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Promoting Microfinance in Asia

BANGLADESH: MICROFINANCE AND FINANCIAL SECTOR DIAGNOSTIC STUDY

FINAL REPORT

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Abbreviations and Exchange Rate

ATM	automated teller machine
BAS	Bangladesh Accounting Standards
BDT	Bangladesh taka (national currency)
BMZ	German Federal Ministry for Economic Cooperation and Development
BNP	Bangladesh Nationalist Party
CDF	Credit Development Forum
CMI	Catalyst Microfinance Investors
CPI	Corruption Perception Index, Transparency International
DFI	development finance institution
FDI	foreign direct investment
FY	fiscal year
GDP	gross domestic product
HIES	Household Income Expenditures Survey, Bangladesh Bureau of Statistics
IAS	International Accounting Standards
ICG	International Consultant Group
IFI	international financial institution
IMF	International Monetary Fund
INAFI	International Network for Alternative Financial Institutions
LPG	liquefied petroleum gas
MDG	Millenium Development Goal
MFA	Multi Fibre Arrangement
MFI	microfinance institution
MRA	Microcredit Regulatory Authority
MSME	micro, small, and medium enterprise
NBFI	nonbank financial institution
NGO	nongovernmental organization
NPL	nonperforming loan
NSPC	National Payment System Council
PKSF	Palli Karma Sahayak Foundation
PLC	public limited company
PMUK	Proshika Manobik Unnayan Kendro
REPO	repurchase agreement
RMG	ready-made garment
SDC	Swiss Development Cooperation
SEC	Securities and Exchange Committee, Bangladesh
SEDF	South Asia Enterprise Development Facility
SME	small and medium enterprise
UNCTAD	United Nations Conference on Trade and Development

Exchange Rate
US$1 = 69.74 BDT
(average exchange rate from July 1, 2007 through June 30, 2008, as calculated by www.oanda.com)
All dollar amounts in U.S. dollars unless otherwise noted.

Executive Summary

Background

Following independence in 1971, Bangladesh has experienced bouts of democracy and rule by two military regimes. A caretaker government, led by military-backed technocrats, has been in place since 2006. While progress has been made in improving the voter registry system, separating the judicial and executive branches of government, and reducing corruption, further political reforms are needed to ensure future democratic elections. Corruption remains pervasive in the country. For the last six years, Bangladesh has been consistently ranked one of the most corrupt countries in the world by Transparency International. As of late 2008, local and parliamentary elections seemed set to proceed, although the extensive preparations required made delays probable.

Macroeconomic Context

Broad market-based reforms in the 1990s accelerated national growth, which rose from an average of 4.2 percent a year in the period 1986–1996 to 5.4 percent in the period 1996–2006. The IMF considers Bangladesh's fiscal policy generally prudent, given its modest deficit and domestic borrowing levels. At year-end 2007, the budget deficit stood at 3.9 percent and was expected to increase to 4.8 percent in FY08, due to higher energy and grain prices, as well as costs associated with natural disaster relief.

What is remarkable is the stability of growth in the country—despite natural disasters—and the broad base of that growth, which includes manufacturing, services, and construction. Geographically, however, growth has remained centered in the urban areas of Dhaka and Chittagong. The volatile agricultural sector is a notable exception, accounting for a high, although declining, 20 percent of GDP; the textile industry remains the country's largest source of export earnings.

Financial Sector

The financial sector consists of the central bank, Bangladesh Bank, 4 state-owned commercial banks, 5 government-owned specialized (development) banks, 30 domestic private commercial banks, 9 foreign-owned commercial banks, and 29 NBFIs. In terms of both industry assets and deposits, private commercial banks command the greatest market share. Additionally, 298 microcredit organizations are licensed by the Microcredit Regulatory Authority (MRA). Insurance companies, stock exchanges, and cooperative banks comprise a smaller part of the financial system.

