

Microfinance in Bangladesh: Searching for Realistic Roadmap of Digital Future

Background: Microfinance – which started as microcredit after independence -- now covers a range of financial products and services, such as savings, credit, insurance, payments and money transfers. The core, however, still refers to offering and servicing small loans to the poor; provided to borrowers or groups who otherwise would have no other access to financial services. Banks and formal financial institutions usually do not extend loans to those with little or no assets or collateral; and in small sizes typically involved in microfinance.

For the microfinance institutions (MFIs), ‘credit for target group’ view results in focus on providing loans in specified quantities and earmarked for specific purposes. This operational approach translates into ‘supply leading finance’. Generally, the target group can only be partly and temporarily reached due to failure of supply based approach. The emergence of ‘pushing the financial frontier view’ shows importance of permanent financial relationships for rural households, and thereby permanence of financial institutions. The ‘cost-covering interest rates’ for MFIs (instead of subsidised interest rates) are a major step towards achieving such permanence.

The emergence and expansion of MFIs has greatly been facilitated by financial liberalisation in Bangladesh since the 1990s. This means a reduced role for government in allocation of capital, less interference with financial institutions, and new opportunities for banks and MFIs to engage in central function of financial institutions: intermediation between savers and borrowers.

At present, there seems to have emerged a consensus on broad objectives of microfinance -- outreach towards low-income people and financial sustainability. Given these two objectives, MFIs need to deal with two central issues in their day-to-day operations: (i) information issue: how to establish borrowers’ ability and willingness to repay; and (ii) cost issue: how to handle small financial transactions cost-effectively having a short duration generally required by low-income people.

The first requires screening, monitoring, and enforcement procedures that comply with specific circumstances of low income people that deviate widely from usual practices. The second requires operating with transaction costs which necessarily lead to interest rates that are well above commercial bank rates, but that are nevertheless still competitive and thus attractive for MFI clients.

The MFIs generally experience a trade-off in their operations between these two objectives: a focus on somewhat better known clients who require larger loans that eases cost issue and brings financial sustainability closer. This, however, leaves smaller clients outside the financial frontier. Conversely, a focus on new clients brings them inside the frontier, but also involves more costs and risks. It is this trade-off between the two objectives that are critical for MFIs.

Despite the above dilemmas, Bangladesh’s microfinance sector has created its unique space as important

financial intermediaries with a significant value proposition to its client base and national economy. The MFIs extend financial products including basic social services to their clients especially in rural and remote areas through their widespread network and infrastructure. This has enabled MFIs to gain valuable experience in providing financial and human development services to extreme poor populations on the one hand and microenterprise loans to credit-hungry cottage and micro enterprises (CMEs) especially in the rural economy.

Through innovations and working closely with target populations and enterprises, MFIs have also gained several strengths, such as ready access to an established client base, experience in cash management in small lots, well-functioning internal audit and monitoring systems, experienced field staff and local branches, client insights for new product development, and experience in client relationship management.

In June 2023, total number of MFIs (licensed under the Microcredit Regulatory Authority, MRA) stood at 731 with more than 25,000 branches and 200,000 employees. These MFIs provided financial and human development services to more than 40 million low income members/microenterprises having a total outstanding loan of Tk 2,493 billion and a savings portfolio of Tk 621 billion. Credit services of microfinance sector are categorised into six groups: (i) general microcredit for small-scale self-employment based activities; (ii) microenterprise loans; (iii) loans for the ultra-poor; (iv) agricultural loans; (v) seasonal loans; and (vi) loans for disaster management. A loan amount up to Tk 50,000 is generally considered as microcredit; while loans above the amount are taken as microenterprise loans.

The concentration ratio of microfinance sector is relatively high in Bangladesh. Overall, 20 largest MFIs control nearly three-quarters of

market share; while the two largest MFIs (BRAC and ASA) have control over half in terms of both clients and financial portfolios.

