Case study Bangladesh:

Financial Linkages in Bangladesh

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Abstract:

Microfinance in Bangladesh has almost reached the stage of a matured market. However, there are still substantial segments of potential clientele who are not serviced by any microfinance organization (MFI). Inadequate finance is one of the most important reasons MFIs have not reach these clients. Fund shortage is more prevalent among the smaller MFIs. Moreover, due to the scaling up of micro-enterprises of the existing clients, they are requiring larger loan amounts. On the other hand, though the formal financial organizations are burdened with significant amounts of excess liquidity, they are not in a position to directly provide services to microcredit clients - it is not viable. Even funding operations of smaller MFIs directly, are out of their reach. In such a situation, an effective linkage between the MFIs with financial constraint and banks with excess liquidity is a simple but highly effective solution.

Introduction

Poverty has always been on the development agenda in Bangladesh. In the history of this country, poverty has been rampant and presently Bangladesh is third in terms of number of poor following India and China. It is a densely populated country of only 150,000 square kilometers and a population of around 140 million. The country consists mainly of a flat delta plain. In addition to its very high population density, the country has a limited natural resource base and is subject to regular natural disasters such as floods and cyclones. This has led to low economic growth and a high incidence of poverty - around 50% of the population lives on less than a dollar a day. However, the country has made notable progress in reducing poverty since independence. Between 1991/92 and 2004, the incidence of poverty declined from 58.8 to 40.0%, although there was more success in urban than in rural areas. However, the rural areas did make better progress in reducing the depth and severity of poverty.

Dependence on agriculture in this economy is gradually declining. However, over 80% of the population lives in the rural areas and all of them, especially the poor, depend on agriculture either directly or indirectly. Landlessness is very high in this country and most of the poor people manage their livelihood as day labourers in the agriculture sector. Moreover, like other developing economies, the burden of poverty falls disproportionately on women. They are the most vulnerable members of society, and they have limited access to opportunities for gainful employment. The rising incidence of landlessness and the decline in home-based economic activities have exposed women in particular, to serious economic pressure. Improving the capability space of these people to participate in non-farm activities fruitfully and enabling them to derive benefits from the existing market structure have been the crucial challenges in the thrust towards poverty reduction. Microfinance in Bangladesh has played the most critical role in the movement in that direction.

Bangladesh is often considered to be the home to "modern" microfinance. The Grameen Bank started operations there in 1976, and the group-and centre-based system, which was pioneered by Grameen is still very widely used, in Bangladesh and in some hundred other countries. Precise figures are not available, but it is likely that a higher proportion of the market of people who need microfinance services, is being reached in Bangladesh than in almost any other country.

Alternative sources of finance for the poor

The ordinary poor people have a few alternative sources to meet their credit demand. These are broadly informal sources, formal sources and semi-formal sources. The informal sector includes private transactions which fall outside the regulated banking framework, such as moneylenders, traders and dealers in agricultural markets, shopkeepers, landlords, friends and relatives. The formal sector includes banks and other regulated financial institutions. The semi-formal sector includes Microfinance Institutions (MFIs) and their programs, which were mostly initiated and in many cases still operated by Non-Governmental Organizations (NGOs). Besides these, there are also some Government organizations, which operate microfinance programs, such as Swanirvar Bangladesh and the Bangladesh Rural Development Board (BRDB), the latter is an apex organization that works with formal cooperatives. These are quasi-government organizations, which are answerable to their line ministries in the government, and are not regulated by the central bank.

Informal sources

People require credit for various purposes including investment, consumption and coping with crisis situations. Informal lenders continue to be the main source of credit for the majority of the population and the last resort for many. Households without access to formal sources, or those whose credit from public sector financial institutions and MFIs is rationed, turn to informal sources. The informal credit sector functions efficiently with low defaults and low transaction costs. Personalized transactions alleviate information problems in screening and monitoring borrowers; geographical proximity makes lenders more accessible; flexibility in terms and conditions allows loans to be customized for borrowers' needs and the threat of monetary and social sanction creates strong disincentives to default.