As of August 2008 the net domestic assets of the country's banking system were valued at BDT 1.9 trillion ($28 billion). In June 2007, total assets stood at BDT 1.5 trillion ($21.8 billion), indicating annual growth of 26.1 percent (BDT 404.2 billion, $5.8 billion) in just one year. According to the regulations of Bangladesh Bank, banks must maintain provisions at the following rates: 20 percent for substandard loans, 50 percent for doubtful loans, and 100 percent for bad debts.

The banking sector has grown quickly since about 1995, with annual average growth rates of between 11 and 23 percent between 1995 and 2005. Private commercial banks have experienced the fastest growth in the sector. The weak performance of nationalized commercial banks and specialized (development) banks continues, however, to hamper financial sector competitiveness. These banks have both very high levels of nonperforming loans (NPLs)—in the range of 30 percent—and high interest rates. The performance of private and foreign commercial banks is stronger, the nonperforming loans of which remain relatively low—roughly 5.5 percent and 1.5 percent, respectively. Their return on assets is also positive: 1.3 percent for private banks and 3.1 percent for foreign commercial banks at year-end 2007.

Microfinance

Microfinance services in Bangladesh are provided by a range of NGO-MFIs, microfinance banks, government programs, nationalized commercial banks, and private commercial banks. Group-based lending methodologies prevail. According to Bangladesh Bank estimates, NGO-MFIs (estimated at 5,000 in number) are the largest providers of microfinance services in the country—serving 61 percent of all borrowers. A striking 90 percent of MFI clients are women and the average loan size is about BDT 4,000 ($57). The average interest rate on savings is 5 percent; the service charges on credit range from 10 to 20 percent for flat collection. The four main players in Bangladesh in terms of MFI members and market share are Grameen Bank, BRAC, ASA, and Proshika. However, the historically strong portfolio quality of these four MFIs declined in FY08 due to the effects of two floods and a cyclone.

The average annual growth rate in the microfinance sector in Bangladesh over the five years 2003–2008 was 23 percent. It is expected to reach 25 percent annually over the next three years (2009–2012) as a result of growing demand for larger loan sizes. Despite its significant outreach—estimated at 60 percent of all Bangladeshi households—microfinance assets remain less than 2 percent of GDP, having increased only marginally relative to GDP since 2001. The total loan portfolio of the microfinance sector is estimated to exceed BDT 135 billion and total borrowers, to exceed 30 million. Although it is difficult to estimate the unique number of microfinance borrowers, taking into account their cross-indebtedness to different microfinance providers, they likely number 18 million. It is estimated that just over 60 percent of them have incomes below the poverty line.

The Microcredit Regulatory Authority Act of 2006 limits two important potential MFI funding sources: equity investments and deposits. Foreign currency financing is also effectively prohibited. MFIs in general have access to a wide range of domestic funding sources. Retained earnings, savings, and the government-funded apex fund, PKSF, are the principal sources of funding for most MFIs. These sources seem adequate to cover current funding needs.

Private Sector and MSME Demand

The exact size of the MSME sector is difficult to quantify, particularly given the lack of recent data. The most recent comprehensive survey was conducted by the International Consulting Group (ICG) in 2003, which estimated the total number of MSMEs at 6 million enterprises. These enterprises employed 31 million people and accounted for roughly 25 percent of GDP. About 75 percent of these enterprises were located in rural areas, 90 percent had fewer than 10 workers, and just 2 percent had between 51 and 100 employees.

Financial constraints are the key obstacle faced by MSMEs in Bangladesh. MSMEs surveyed in the ICG study cited financial constraints more frequently than any other problem. **SMEs—the "missing middle"—face additional hurdles to accessing finance.** The total number of SMEs in the country is estimated at 79,754 establishments. SMEs generally seek loans ranging from BDT 20,000 to BDT 500,000 ($287–$7,170), which fall out of the target client range of MFIs. With two key exceptions (BRAC Bank and the state-owned BASIC Bank—the key players in this financing market), banks that cater to SMEs dedicate only a small proportion of their portfolios to SME finance.

Summary of Gaps

Banks and NBFIs. Banks and NBFIs may borrow in foreign currency, but the repayment of interest in foreign currency is prohibited. This restriction may impede banks and NBFIs from accessing important potential sources of international financing—and thus from expanding their SME loan portfolios.

