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Finance for All

Microfinance and Financial Inclusion

The financially underprivileged sections of society—women, poor and low-income households, small and marginal farmers, informal sector participants, and cottage, micro, small and medium enterprises (CMSMEs) -- often face several constraints when accessing affordable finance. They are generally perceived as high-risk, owing to lack of collateral and poor financial position, thus making credit extension a high-cost business for lenders.

Moreover, the demand for small-sized loans further worsens the lending cost dynamics. However, microfinance has been leveling the financial playing field by providing tailored loans to such borrowers located at hard-to-reach geographic areas. But the key issue is: what is microfinance and how is it promoting financial inclusion?

In simple terms, microfinance is composed of financial services (e.g. savings, loan products, insurance services, etc.) which are provided to unbanked and underserved households and businesses usually in the form of small amounts to meet the requirements of the poor and low income households and small enterprises (earlier known as microcredit).

The loans provided by the microfinance institutions (MFIs) can be used for a variety of purposes, including income generation and meeting personal requirements of house building, installing water and sanitation facilities, and meeting education and health expenses. Additionally, MFIs offer other financial services, such as savings, insurance, making transactions and receiving remittances, and pension facilities.

Thus, microfinance enables credit-deprived households and CMSMEs to access loans and other financial services, streamline cash flows, and fuel growth, while also serving as a crutch to cope with crisis and rebuild in the aftermath of a crisis.

As of June 2023, the total amount of funds in MFIs was Tk.1.62 lakh crore. In June 2019, the amount of fund was Tk. 88,467 crore. The main sources of assets for MFIs are clients' savings, loans from the Palli Karma-Sahayak Foundation (PKSF), loans from commercial banks, donor funds, cumulative surplus, and other funds, including government funds and foreign loans. At the end of June 2023, other funds of MFIs amounted to Tk. 9,018 crore or 5.6% of the total funds, a part of these funds being foreign loans. However, during the same period in 2019, the fund amounted to Tk. 1,571 crore, constituting 1.78% of the total funds.

At the end of June 2023, the share of foreign funds in the sources of funds for MFIs in Bangladesh is 0.2%, amounting to Tk. 344 crore. Four years ago, in 2019, the fund's share was 0.62%, totaling Tk. 546 crore, according to Annual Statistics for Microfinance in Bangladesh, June 2023.

The MFIs registered an increase in loan disbursements by 30% in fiscal year 2022-23, while their savings increased by 25.11%. According to the report, loan disbursements at the end of June of FY2022-23 stood at Tk. 2.49 lakh crore as against Tk.1.91 lakh crore in the previous fiscal year. The amount of savings of the institutions at the end of June 2023 stood at Tk. 62,000 crore, as compared with Tk. 49,000 crore in the same period of the previous year. But what has spurred this rapid growth of microfinance in Bangladesh?

As mentioned above, low-income households and small enterprises find it difficult to access affordable credit and avoid falling into a debt trap. Consequently, microcredit revolution started in Bangladesh soon after independence and started to expand rapidly to provide loans to the poor people especially women living in rural hinterlands. Later on, the government also joined the microcredit movement following distinct models of microcredit distribution and collaboration with the MFIs.

These models aimed at improving rural credit penetration by following community-based approaches along with focus on providing small loans directly at flexible terms, without requiring collateral. The micro-lending landscape was further polished through several reforms introduced by the MFIs themselves and the Microcredit Regulatory Authority (MRA).

Presently, microfinance is provided by a plethora of lenders, not limited to MFIs but also by the commercial banks, non-banking financial institutions, cooperative banks, and various government department and agencies. So, how does microfinance act as the financial inclusion enabler?

Financial inclusion, as the term suggests, indicates access to adequate, inexpensive, and responsible financial products, which have been tailored to the borrower’s needs. It precludes access to the full suite of financial services, including deposits, digital payments, lending and insurance.

Due to poor credit penetration historically, poor and low-income households and CMSMEs were forced to rely on informal lenders who charged exorbitant interest rates. However, with rapid penetration of microfinance, barriers to formal lending and economic loan products have been broken. Over the years, financial inclusion has improved significantly in Bangladesh. This means people at the bottom of the pyramid are benefiting from increased loan access that can augment their income and wealth generation in the long run.

The expansion of microfinancing can tremendously benefit women and women-led CMSMEs. This enables women to become financially independent, while also having a higher say in the household's financial decisions. However, there is scope for more. Presently, there are several million women-owned enterprises in Bangladesh, with over 98% of them belonging to the cottage and micro category. Available reports indicate a huge amount of unmet credit demand by women-owned cottage and micro enterprises (CMEs)—a space that can be filled by microfinance.

As Jeffery Sachs, the well-known economist maintains: "The key to ending extreme poverty is to enable the poorest of the poor to get their foot on the ladder of development." But this ladder requires access to a minimum amount of capital, which serves as the necessary boost to climb up the first rung of the development ladder.