Informal loans are generally believed to be used mainly for non-commercial purposes, such as consumption, marriage, other social expenses, and medical costs or other emergencies. The sources of loans are widely diversified - most are from neighbors (37%), relatives (16%), friends (26%), and the rest (21%) from professional moneylenders. Interest rates range from zero in the case of relatives, friends and neighbors to 10% a month or more for credit from moneylenders. Despite momentous spread of the alternative sources of credit, informal borrowing continues to make up the majority of the financial involvement of the poor.

Formal sources

Generally speaking, banks and other formal financial institutions in their present structure cannot serve the clients who save and borrow in micro amounts. This has widely been discussed in the context of information asymmetry and the most important reason of the rise of microfinance institutions. However, this is not to say that there has not been any effort from the banks to serve them. The following table summarizes the microfinance operations of those commercial banks in Bangladesh at the end of December 2004. The figures in the table include both wholesale and retail microfinance:

Sl No.	Name of the Bank	Cumulative Disbursement (Million US$)	Total Loan Outstanding (Million US$)	Recovery Rate (%)
1	Sonali Bank	75.71	35.69	76
2	Agrani Bank	38.70	14.68	90
3	Janata Bank	52.69	20.18	85
4	Rupali Bank	0.28	0.22	84
5	Bangladesh Krishi Bank	19.13	7.34	83
6	Rajshahi krishi Unnayan Bank	3.03	0.97	89
7	Ansar-VDP Unnayan Bank	5.99	0.88	98
8	Social Investment Bank	0.52	0.13	94
Total		196.05	80.09	87

Source: CDF statistics 2004

Besides the state-owned banks (who are already in the rural areas to implement government-launched programs), some private banks have started their own retail microfinance operations, such as, the Islami Bank, Social Investment Bank Ltd who have developed a substantial business with self-help groups, based on Islamic banking principles. Others, such as the privately owned Pubali Bank, BASIC Bank, Southeast Bank, NCCBL and Jamuna Bank have already entered the market as wholesalers, using the existing MFIs as distribution channels, and in the process of helping the MFIs to overcome their own shortage of funds.

Semi Formal Microfinance Organizations (MFIs)

The Grameen Bank is Bangladesh's largest MFI, and it is the only MFI, which is a registered bank. All the other institutions are NGOs-MFIs. Some of the biggest and best known are BRAC, Proshika, ASA, BUROTangail, TMSS and Shakti Foundation, and the largest five organizations, Grammen Bank, BRAC, ASA, Proshika and TMSS account for almost 89% of the total amount disbursed.

There are, however, many hundreds of others. The Credit and Development Forum (CDF), a network of MFIs, estimates that in addition to its own members (1,500), there are about 1000 MFIs, which are not CDF-members but are offering micro-financial services. Whatever the number, the MFIs have achieved remarkable success in outreach and the quality of services provided to their clients, and in their contributions towards sustainable poverty alleviation.

Almost all the MFIs use the Grameen Bank model of group lending. The peer monitoring and joint liability structure of this credit delivery mechanism overcomes the screening and enforcement problems that traditional banking systems suffer from. Strong leadership, functional autonomy, freedom from political-pressure, rational and economic interest rates, diversified portfolios, regular savings, well-trained staff, performance-based incentives and mandatory loan insurance are all key elements in the success of MFIs in Bangladesh.

However, the key issue here is the borrower member -ratio which varies from as low as 40 percent to 90 percent. A significant number of MFI-NGOs, mostly the smaller ones, have comparatively lower borrower ratio. Average size of their disbursed loans is also lower than the standard. The basic reason is that they face severe fund crisis and depend highly on the savings of their clients as the source of their revolving loan fund. Essentially, these NGOs have geographical outreach without the ability to meet their client's loan demands.