Structural transformation of microfinance:

Over the years, microfinance sector in Bangladesh has changed rapidly along with significant transformations from group-based limited-scale microcredit operations to individual microenterprise operations in order to create widespread and sustainable development impacts. Throughout these years, microcredit has graduated from its mainstream activity of supporting basic needs of the poor to nurturing broader farm and nonfarm activities and microenterprises of the graduating microcredit borrowers and microentrepreneurs. The focus on ‘appropriate’ finance through scaling up credit to meet threshold level of activities for generating sustainable livelihoods -- along with targeting extreme poor groups and remote areas; mobilising poor for promoting social development; creating awareness on health, education, women empowerment and other social issues; providing access to technologies and decent income earning opportunities, focus on green and climate-resilient activities, and the like—has provided MFIs a unique opportunity to emerge as important partners of development in Bangladesh.

Over the decades, source of financing of MFIs’ operations has broadened to include loanable funds from several sources, such as members’ savings, cumulative net surplus, borrowing from banks, concessional loans such as from Palli Karma-Sahayak Foundation (PKSF), loan from large MFIs, loan from non-institutional sources (e.g. board and client members), and other sources such as reserve fund, staff security fund, loan loss provision fund and others. The most important sources of fund for MFIs are savings of their members/clients (43 percent) followed by cumulative net surplus (31 percent) and borrowings from banks (19 percent).

Overall, MFIs have contributed much towards

expanding access of poor and low-income households to microfinance services. In Bangladesh, microfinance to poor (especially poor women) is widely treated as virtuous and is seen as valuable for the country's poverty reduction efforts. Microfinance is also considered as a relatively efficient means for assisting the poor. Although interest rates on micro-loans are relatively high, it is treated as a positive mechanism for rationing limited volume of microfinance to borrowers who can earn sufficient returns to cover costs. In practice, this self-selection process is far from perfect; because the poor may borrow in desperation and become locked into a vicious cycle of indebtedness. There may exist moral hazard problems as well.

While the controversy about effectiveness of microfinance in poverty reduction in Bangladesh is deep, an adequate assessment of the capacity of microfinance to reduce poverty needs to employ an economy-wide framework. Although microfinance can provide short-term relief from poverty, it is probably not a long term solution for poverty, especially in situations where poor households own small amounts of land or other productive assets. In modern agriculture, there exist strong positive economies of scale which small farms are unlikely to tap to the required extent and benefit in the longer term. The nonfarm economic opportunities may also remain limited in the absence of strong economic growth and technological innovations.

A more important aspect of microfinance, however, is its role in increasing status of women and their bargaining power in family as most micro-loans are given to women in Bangladesh. Although there exists counter evidence that increased access to microfinance does not necessarily improve health and educational status of women and fails to enhance their role in decision making within households, these results may be context-specific, situational, and dependent on nature of patriarchy in society. The overall picture in Bangladesh society is,

however, more positive, where many women have been empowered and became successful microentrepreneurs through using microcredit as their stepping stone.

Extrapolation of effects of microfinance on individual households to rural economy gives some idea of overall consequences. Increased individual capacity to deal with shocks reduces effects of a co-variant shock for the rural population as a whole, at least when a substantial share is within financial frontier. Further, increased saving in financial assets means a shift away from storing wealth in assets with zero or low productivity. The above process of financial deepening helps reduce inequality and raise income of poorer segment of population. Finance-intensive growth is generally associated with low poverty.

The process has direct relevance for microfinance in rural areas, since providing rural households with access to savings and credit is the core of financial deepening. The effects of financial deepening go beyond individual links between MFIs and households, because a reduction of capital locked up in poorly productive assets and availability of capital for new, trustworthy clients with productive uses fundamentally affects economic relationships in rural areas. Microfinance thus positively affects economic life in rural areas expanding outreach. Enlarging microfinance to include a substantial share of rural population makes positive effects more visible as well.

Over the years, civic organisations (e.g. NGOs) have worked together with the local government institutions (LGIs) in Bangladesh to effect transformative changes at the grassroots level and create linkages with upwards – not just with government initiatives, but also to transform underlying behaviours and ideas that underpin social development. At the aggregate level, these micro efforts and ensuing micro-macro transmissions provide powerful stimulus to

create rapid social outcomes in Bangladesh.

Challenges of microfinance: Despite significant positive achievements, a major challenge for MFIs is their high transaction costs -- large volume of resources traditionally needed to support huge number of small transactions resulting in high costs with low returns per transaction.

For poor in Bangladesh, the need is to re-design conventional financial products to reflect their requirements and demands. In this context, MFIs are best equipped to serve the poor effectively. Further, MFIs need to work out the right balance between financing income generating activities of the poor and deprived groups and financing CMEs and making larger loans.