Hence, by facilitating inclusive participation, microfinance can accelerate the pace of poverty reduction—a target christened in the UN's 2030 Sustainable Development Goals (SDGs). In fact, financial inclusion can directly assist in meeting 7 of the 17 SDGs worldwide

Providing access to immediate, short-term microfinance loans aids CMSMEs in meeting their capital requirements, thus fueling growth. Likewise, microfinance stems from falling into vicious debt cycles by arranging funds in times of emergencies.

At present, buoyed by exponential smartphone penetration, cheap data, and integration of tech with finance, microfinance has been given a new lease on life. By offering digital payments, mobile banking, cash flow-based loans, prepaid instruments, etc., lenders have been sustaining the momentum of microfinance and financial inclusion.

Several traditional lenders have started to collaborate with financial companies that mine customer data based on their digital footprint and transaction history to ascertain their creditworthiness. By further interpreting these results through artificial intelligence (AI)-based models, lenders are now in a better position to sanction loans tailored to the borrowers' needs.

Subsequently, they can also start cross-selling products, such as offering insurance and pension products along with credit. This can go a long way in further improving the financial literacy of the masses.

Financial inclusion has been a key focus area for Bangladesh Bank and the government to improve penetration of financial services across the country. Determined to achieve universal financial inclusion, there are sustained efforts to increase the penetration of formal financial services for the unbanked.. Technology is shaping the future of finance and with it customer expectations are increasing around transparency and safeguarding interests like data privacy and protection. Partnerships with fintech players are providing an impetus to the microfinance sector in many ways. In the times to come, the microfinance players will be seen leveraging data analytics and artificial intelligence to increase efficiency and their reach.

Offering a loan for a cycle, water and sanitation or solar cooking and energy solutions amongst others can significantly improve the livelihood of the borrower, while the MFIs have the opportunity to further deepen their relationship with the existing clients and attract new clientele alike. For these products to have a significant impact on both the borrower and the lending institution itself, an increase in the volume and value of such loans dispersed is needed in the coming years. The MFIs will have to diversify their product portfolio and include fee-based products such as micro-insurance to tackle the pressure arising from the rising competition in the sector.

By responsibly lending to microfinance borrowers, the microfinance lenders can ensure that the borrowing household is not stressed by taking on additional debt that it may not have the ability to repay. It is important for microfinance lenders to adopt a customer-centric approach and leverage the data and technology available to more effectively and efficiently continue to provide credit to the financially excluded women from society. With one-stop-shop being the 'mantra' in the financial services sector, microfinance lenders are well-positioned to embrace the same and extend services beyond lending.

No doubt, microfinance has been serving as an essential economic conduit for enhancing credit access and promoting financial inclusion. Not only it enables last-mile connectivity by affording loans to borrowers living in the remotest corners of the country, but it also helps in empowering underprivileged classes, reducing poverty, and improving living standards.

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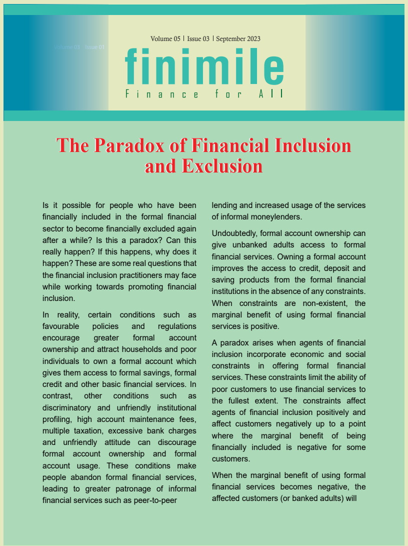
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The Paradox of Financial Inclusion and Exclusion

Is it possible for people who have been financially included in the formal financial sector to become financially excluded again after a while? Is this a paradox? Can this really happen? If this happens, why does it happen? These are some real questions that the financial inclusion practitioners may face while working towards promoting financial inclusion.

In reality, certain conditions such as favourable policies and regulations encourage greater formal account ownership and attract households and poor individuals to own a formal account which gives them access to formal savings, formal credit and other basic financial services. In contrast, other conditions such as discriminatory and unfriendly institutional profiling, high account maintenance fees, multiple taxation, excessive bank charges and unfriendly attitude can discourage formal account ownership and formal account usage. These conditions make people abandon formal financial services, leading to greater patronage of informal financial services such as peer-to-peer lending and increased usage of the services of informal moneylenders.

Undoubtedly, formal account ownership can give unbanked adults access to formal financial services. Owning a formal account improves the access to credit, deposit and saving products from the formal financial institutions in the absence of any constraints. When constraints are non-existent, the marginal benefit of using formal financial services is positive.

A paradox arises when agents of financial inclusion incorporate economic and social constraints in offering formal financial services. These constraints limit the ability of poor customers to use financial services to the fullest extent. The constraints affect agents of financial inclusion positively and affect customers negatively up to a point where the marginal benefit of being financially included is negative for some customers.

When the marginal benefit of using formal financial services becomes negative, the affected customers (or banked adults) will

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