Government Microfinance Programmes

Many countries have implemented heavily subsidized credit programs in the past, usually through specialized development finance institutions, but often, as in India, using the commercial banks as distribution channels. These programs have usually failed, and "New paradigm" MFIs have subsequently come into the market and have demonstrated the merits of their radically different approach. Bangladesh is unusual in that a number of government departments have introduced their own public sector microfinance programs, subsequent to the success of the MFIs. These programs are usually focused on particular issues and institutions, and they have not been implemented through commercial banks except in BRDB. The following table shows the extent and the performance of some of the more important government micro-finance programs.

Selected Government Microfinance Programs, as of December, 2003

Sl No	Name of the Govt. program	Cumulative Disbursement (Million US$)	Total Loan Outstanding (Million US$)	Recovery Rate (%)
1	Bangladesh Rural Development Board (BRDB)	465	80	82
2	Department of Youth Development	85	8	81

3.	Palli Daridro Bimochon Foundation (PDBF)	165	17	97

Source: CDF statistics 2003

There are also some smaller government programs, lending to a few thousand or even a few hundred people. The government programs are generally donor-funded, with a fixed duration, usually between five and ten years. They are staffed by government personnel who are attached to them for the life of the project, at attractive salaries. MFIs, on the other hand, are permanent institutions with a long-term commitment to their clients. Their service charges are usually higher than those of the government projects, because they have to be sustainable.

Wholesale Finance to NGO-MFIs

Formal Financial Institutions in Bangladesh

There are both public and private financial institutions in Bangladesh. The public sector comprises the state-owned commercial banks, a number of specialized banks including two agricultural development banks, the industrial development bank and other development finance institutions. The private sector comprises privately owned commercial banks including BRAC Bank, foreign banks and some private development financial institutions. The following table summarizes the amount of excess liquidity with these formal institutions.

Excess liquidity with banks at June, 2005

Type of formal institution	Million US$
Nationalized commercial banks	911.43
Private commercial banks	405.08
Foreign commercial banks	258.10
Specialized commercial banks	119.37
Total	1693.97

Source: Bangladesh Bank statistics

Excess liquidity with the commercial banks stood at over Tk. 100 billion at the end of June 2005. Despite drastic declines in the rate of interest both in the deposit and loans, all the banks, especially the nationalized commercial banks, are burdened with such huge excess liquidity. A portion of this liquidity can solve the fund crisis that most of the smaller NGOs are facing in their microfinance operations.

Sources of Fund for MFIs

Cash flow to the MFIs generate mainly from the following sources:

Sources of fund for MFIs

Sources of fund Revolving Loan Fund (RLF)	Share in RLF	
	2004	2003
External sources (international donors and NGOs)	10.68	13.30
Members' savings	28.50	28.50
Service charges	23.69	23.80
NGOs' own fund	4.38	3.70
PKSF	17.01	20.8
Local banks	12.74	8.30
Others	3.00	1.60

Source: CDF Statistics, 2004

- Donors

Traditionally, bi-lateral donors have supported MFIs in Bangladesh. In the initial years of microfinance in Bangladesh, donor's support to the MFIs in the context of credit funds had been very significant. But, over the last 10 years, donor's contribution to the RLF had declined from 33.51% in 1997 to 11% in 2004.

- Deposit services

Savings are an important vehicle through which MFIs can have their poor clients manage their own liquidity. On the part of the NGOs/MFIs, savings mobilization represents lower cost capital compared to other private sources. Three forms of deposits mobilization can be identified: compulsory deposits, voluntary deposits from MFI clients and voluntary deposits from other private sources.

- PKSF wholesale funds

The most critical problem faced by MFIs today is finding money to lend out to the poor. Existing microcredit programs are coming to a virtual halt in their expansion programs and are finding it difficult to continue their present programs because of a lack of funds. One solution that Bangladesh found to this problem was to create a national wholesale fund under PKSF. The Government of Bangladesh and the World Bank put their money into PKSF, which in turn makes this money available to their partner NGOs.