MFIs. First, foreign currency financing is effectively prohibited, given that MFIs are allowed to accept foreign currency loans only at 0 percent interest—in other words, interest-bearing foreign currency loans are prohibited. Second, MFIs are prohibited from transforming into banks or NBFIs. They may, however, establish sister banks, following the BRAC Bank example. Bank regulations, such as a minimum public placement of 20 percent of shares, must be followed.

Improvements in corporate governance, reporting, and transparency are also necessary.

Retail microfinance. Industry data points to a generally well-served retail microfinance market. This does not, however, preclude the existence of specific gaps within the market.

- Although there is generally a good supply of credit, **two groups remain underserved in Bangladesh: the poorest of the poor and "graduating" microfinance clients**. While some MFIs have begun to offer savings and credit products to the former, demand remains largely unmet.

- Given the regulatory limitations on the product offerings of MFIs, **there is a lack of flexible, diversified savings products, insurance products, and remittance services on the market.**

Retail SME finance. There is significant unmet demand for retail SME financial services in Bangladesh. Retail loan sizes demanded by this group are generally too large for MFIs. MFIs, moreover, do not have the human resources or systems capacity to offer individual loans. Banks and NBFIs have also been hesitant to address these clients.

Refinancing. The sources of refinancing are overwhelmingly domestic and exclusively in local currency. However, existing refinancing sources may be insufficient to help MFIs keep up with the growth of their client base.

Refinancing for SME retail lending. Current refinancing options for providers of SME finance are limited. Bangladesh Bank has issued a clear call for additional support, noting that its current resources are not sufficient to close the gap.

There is also significant demand for MSME financing among banks and NBFIs willing to engage in downscaling. As with the case of MFIs, however, regulatory hurdles may impede opportunities for direct debt investments.

Projections

Based on information from local experts, this study makes the following assumptions about the microfinance sector over the next three years:

1. Equity will increase 10 percent each year over the next three years. This estimate is based on the trend in MFI profitability in Bangladesh (MIX Market data) for the two years, 2006–2008.
2. Savings will decline by 5 percent each year. Due to higher inflation levels, poor people have begun to withdraw savings to maintain their standard of living. Moreover, due to increasingly flexible savings products, these clients can withdraw their savings more easily.
3. PKSF funding will increase by 20 percent annually, as it has introduced new microfinance programs to provide MFIs additional funding. This estimate is based on the five-year average growth rate of funding to MFIs, 2002–2007.
4. Banks and NBFI funding will increase by 10 percent annually. Bangladesh Bank has recently initiated policies to encourage banks and NBFIs to increase agricultural and SME funding. To meet these targets, most banks are providing funding to MFIs for agricultural credit.
5. The remainder of the microfinance market will remain static.

Introduction

Political Environment

Following independence in 1971, Bangladesh has experienced bouts of democracy and rule by two military regimes. Since 2006 a caretaker government led by military-backed technocrats has been in place. In January 2007, the army, in a move generally supported by the population, intervened to quell political violence that had arisen when the opposition Awami League protested attempts by the outgoing Bangladesh Nationalist Party (BNP) to rig elections, which never took place. A state of emergency was declared, and the caretaker government assigned itself extraordinary powers and brought other political activity effectively to a halt. Concurrently, and reportedly under military pressure, the president resigned as chief advisor and was replaced by Dr. Fakhruddin Ahmad, the former head of the central bank. The caretaker government's ambitious plans to expand the voter registry, diminish corruption, and hold elections before the end of 2008 attracted domestic and international support.[1]

While progress has been made in improving the voter registry system, separating the judicial and executive branches of government, and reducing corruption, **further political reforms were needed to ensure that democratic elections were held before the end of 2008.** Dialogue between opposing political factions, especially between the BNP and Awami League, was a prerequisite to successful elections; a roadmap and timeline for elections needed to be implemented and adhered to, and the government's anti-corruption campaign required adherence to democratic principles, such as requiring warrants for arrests.[2] Local and parliamentary elections seemed set to proceed, although the extensive preparations required made delays probable. However, as long as emergency rule remained in place, the chance that elections would be free or fair was low.[3]

