in manufacturing.

Theme II:

Addressing financial inclusion in a world restricted by security concerns

CHALLENGE 4

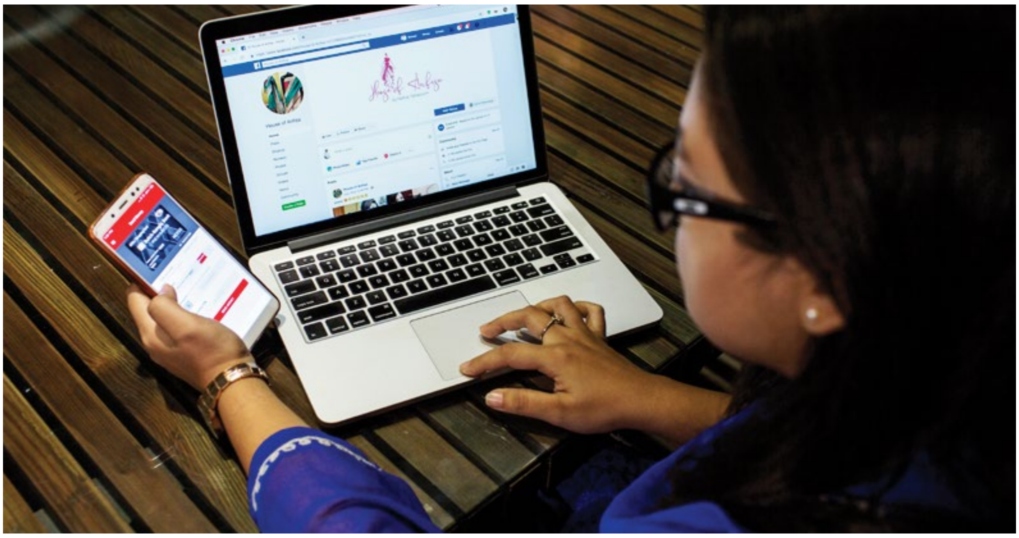
Rule-based limits on transactions are restrictive for financial inclusion and demands for countering money laundering and terrorist financing may be better served through efficient monitoring.

Issue 4.1Low transaction limit on P2P transactions

Concerned regulatory body: BB (PSD) & BB (BRPD),NBR

Recommendation:
The regulatory authority may like to find ways to encourage these people to open accounts as business entities, which may require relaxed fiscal measures; or alternatively, to relax the limits with increased real time monitoring.

Action required:
A public declaration from the NBR that no information on transactions will be used for tax



CHALLENGE 5

Regulators need assurance on safety and security of stored data as well as access to monitor while the providers find cloud storage a cheaper option

Issue 5.1 Financial data can be stored only in digital storage facilities allowed under ICT guidelines and approved by the Bangladesh Bank (BB).

Concerned regulatory body: BB (PSD), ICT Division, BB (BRPD), BB (BFIU)

Recommendation:

In all likelihood, BB has this a digital storage regulation in place to counter money laundering and terrorist funding. Such regulation seems justified and important in order to protect national security. Yet, recommendations are made along two tracks: (i) develop guidelines for safe storage of funds to reduce cost; and (ii) invest to develop locally owned clouds for data storage.

Action required:

Bangladesh Bank may develop guidelines to allow banks for safe storage and to reduce cost using cloud technology

Theme III:
On improving understanding and coordination

CHALLENGE 6

Lack of consistency in KYC and presence of rigid/lengthy requirements

Issue 6.1 Lack of consistency in KYC and presence of rigid/lengthy requirements.

Concerned regulatory body: BB (BFIU)

Recommendation:
A consistent set of KYC requirements should be developed that are simple, tiered, and useful for regular monitoring. Biometric information collected under e-KYC may be used for real time access by authorities given approvals/monitors.

Action required:
Revise BFIU guidelines to allow uniform digitized KYC requirements removing ambiguities around hardcopy requirement in BFIU Circular No. 10 dated 28/12/2014, MLTF Risk Management Guidelines 2015: Section 7, Clause 7.9, Evidence Act, 1872, Chapter 1, Clause 2(e).

Issue 6.2 Retention of hard copies of KYC documents

Concerned regulatory body: BB (BFIU)

Recommendation:
MFS firms need not maintain hard copy KYC records. Abolishing this requirement will reduce rental cost, employee time, and transaction cost charged to the MFS clients.

Action required:
Revise BFIU guidelines and acts to allow digitized KYC documents as evidence which in turn will reduce hardcopy maintenance cost.

CHALLENGE 7

Lack of consensus around entry points for promoting innovations and innovative products.

Issue 7.1 Lack of clear privacy guideline

Concerned regulatory bodies: BFIU in collaboration with PSD (BB);BB (IT)

Recommendation:

It is strongly recommended that BB has a detailed privacy policy with regards to financial and client level data; and developing multi-tiered information sheets aligned with privacy policy and identify clearly discernible minimum requirements on identification and verification of clients. In addition, develop infrastructure and capacity at BB to act as a back end service provider.