- Bank loans

In addition to savings mobilization, MFIs can forge links with commercial banks to access long term means to mobilize funds for lending. In the case of Bangladesh, MFIs trying to access commercial funds are faced with three major bottlenecks: rigid collateral laws, higher rate of interest and absence of any policy guidelines for funding the MFIs by the banks. To facilitate growing partnership between MFIs and the banks, the relevant financial authority will need to do one of the following:

(i) Act as guarantors on behalf of MFIs or establish Guarantee funds. These funds would provide a guarantee on loans made by the commercial banks to the MFIs. Donors can build a Guarantee Fund and act as guarantors too, for the loans to MFIs. The proportion of the guarantee can diminish as the relation between the bank and MFI develops;

(ii) Instruct banks to allow MFIs to pledge their "borrower receivables" (or loan outstanding) as collateral based on the MFI's record of performance.

(iii) The central bank/donors can pursue the government to subsidize over the higher rate of interest charged by the banks, the private banks in particular (*their funds are usually more expensive than the public banks*), so that the banks are enticed to leverage more funds to MFIs.

(iv) Like NABARD in India, the Central Bank can approve and issue policy guidelines to the commercial banks to fund MFIs. The guidelines must address the collateral requirement by commercial banks and direct them to introduce ONE STOP SERVICE at their head offices for disposing of the MFI's loan applications to overcome the procrastination, bureaucracy etc., the banks historically suffer from. This seems to be moving away from the conventional banking norm, which requires that loan applications are received at and processed through bank branches.

Swiss Agency for Development and Cooperation (SDC)'s repayment guarantee -an example

SDC under a signed agreement, stood guarantor for a loan from Sonali Bank to Shakti Foundation, a women-led NGO working for disadvantaged women in city slums. The guarantee started at 80% of Sonali Bank's finance to Shakti in the first year, reduced to 70% in the second year and 50% in the last/third year of the loan term. The recovery rate was continuously 100% and confidence was built in, so much so, that Sonali Bank approved the second loan to Shakti Foundation without any guarantee from SDC. In fact, SDC-guarantee was aimed at substituting the bank's collateral requirement and promote a mutually beneficial business relationship by building confidence between the commercial *banks and the MFIs for generating a collateral-free never-ending cash-flow for the microfinance industry of Bangladesh.*

As an alternative to this option, rating the MFIs and recommendation of the rating agencies can be used in the decision making process of approving loans by the banks to the MFIs. Sonali Bank, Janata Bank, Pubali Bank and a few other banks have adopted the rating mechanism in their process of approving loans to the MFIs. SDC (jointly with Pubali Bank Ltd) and IFAD (jointly with Sonali Bank) have been co-financing the MFIs.

- Accumulated surplus

The operational surplus earned from credit operations was the third contributor to the RLFs in Bangladesh.Statistics of 657 MFIs as of December, 2003. It depicts a 14% contribution by accumulated surplus from service charge to MFI's RLF.

Performance of commercial banks and MFIs Linkage wholesale funding

It is very important to note here that recovery rate from fund wholesaling is higher for almost all these banks compared to their recovery rate in direct microfinance service delivery. For example, the overall recovery rate for Sonali Bank, the largest bank in Bangladesh, from its microfinance activities is only 76 percent. However, the recovery rate from wholesaling is well above that figure. One of the crucial reasons for this high disparity is that there is synergy in linkage between the banks and NGO MFIs. Their respective comparative and competitive advantages are highly complementary which lays the foundations for a win-win situation.