Corruption remains pervasive. For the last six years, Bangladesh has been consistently ranked as one of the most corrupt countries in the world by Transparency International. Most recently, it ranked 162 out of the 180 countries on the Corruption Perception Index (CPI)—a rank shared with countries such as Cambodia, Turkmenistan, and Venezuela. The government has made fighting corruption a centerpiece of its agenda. Its tough anticorruption campaign, which led to 440,000 arrests, is viewed on one hand as retribution against corrupt politicians who led the country for many years. On the other hand, the campaign has spurred members of the international

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[1] International Crisis Group (ICG), 2008, "Restoring Democracy in Bangladesh," Crisis Group Asia, Report no. 151, April 28, 2008, ICG, Dhaka/Brussels, http://www.crisisgroup.org/home/index.cfm?id=5408 (accessed August 2009).
[2] Ibid.
[3] *The Economist*, 2008, "The Unnoticed Emergency," June 2, 2008.

community, especially human rights groups, to call into question the government's adherence to democratic principles and human rights treaties.[4]

Islam has been established as the state religion, although freedom to practice other religions, within certain bounds, is protected by law. The majority of the 150 million population is Muslim (89 percent); Hindus comprise roughly 10 percent of the population, followed by very small minorities of Buddhists and Christians.[5] While traditionally viewed as a moderate and tolerant country, discrimination and violence against religious and ethnic minorities have become more frequent in recent years. Minorities generally exhibit low levels of political participation and have poor access to financial services; they have been subject to land confiscation by members of the Muslim majority under the pretense of the Vested Property Act. Hindu temples have also been attacked.[6]

The causes of this surge of discrimination and violence include the degradation of political institutions; inflows of funding from Saudi religious charities that promote the growth of Washbasin madrassas and the spread of a xenophobic and extreme version of Islam in Bangladesh; the infiltration of the Pakistani intelligence services into Bangladesh (in order to promote friction in northern India); and, finally, discrimination and violence against Muslims in India, which are used by Islamic extremists in Bangladesh to fan the flames of religious intolerance.[7] Although key leaders of two banned militant groups have been executed, large networks of militant activists remain in the country.[8]

The caretaker government is aware of this threat: a new counterterrorism ordinance was adopted in June 2008. However, this ordinance has received criticism for its overreaching definition of terrorist acts, legalization of arbitrary arrests, and limitations on certain freedoms, particularly the freedom of speech.[9] Additionally, tensions have flared between Bengali settlers and the Jumbo indigenous people. Although a peace accord was signed to resolve the

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[4] BBC World News, 2007, "Bangladesh at a Crossroads," April 5, 2007, http://news.bbc.co.uk/2/hi/south_asia/6530781.stm (accessed August 2009).

[5] Bangladesh Bureau of Statistics, 2007, *Statistical Yearbook of Bangladesh 2006*, 26th edition (Dhaka, Bangladesh: Bureau of Statistics), http://www.bbs.gov.bd/dataindex/yearbook_06.pdf (accessed August 2009), and U.S. Department of State, Bureau of Democracy, Human Rights, and Labor, 2008, "Country Reports on Human Rights Practices—2007," March 11, 2008, U.S. Department of State, Washington, DC, http://www.state.gov/g/drl/rls/hrrpt/2007/100612.htm (accessed August 2009).

[6] See Rabindranath Trivendi, 2008, "Hindu Lost 26 Lakh Acres of Land in Bangladesh," *Asian Tribune,* May 16, 2008, http://www.asiantribune.com/?q=node/11189 (accessed August 2009). The Vested Property Act has raised human rights concerns among international actors, such as the U.S. State Department and Amnesty International.

[7] Samit Ganguly, 2006, "A New Challenge for Bangladesh," *YaleGlobal Online* [Yale Center for the Study of Globalization, Yale University], March 30, 2006, http://yaleglobal.yale.edu/display.article?id=7196 (accessed August 2009).

[8] *The Economist,* 2008, "The Unnoticed Emergency."