Action required:

Complete the unification of KYC, account opening information and e-KYC within a multi-tiered structure and ensure that retailers do not impose excess burdens on clients of banks and MFS providers.

Issue 7.2 Lack of understanding of some innovative financing tools

Concerned regulatory body: All regulatory authorities

Recommendation:

Some organs of regulators may consider establishing a research cell which can spend more time in research activities rather than being in operations.

Action required:

Assess and strengthen research capacities within each regulatory authority.

CHALLENGE 8

Coordination between regulator and operator is critical for promoting innovative products and creating interoperable system

Issue 8.1 Lack of effective set of rules to promote innovative products

Concerned regulatory body: All regulatory authorities

Recommendation:

To develop an effective set of rules during the transition from NOC-based decision-making to a rule-based system. Regulators can consider introducing guidelines for experimentation under close supervision for a finite period. Such a regulatory sandbox approach will provide a platform, where firms will be allowed to experiment with innovative products where certain regulations are relaxed within the platform. This will be done under a controlled environment, and under the close supervision of the regulators. If the experiment is successful, it can be scaled up and some regulatory changes can be advised.

Action required:

Decisions at levels of individual regulatory authority

Issue 8.2 Lack of interoperability among MFS firms

Concerned regulatory body: BB (PSD) and BTRC

Recommendation:

BB should make sure that interoperability of MFS is established within a specific deadline. Following Tanzania's successful example, industry inputs need to be considered in order to make interoperability effective.

Action required:

An interoperable operating system and guideline across MFS, DFS and banks will gradually become imperative for providers and consumers to enjoy the benefit of digital ecosystem.

Challenges regrouped

1	2	3
Financial inclusion involving MFIs may not be fruitful if not supported by appropriately designed insurance products.	Bank finance is either inaccessible or too costly for MSEs, and regulatory changes may open alternative sources of funds for them.	Better comprehension of the digital application concepts are necessary to build consensus around entry points for promoting innovations and innovative products.
4	**5**	**6**
Coordination in FinTech between regulators (inter-agency cooperation) and between operators (interoperability) is critical.	The regulators need to provide safety and security of client data , as well as access them for monitoring, while cloud storage is cheaper for providers.	The lack of common understanding or confusion regarding the requirements of KYC related information in hardcopies restricts financial inclusion.

Issues	Key Policy Recommendations
Introduction of composite insurance products combining life and non-life service options require NOCs from MRA and IDRA and are heavily uncertain. Lack of detailed investment guideline to pilot partner-agent model and narrow perspective on microinsurance	IRevise Insurance Act 2010, specifically Chapter 2, Section 5 in Clause (1) and (2) to include composite insurance products (life and non-life) and separate composite guideline for MFI. Relax investment guidelines of IDRA to pilot partner-agent model between insurance companies and MFIs for last mile distribution of microinsurance and create separate regulatory space to cover risks through defining and implementing microinsurance scope. IDRA may consider piloting partner-agent model providing composite insurance products through a regulatory sandbox approach.
These changes will trigger deeper insurance penetration by annually covering risk of at least total $7,500 million and generate premium income of $80 million. Also, through microinsurance approximately 12.5 million microfinance borrowers can be benefitted	
Lack of consistency in KYC and presence of rigid/lengthy requirements. Retention of hard copies of KYC documents which has cost implication. Financial data can be stored only in digital storage facilities allowed under ICT guidelines and approved by the Bangladesh Bank (BB).	Revise BFIU circulars for a consistent set of KYC requirements across different sectors and services that are simple and useful for regular monitoring. Revise BFIU guidelines and acts to allow digitized KYC documents as evidence which in turn will reduce hardcopy maintenance cost by at least 50% (printing, storage, transportation, employee time, auditing) and transaction cost charged to the MFS clients. BB could develop guidelines that allow banks to store financial data using cloud technology and invest to develop locally owned clouds for financial data storage.
With these changes enacted, cost of maintaining hardcopies of KYC documents will be reduced by at least 50%. Also, cloud technology will allow banks to access data efficiently by at least 25% and reduce technical error with regards to data hosting and error by approximately 30%	
Except the venture capital, equity financing, and impact investment, the BSEC Alternative Investment Rules (2015) impedes a ny other form of alternative investment such as crowdfunding.	Amend the existing rules and guideline of BSEC to introduce Crowdfunding's an alternative investment tools and mobilize small savings to finance specific MSEs. A regulatory sandbox approach may be undertaken to test the viability of such arrangements that ensure accountability of third party service providers.

These changes will trigger experimenting in equity market and allow innovative businesses to reach out to a large number of potential investors at once.

Note: The report also discusses and recommends on supply of actuaries, interoperability, data storage and privacy, agent banking and agency level coordination.

Contact:
BFP-B
Road 27, House 71, Level-3,
Gulshan 1, Dhaka 1212,
Bangladesh.

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