Sl No.	Name of Bank	No.of MFIs financed	Cumulative Disbursement*	Outstanding*	%of recovery
1.	Sonali Bank	60	12.47	5.19	97%
2.	Janata Bank	07	2.04	0.03	98%
3.	Agrani Bank	31	20.60	14.57	95%
4.	Basic Bank	29		3.20	100%

* in million US $

<u>*Comparative advantages of commercial banks in Microfinance*</u>

- Regulated institutions fulfilling the conditions of ownership, financial disclosure and capital adequacy that help ensure prudential management.
- Physical infrastructure including a large network of branches from which to expand and reach out to substantial numbers.
- Well-established internal controls and administrative accounting systems to keep track of a large number of transactions.
- Ownership structures tend to encourage sound governance structures, cost effectiveness and profitability, which leads to sustainability.
- Own source of funds (deposits, capital, reserves, and refinance) need not depend on scarce and volatile donor resources.
- Offer loans, deposits and other financial products that are in principle attractive to micro financial clients.
- Established training systems or a well-defined training policy to outsource.
- Lower risks.
- Lower administrative costs.

<u>*Comparative advantage for NGOs*</u>

In Bangladesh, the NGOs are involved in various social, economic and educational activities, more intensively in the rural areas. The following are advantages of NGOs over public agency (Khan, 2003):

- Capacity to reach the poor and work with them in remote areas
- Capacity to effectively encourage and promote local participation
- Capacity to work quickly and with other relevant agencies in a flexible manner
- Capacity to experiment, innovate and adapt.
- Capacity to facilitate local resource mobilization and ensure local development
- Advocacy capability

There is ample potential for a bank and an MFI to benefit from each other's comparative advantages by establishing linkage between the two.

Obstacles for Commercial banks in Microfinance:

- Commercial banks generally think micro clients are not good bank clients and therefore, engagement in microfinance does not make good business sense.
- Participation in subsidized small farmer credit programs and directed small lending has led to perceiving microfinance as failure and social obligation, not as a business opportunity.
- Ownership structure of commercial banks in the public sector.
- Higher transaction costs of managing large numbers of loan accounts.
- Mindset, attitude and commitment level of staff.
- Regulation, supervision and prudential norms.
- Non-availability of collateral.
- Loan procedures, policies.
- Communication gap

Mission of Bank-MFI linkage programme

- Performance-based credit support to the qualified MFIs for on-lending by them to their clients.
- To supplement and complement the Government's efforts for poverty-reduction and socio-economic empowerment of poor men and women.
- To develop an effective and mutually beneficial business partnership with NGO-MFIs free of collateral.

To be eligible for the bank's loan, an MFI must fulfill the following terms and conditions:

- MFIs with commendable reputation.
- Registration with appropriate Government bodies.
- Adequate experience, good track records, clear mission, etc.
- Satisfactory network, volume and outreach.
- Recovery rate minimum 95% on demand and on a continuous basis.
- Loan terms: maximum 3 years with negotiable moratorium at the beginning.
- Interest rate: 5% - 10% (depending on products) per annum, simple rate on reducing balance method basis.
- Collateral: Established confidence and close monitoring substitutes for collateral.
- RLF having sizeable equity.
- Executive committee having experienced, non-partisan and socially reputed persons.
- Good audit report.
    - Transparent and systematic accounting and MIS system.

CDF's Credit Linkage Programme

CDF is a network organization for the very large microfinance industry of Bangladesh. It was established in 1992. The principal objective of the organization is to enhance competencies of MFIs in Bangladesh to enable them to provide adequate and appropriate financial services to the poor through adoption and replication of best microfinance practices. CDF works as a conduit for channeling microfinance information to its stakeholders. In Bangladesh, it is the central microfinance networking organization, providing considerable operational and technical support to the MF-NGOs. It amplifies the voice of the small and medium MF-NGOs and builds an effective advocacy platform for addressing the policy issues in the microfinance sector.

Principal Activity

The MF sector was once highly dependent on grants and scarce local resources. Now more than half of funding comes from Bangladeshi sources, about 20% from donors and another 25% from bilateral agencies. CDF is trying to arrange funds from the mainstream banking sector, PKSF and donors, for its network members. The underlying areas of fostering cooperation between the commercial banks and the NGOs include: promoting relationships with the banking sector, scouting international experience and providing referral services for the potential NGOs.