[9] Human Rights Watch, 2008, "Bangladesh: Repeal New Terror Law," June 29, 2008, Human Rights Watch, New York, New York, http://hrw.org/english/docs/2008/06/30/bangla19227.htm (accessed August 2009).

long-standing problem, the institutional mechanisms supporting the accord have decayed under the current regime.[10]

Although Bangladesh has signed all major human rights treaties, human rights have suffered under the caretaker government, as reflected in increasing criticism from human rights groups.[11] In addition to the infringement of the rights of religious and ethnic minorities, political opposition leaders and human rights activities have also endured human rights abuses. Torture, extrajudicial killings, and overcrowded prisons plague the country. Improvements in human rights have little chance until the political situation is resolved.

The media is dominated by state-owned broadcasters. Rural areas have little access to the satellite and cable channels available to urban viewers; the primary rural media is state-run radio. While freedom of the press is cemented in the constitution, the government indirectly controls the media through the placement of official advertising and journalists are regularly harassed by police and political activists.

Looking ahead, the political situation will likely remain unstable in the near term. Key threats to political stability are expected to arise from the upcoming elections and increased violence from extremist groups. Elections will likely devolve into a contest between the Awami League and the BNP; delays are likely, and in the meantime, tensions could increase, particularly due to open questions surrounding the army's role in politics.[12]

Macroeconomic Context

Broad market-based reforms in the 1990s accelerated national growth, which rose from an average of 4.2 percent a year in the period 1986–1996 to 5.4 percent in the period 1996–2006.[13] What is remarkable is the stability of growth in the country—despite natural disasters—and the broad base of that growth, which includes manufacturing, services, and construction. Geographically, however, growth has remained centered in the urban areas of Dhaka and Chittagong. The volatile agricultural sector is a notable exception, accounting for a high, although declining, 20 percent of GDP; the textile industry remains the country's largest source of export earnings.[14] In 2007 real GDP growth reached 6.5 percent, driven by the industrial and service

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[10] Peace Campaign Group, 2008, "Non-Muslim Ethnic Minorities Persecuted in Bangladesh," April 24, 2008, Peace Campaign Group, New Delhi, India. Also see Bangladesh Watchdog (online blog), 2008, "Fresh Violence in CHT: Indigenous Villages Attacked," April 25, 2008, http://bangladeshwatchdog.blogspot.com/2008_04_01_archive.html (accessed August 2009).

[11] The Economist, 2008, "The Unnoticed Emergency."

[12] Ibid.

[13] World Bank, 2007, "Bangladesh at a Glance," September 28, 2007, World Bank, Washington, DC, http://devdata.worldbank.org/AAG/bgd_aag.pdf (accessed August 2009).

[14] Sandeep Mahajan, 2007, "Bangladesh: Strategy for Sustained Growth," Bangladesh Development Series, no. 18, Poverty Reduction and Economic Management Unit, World Bank, Washington, DC, http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/0,,contentMDK:21421907~pagePK:146736~piPK:146830~theSitePK:223547,00.html (accessed August 2009).

sectors, which grew by 9.5 and 6.2 percent, respectively.[15] Despite the threat posed by political instability, growth projections remained stable at 6.2 percent for 2008, driven by growth in household spending and investment. Growth projections for the period 2009–2012 range between 6.0 and 6.4 percent.[16] GDP per capita has more than doubled since 1975; in recent years it has grown more slowly, although commensurately, with GDP growth overall and is projected to continue on this trajectory.[17]

Table 1. Macroeconomic Picture, 2005–2007

	2005	2006	2007
GDP in billion US$ (billions)	60.3	61.9	68.4
GDP deflator (annual %)	5.1	5.2	6.8
GDP growth (annual %)	6.0	6.6	6.4
GDP per capita current US$	398.75	415.42	455.48
Official exchange rate US$ (average)	64.6	70.3	70.5
Foreign direct investment (FDI), net inflow (millions US$)	813	697	653
CPI (Base 1995–96 =100)	153.2	164.2	176.0
Sector share in GDP %			
Agriculture	26	20	19
Industry	27	28	28
Services	53	52	52