The MFIs also need to work in designing new and innovative financial products and services with terms and conditions more suitable for vulnerable and risk-averse groups of poor households. Probably, these need to give more emphasis on creating multiple income sources, accumulating productive assets and adopting risk minimising techniques (e.g. microinsurance). Along with appropriate supply side policies, demand side interventions are also necessary to ensure that poor and low-income households are financially literate with ability to use services productively and efficiently. For this, policy implications are twofold: (i) the government's policy attention for rural finance has been vindicated, though not policies with the aim to provide capital, but policies to enable financial institutions to mediate between savers and borrowers; and (ii) policies need to encourage financial institutions (including MFIs) to participate in pushing the financial frontier to include new, low-income rural households, by tackling information problems through innovative screening, monitoring, and enforcement procedures.

Microfinance and digital financial services: For increasing access and performing more efficiently, MFIs need to capitalise on rapid

advances in mobile communications and digital payment services (DFS) to connect poor households to affordable and reliable financial services. For the poor, access to financial services supports them to successfully adopt new farming technologies, invest in new business opportunities, or find new and more productive jobs. At the same time, access to DFS prevents a large number of people from falling back into poverty or into deeper poverty due to health problems, financial setbacks, and other shocks. Simple yet powerful innovations such as digital wallet and other innovations help reach a greater number of poor and drive down transaction costs. Although Bangladesh still has a long way to go to take the full advantages of digital finance, the country is moving rapidly to build required ecosystems and remove barriers to ensure progression from payments to solutions 'beyond payments'.

For exploiting digital technology both effectively and efficiently, key issues for MFIs are to ensure that: (i) financial products and services are tailored to specific needs of different groups of their customers; are transparent and secure; and provide optimal balance between different features of products and their prices; (ii) DFS are introduced through adopting well-sequenced and well-coordinated policies to nurture in-house technological innovation and ensure that financial operations become more efficient and diversified; (iii) for harnessing widespread transformative power of digital technology, MFIs need to identify both opportunities and challenges, such that the management is prepared for both rewards and risks of digitising financial services and reaching members of financially excluded groups; (iv) in digitising financial services, MFIs are required to place emphasis on designing customer-centric financial products and services especially suited to low-income and financially excluded individuals and enterprises.

For MFIs, adoption of customer-centric approach is instrumental in bridging 'access-usage gap' in

digital technologies. Although more than 90 percent of MFI borrowers are women, less than 20 percent of digital finance users are women. This shows the existence of a significant gender divide in access to DFS which has strong repercussions on uptake of digital technology by MFI members.

For successful digitisation, MFIs need to resolve a number of issues for creating an inclusive digital landscape, such as where to start, how to judge readiness of a particular MFI to undergo digital transformation, what challenges and risks should be considered before embarking on transformation routes, and similar issues.

In Bangladesh, many MFIs have undergone digital transformation successfully enabling them to evolve, scale, and compete more efficiently in the rapidly changing financial landscape. The expectations of customers are also changing rapidly which are increasingly being shaped by their experience with smartphone apps, fintechs, and social media. For MFIs, digitising operations will no doubt emerge in the coming years as one of the most credible ways to meet changing expectations of their customers in Bangladesh.

In reality, it is true that not all MFIs are ready to digitise to the same extent or at the same speed. The need for MFIs is to prioritise the processes for digital transformation based on their current and desired level of digital maturity. Based on available best practices, a framework may be used to deepen understanding of digital transformation by specific MFIs, identify digital transformation objectives and maturity for adoption, and take steps towards adopting successful digital transformation.

For CMEs, adoption of digital technologies by MFIs can help to address specific challenges in the value chain—especially those that need financial service solutions, and where traditional finance has limitations to fully address demands in the rural market. This is often due to high infrastructure costs and a lack of incentives to adapt products to unique needs of these enterprises. Digital finance also offers a way to expand access to formal financial system, taking advantage of rapid growth of digital and mobile telephone infrastructure and advent of agent banking. These factors have a direct link to increasing microentrepreneurs' income and wellbeing.