In the present situation, there are around 1500 NGOs/MFIs as partners of CDF operating microcredit programs in the country. CDF organizes training for their capacity building in the program operation. As capacity builds up, they need RLF for credit program operation and expect CDF to provide them with some funding. There is a huge demand for linkage service with CDF in this sector. CDF plans to reach out to at least 150 NGOs/MFIs under linkage microcredit programs over the next 3 years.

Beginning with Sonali Bank(*the largest bank in Bangladesh*) in 2001, CDF signed a similar agreement with Janata Bank in 2004, *the second largest bank of Bangladesh*. Intervention with Sonali provides 50 MFIs access to funds while Janata provides any number of eligible MFIs access to its (Janata) funds over a period of 5 years commencing from July, 2004. CDF, as part of its lobbying job has been motivating and enticing the private sector banks to enter into this sector. As a result, a good number of private banks have started showing interest in the CDF's credit linkage program. Southeast bank, a pioneer in the private sector, over time made an agreement with CDF, which outlays an amount of Taka 20 million for disbursement among 40 small MFIs. The second pioneer in the private sector is the Jamuna Bank Limited, which already approved an amount of Taka 20 million to direct funds through CDF to MFIs for promotion of micro enterprises. CDF, over time received Taka 10 million from NCCBL, another excellent private bank and wholesaled to partner MFIs a couple of weeks before. CDF signed a similar agreement with Dhaka Bank Ltd for a wholesale fund of Tk.20 million. Pubali Bank Limited, the largest private sector bank in Bangladesh is on line to reach out to the MFIs through CDF intervention. With all these funds building initiatives, CDF is moving forward to addressing the huge outcry from its partners, for funds to retail out to their clients.
The following table summarizes the position of loan available by MFIs from CDF-Bank linkage program:

Bank Linkage (CDF as facilitator and repayment guarantor)

Sl No.	Name of Bank	Number of MFIs	Loan amount (in million BDT)
01	Sanali Bank	22	11.40**
02	Janata Bank	14	8.50
03	Southeast Bank Ltd*	07	3.50
04	Jamuna Bank Ltd*	06	3.00

* Privately owned banks

** US$1=65 BDT

Bank Linkage (CDF as borrower for on lending to MFIs)

Sl No.	Name of Bank	Loan amount (in million BDT)
01	NCCBL*	10**
02	Dhaka Bank*	20

* Privately owned banks

** US$1=65 BDT

Action Research Fund

To cater to the huge need of its partners, CDF has been funding small MFIs from its own resources under an action research program. This intervention aims to cater to the emergent credit need of the partners, who have to wait longer for funds from commercial banks. This is, however, a stopgap arrangement and is being or will be replaced by the loans received from the banks. The objective of this project is to see how the small MFIs sustain with the funds borrowed at the commercial rate.

The following position summarizes the loans provided to MFIs by CDF from Action Research Fund:

- No. of MFIs : 33
- Amount of Loan : 19.0 (*in million BDT*)
- Repayment Rate : 100%

Research findings

Different research findings (Roy,1998) reveal that Bank-NGO linkage has the better performance in terms of recovery, rate of earnings and in minimizing the operational/administrative cost. The growth of investment and outreach is increasing over time, which indicates a positive trend. As the classified loan makes up only 1-4% compared to the other credit programs (32-39%), it has hardly any cost to the society. As Bank- MFI linkage is wholesale lending, its administrative costs are minimal. So, cost of fund is lower than other credit programs.

Bottom line

In Bangladesh, the state-owned commercial banks have huge funds available for loan as most of the traditional loan programs have either been non-performing or poorly performing, resulting in a high delinquency rate. The MFIs, on the other hand, have very satisfactory records of loan disbursement, utilization, outreach, and repayment. Bank-MFIs credit linkage, therefore, benefits: (a) a bank in terms of profitability and business expansion,(b) an MFI in terms of sustainability, outreach and making provision of larger loan amounts for its graduated clients and(c) borrowers in their socio-economic development.