Source: World Bank, n.d., "Key Development Data & Statistics," Web page on World Bank Web site, Washington, DC, http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/0,,contentMDK:20535285~menuPK:1192694~pagePK:64133150~piPK:64133175~theSitePK:239419,00.html (accessed September 2009); IMF, 2008, "World Economic and Financial Surveys: World Economic Outlook Database," April 2008 edition, IMF, Washington, DC, http://www.imf.org/external/pubs/ft/weo/2008/01/weodata/index.aspx (accessed September 2009); Bangladesh Bank, n.d., "Consumer Price Index and Inflation in Bangladesh," Table VIII in "Monthly Economic Trends," http://www.bangladesh-bank.org/pub/monthly/econtrds/econtrdsviii.pdf (accessed September 2009). Historical average currency exchange rate provided by oanda.com (www.oanda.com) [accessed September 2009].
Note: Values rounded to first decimal place. CPI – Consumer Price Index.

Foreign direct investment (FDI) flows into Bangladesh have increased consistently from the early 1990s, rising from an annual average of $218 million in the period 1990–2000 to $697 million in 2006, when the total stock of such flows totaled $4.1 billion. This figure compares unfavorably, however, to FDI growth in the country's more investment-friendly South Asian neighbors, such as India. Globally, Bangladesh remains an underperformer regarding FDI inflows, ranking 121 out of 141 countries on the UNCTAD Inward FDI Performance Index. **Outward FDI flows from**

[15] Bangladesh Bank, 2008, *Financial Sector Review* III, no. 1 (February), Bangladesh Bank, Dhaka, Bangladesh, http://www.bangladesh-bank.org/mediaroom/press_release/press/fsr_08_pressrelease.pdf (accessed August 2009). The World Bank "Key Development Data & Statistics" database puts GDP growth at 6.6 percent in 2006 (see table 1 of this paper).
[16] Ibid.
[17] World Bank, 2007, "Bangladesh at a Glance."

Bangladesh are minimal.[18] Sectorally, FDI has played an important role in the start-up of the ready-made garment (RMG) industry in Bangladesh; inward flows continue to be directed towards the RMG subsector in particular, as well as the power, energy, telecommunications, and manufacturing sectors, more broadly.[19]

Inflation remains high, reflecting rising global food and energy prices. Consumer price inflation stood at 9.1 percent in 2007 and was projected at 8.5 percent for 2008 and 9.0 percent in 2009.[20] The reduction of fuel subsidies in July 2008 compounded the threat of increasing inflation—fuel price hikes ranged between 37.5 percent for diesel and kerosene, which are used primarily by the poorer rural population, and 68 percent for liquefied petroleum gas (LPG, used in appliances and vehicles), with hikes for petrol and furnace oil in the middle of the range. While the subsidy reduction improved the government's fiscal position, the state-owned oil company BPC faces a loss of roughly $1.5 billion, which has been financed by increased domestic borrowing.[21] BPC's declining credit quality has also negatively impacted the financial sector (see "Performance" section). Rising inflation, particularly food and energy prices, may also disproportionately erode the purchasing power of the poor. The government has promised to increase other pro-poor subsidies to compensate for the hike in fuel prices.[22]

Despite significant progress—the World Bank reports that the poverty rate has fallen by 20 percent since the early 1990s—40 percent of the Bangladeshi population lives below the national poverty line.[23] Moreover, per capita GDP compares unfavorably to that of the country's South Asian neighbors, adult illiteracy rates remain high (50 percent), and child malnutrition and maternal mortality rates are among the highest in the world. GDP per capita in urban areas is significantly higher than in rural areas.[24] The core of the government's poverty reduction strategy lies in directing credit to disadvantaged sectors, including small and medium enterprises (SMEs) and agriculture; incentivizing commercial banks to provide credit to disadvantaged sectors; and promoting microfinance for the poor.[25]