Designing MFI business models: Business models, to a large extent, determine costs incurred to deliver financial products/services on the one hand and value generated on a sustainable basis, on the other. This in turn determines whether provision of financial products and services will be sustainable or not. As such, designing efficient business models is a key determinant of successful delivery of financial services by MFIs. It also needs to be recognised that business models are inspired and motivated by various factors. Usually, MFIs adopt diverse strategic approaches to product development, including roll-out and scale-up. The key for MFIs is to adopt pragmatic approaches towards developing business models recognising both operational, regulatory and policy challenges as well as practical difficulties of reaching the customers.

One of the key concerns for developing business models of MFIs is challenges that emerge from traditional small transactions, completing paperwork and other complexities. For MFIs, microfinance value chain involves multiple players which allow several business model alternatives. In fact, MFIs can potentially emerge as intermediaries with a significant value proposition to their client base, extending financial products through their existing and innovative digital infrastructures in remote rural areas.

Innovation drivers for MFIs: The innovation drivers of MFIs need to encompass both push and pull factors. The push factors come from external sources outside microfinance sector that motivate MFIs

to develop innovative financial products and services to expand outreach to currently excluded and low-income groups. Internal factors act as pull forces which come from within MFIs encouraging them to develop internal capacities for delivering better-suited and efficient services to these groups.

The most important push factor is the government's determination to rejuvenate the financial sector to overcome the deep scars of past mismanagement and corruption; and make the sector more inclusive. In this context, MFIs may follow a three-pronged approach: (i) expand capacity and enhance confidence of potential customers regarding efficient delivery of tailored financial products and services; (ii) provide information and education on access to and use of DFS by microfinance sector; and (iii) encourage delivery of a variety of financial products and services using digital and more efficient mechanisms in line with needs and demands of different target groups. The MRA, as the key

regulator, may design specific measures in these areas.

In the coming decades, priority for MFIs would be to provide their services in more efficient and sustainable ways facilitated by a better understanding of local communities, adopting innovative service design and delivery models, and lending techniques. Further, new innovations may also be explored in the existing MFI models.

The MFIs may explore feasibility of developing partnerships with other financial service providers for performing some of their activities e.g. accepting repayment installments and micro-savings, releasing micro-loans to microcredit/microenterprise borrowers, providing microinsurance and other services through creating access points of financial services in locations where MFI branches are not available.

The MFIs may also explore several options to enhance and sustain their activities to meet

emerging challenges: (i) build a long-term relationship with banks for supply of funds for lending; (ii) design new and digital financial products/services particularly long term housing loans and multiple loans including emergency loans and risk minimising microinsurance products; (iii) implement human resource development programmes both through training of existing staff and recruiting adequately skilled personnel especially in digital technologies; (iv) enhance security of funds especially in relatively less accessible areas; (v) ensure access to information technology for complete documentation of members and borrowers using information from credit information bureau for microfinance sector; (vi) use right skills and information for selecting borrowers/microenterprises and providing services; and (vii) explore options to mobilise voluntary and term deposits.

Repositioning microfinance: The MFIs have already emerged as major players in providing financial services to the poor and disadvantaged in Bangladesh. More than 40 million individuals exist under the microfinance network and about 2 million small businesses are lateral entrants into MFIs' credit network. Most of these clients are parts of the 'missing middle' in the formal bank credit market. Over time, horizon of MFIs has also expanded; micro loan products have diversified to include both financial and non-financial products.

Moreover, the regulations of MFIs have contributed to a structural shift in microfinance market, signifying a move towards microenterprise based higher loan size creating intense competition for loans between microenterprises and traditional household based activities. On the other hand, with emphasis on sustainability, MFIs have also targeted their activities with a renewed focus on transaction costs and risk minimising approaches. On the other hand, coverage of poor members under MFI financial network has been facilitated by availability of subsidised funds, institution of risk minimising informal

microinsurance (e.g. credit, livestock, and health insurance) and programme-induced and targeted lending activities. However, shift towards microenterprises-based lending activities has perhaps affected the loan portfolio of extreme and moderate vulnerable poor households at least to a certain extent.