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[18] UNCTAD, 2007, *World Investment Report 2007* (Geneva: UNCTAD), http://www.unctad.org/en/docs/wir2007_en.pdf (accessed August 2009); andUNCTAD, 2007, "Bangladesh Country Fact Sheet," UNCTAD, Geneva, Switzerland, http://www.unctad.org/sections/dite_dir/docs/wir07_fs_bd_en.pdf (accessed August 2009).
[19] Md. Abdullahel Kafi, Mohammad Main Uddin, M. Muzahidul Islam, 2007, "Foreign Direct Investment in Bangladesh: Problems and Prospects," *Journal of Nepalese Business Studies* IV, no. 1 (December 2007): 47–61, http://www.nepjol.info/index.php/JNBS/article/viewFile/1029/1044 (accessed August 2009).
[20] *The Economist* and The Economist Intelligence Unit, 2008, "Bangladesh: Economic Data."
[21] Reuters, 2008, "Bangladesh Raises Fuel Prices to Cut Subsidies," July 1, 2008, http://www.reuters.com/article/GCA-Oil/idUSDHA13642820080701 (accessed August 2009).
[22] Anand Kumar, 2008, "Surging Energy and Food Prices will Accelerate Economic Downtrend in Bangladesh," Institute for Defense Studies & Analyses, New Dehli, India, July 30, 2008, http://www.idsa.in/publications/stratcomments/AnandKumar300708.htm (accessed August 2009).
[23] Bangladesh Bureau of Statistics, 2007, *Statistical Yearbook 2006*. Based on daily intake of less than 2,122 kilocalories per day.
[24] World Bank, 2007, "Bangladesh at a Glance;" and Mahajan**,** 2007, "Bangladesh: Strategy for Sustained Growth."
[25] Bangladesh Bank, 2008, *Financial Sector Review* III, no. 1 (February).

Bangladesh has a total labor force of about 70 million.[26] The labor market is highly segmented—between rural and urban areas, public and private job markets, and by gender. The majority of the labor force (a whopping 80 percent) is employed in the informal sector. All of these factors hinder the efficient functioning of the labor market. A 2005–2006 labor survey found that 23 percent of the labor force lived in urban areas and 77 percent, in rural areas, and that 48 percent was employed in the agricultural sector.[27] Urban areas provide more employment opportunities and a wage premium, yet labor mobility is impeded by poor living conditions and the higher cost of living in urban areas. There is also a significant wage premium for public sector jobs, which distorts wage structures. The workforce is predominantly male: only 25 percent of females who are eligible to work do so, and their wages are significantly lower than those of males.

In addition, skilled labor is severely lacking in Bangladesh. The average education of the workforce is just four years. Education and training in the country are, moreover, not geared toward market needs.[28] Overall, unemployment stands at just over 4 percent, but underemployment is rampant—particularly for women, for whom the underemployment rate is estimated at 68 percent.[29]

Significant amounts of labor are exported to the Middle East and even more to the country's prosperous South Asian neighbors. About 140,000 people per year, primarily semi-skilled and unskilled laborers, emigrated abroad from 1976 to 2004.[30] Remittances totaled approximately $7.9 billion—about 12 percent of GDP—in fiscal year 2008 (FY08, July 2007 through June 2008), representing growth of just over 30 percent over the previous fiscal year.[31] In FY07, remittances were estimated at about 9.85 percent of GDP.[32]

The key fiscal challenge for Bangladesh is to improve its revenue sources by, among other things, diversifying the tax base, reducing poverty, and promoting growth. The IMF has evaluated Bangladesh's fiscal policy as

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[26] Central Intelligence Agency (CIA), 2008, *World Factbook* (2008 online version), CIA, Langley, Virginia, https://www.cia.gov/library/publications/the-world-factbook/geos/bg.html (accessed October 2008).

[27] Bangladesh Bureau of Statistics, 2007, "Key Findings of Labor Force Survey, 2005–06," Bangladesh Bureau of Statistics, Dhaka, Bangladesh, http://www.bbs.gov.bd/dataindex/labour_%20force05-06.pdf (accessed August 2009).

[28] Mahajan, 2007, "Bangladesh: Strategy for Sustained Growth."

[29] Ibid.