At present, there are three major targeted clientele groups of MFIs: (i) vulnerable poor including extreme poor and moderate poor; (ii) graduating microcredit members; and (iii) lateral entrants of small businesses e.g. microentrepreneurs. This has also led MFIs to adopt two major mechanisms to deliver financial services to clients: (a) relationship-based lending to individual microentrepreneurs and small businesses; and (b) group-based lending under which several small borrowers come together to apply for loans and other services as a group. The group-based model represents an approach under which the poor and near-poor households can have access to an appropriate range of financial services, including not just credit but also savings, microinsurance, and fund transfers.

Some evidence shows that, for MFIs, default rate is higher in relationship-based microenterprise lending than in group-based lending. Moreover, as average size of microenterprise loans is much higher than in group-based loans, even a low default rate of the former loan causes a bigger liquidity constraint for MFIs. On the other hand, net returns are higher for microenterprise loans as these loans generally have low administrative and supervision costs. Thus, there is a dilemma; and the need for MFIs is to strike a right balance between the two types of loans and minimise risks of microenterprise loan default. Further, while meeting demands of these clientele groups comprising the ‘missing middle’ is no doubt important, supporting excluded vulnerable and extreme poor households is also critical towards fulfilling MFIs’ social mission.

Over the years, the interplay of both external and internal factors has motivated MFIs to develop innovative financial products and services to expand outreach and create internal capacities for delivering better microfinance services in Bangladesh. The government’s policy and institutional reforms have also facilitated development of innovative delivery techniques and appropriate products. Since its establishment under the Microcredit Regulatory Authority Act 2006, Microcredit Regulatory Authority (MRA) is working towards creating policy, regulatory and institutional frameworks for integrated development of microfinance sector which is both socially beneficial and profitable. In addition to traditional microfinance products, a wide variety of financial products and services is now available that are more accessible to the poor, better suit their cash flow challenges, and help address future spending needs.

The presence of a wide network of MFIs and other financial service providers (FSPs) has also created significant opportunities for increasing access to financial services in Bangladesh. Obviously, the gaps that presently exist in universal financial inclusion provide both a challenge and an opportunity to ensure effective access to and use of financial products and services by all residents of Bangladesh.

In fact, the double bottom line of fulfilling the social mission and providing financial services in a profitable and sustainable manner has been guiding the new generation activities of MFIs in Bangladesh. The MFIs are adopting more effective and innovative business models for ensuring financial viability, supported by innovative loan collection techniques and monitoring and supervision methods.

In short, the operational characteristics of microfinance market in Bangladesh show that: (i) around 58 percent of extreme poor households still do not have access to microfinance market; (ii) around 53 percent of moderate poor do not access financial services of MFIs; (iii) female-headed households have lower access to microfinance services; and (iv) there seems to exist a recent trend of rising flow of credit

to non-poor households who are graduating members and lateral entrants belonging to CMEs.

Considering these realities, three aspects of financial operations of MFIs need attention in the coming years: (i) explore innovative and sustainable measures to ease binding financial constraints to provide financial services to target population/business groups; (ii) develop appropriate financial products/services (including housing, business scaling-up and enterprise development, technology adoption, and emergency loan products) to meet the needs of different groups of excluded poor households/CMEs; and (iii) ensure more efficient and cost effective MFI operations through adoption of digital and modern technologies and resolve the asymmetric information problem of excluded households/enterprises.

In addition, capacity building of MFIs needs to be prioritised to meet demands of different segments of targeted populations through addressing problems like lack of skilled and trained staff; inaccessibility to haor, hilly and remote areas; limited access to technology and information; inadequate information flows to excluded households/enterprises; and limited financial education to manage financial resources more productively and efficiently.

Despite significant positive achievements, the challenge for MFIs is their high transaction costs needed to support large number of small transactions which are unique features of their operations. For overcoming the challenge, the adoption of digital technology is a major enabler which is proven, scalable, secure, cost-effective, and is likely to be sustainable. Although MFIs still remain unchallenged in serving the poor and low income segments, but the urgent need is to dream for a digital future.

The MFIs need to search for a roadmap towards that future; and to grow and expand mission to issues like support climate adaptation and mitigation efforts as well in Bangladesh. The key is to learn how MFIs can leverage technology to grow their business, deliver value to their customers, and embark on digital future. Although Bangladesh still has a long way to go to take the full advantages of digital finance, the country is moving rapidly to build the required ecosystems and remove the barriers through creating enabling policy and regulatory environment.



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