[30] Rashed Al Hasan, 2006, "Harnessing Remittances for Economic Development in Bangladesh," INAFI (International Network of Alternative Financial Institutions), Bangladesh Working Paper Series, no. 1 (April 30, 2006), INAFI Asia, Dhaka, Bangladesh.

[31] Bangladesh Bank, 2008, *Financial Sector Review* III, no. 2 (June). Available on the Web site of the Bangladesh Bank, http://www.bangladesh-bank.org, choose "Publications," "Archive," and "Half Yearly Financial Sector Review" (accessed August 2009).

[32] Estimate based on figures provided by Bangladesh Bureau of Statistics, 2007, "Key Findings of Labor Force Survey, 2005–06."

generally prudent, given its modest deficit and domestic borrowing levels.[33] At year-end 2007, the budget deficit stood at 3.9 percent and was expected to increase to 4.8 percent in FY08, due to higher energy and grain prices, as well as costs associated with natural disaster relief.[34] The ratio of total debt to GDP stood at 25.5 percent in FY08.[35] High global energy and food prices will continue to pose fiscal challenges, however, despite the reduction in energy subsidies.

At the end of 2007, the national currency (the taka, or BDT) was trading at 68.87 to the U.S. dollar. After a volatile period in 2006, the BDT remained relatively stable throughout 2007 and the first half of 2008. The Economist Intelligence Unit forecast a stable taka in 2008, followed by a period of gradual depreciation against the dollar.[36] Because of the rising cost of imports, the central bank in April 2008 injected $600 million into the banking system to help the country meet import payments and cushion the downward trend of the taka. Foreign exchange reserves have fallen significantly from all-time highs reached in first quarter 2008.[37]

Bangladesh in the future will face challenges in balancing growth; an unstable political environment; and poverty reduction against a backdrop of rising import prices, increasing inflation, a depreciating taka, and a relatively unskilled and immobile labor force. Nevertheless, growth is projected to remain stable, given the country's broad growth base and strong manufacturing industry. Bangladesh has also prudently managed economic policy in the past despite numerous challenges, including those posed by the high cost of disaster relief.

Rating

To date Bangladesh has not been rated by any of the three major international rating agencies. In early 2008, Bangladesh Bank contacted several international rating agencies, and reportedly S&P and Moody's have initiated the ratings process. The Economist Intelligence Unit assigned Bangladesh a "B" rating in October 2008.

Government Priorities

Bangladesh has committed itself to achieving several Millennium Development Goals (MDGs) by 2015, particularly that of reducing poverty. Significant progress has been made on seven of the eight MDGs, although little progress has been made in reducing maternal mortality.[38] The World

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33 IMF, 2007, "Bangladesh: Selected Issues," IMF Country Report No. 07/230, IMF, Washington, DC, http://www.imf.org/external/pubs/ft/scr/2007/cr07230.pdf (accessed August 2009).
34 The Economist and The Economist Intelligence Unit, 2008, "Bangladesh: Economic Data."
35 Figures provided by Economic Relations Division, Ministry of Finance, and Statistics Department, Bangladesh Bank, summer 2008.
36 The Economist and The Economist Intelligence Unit, 2008, "Bangladesh: Economic Data."
37 Reuters, 2008, "Bangladesh Injects $600 Million to Cool Forex Market," April 21, 2008, http://in.reuters.com/article/asiaCompanyAndMarkets/idINDHA13385320080421 (accessed August 2009).
38 See "The MDGs and Bangladesh," UNDP Web site, UNDP, Dhaka, Bangladesh, http://www.undp.org.bd/mdgs.php (accessed August 2009).

Bank has called on Bangladesh to strengthen the accountability and transparency of public services as an essential element of meeting the MDGs.[39]

The government has placed a priority on diversifying its export base, currently concentrated in the ready-made garment industry, in light of the 2005 expiration of the Multi Fibre Arrangement (MFA)[40] and increasing competition from China and India. It has also reformed trade policy and engaged in export promotion, including lowering the cost of credit and providing tax breaks to export industries.[41]

In addition, the government seeks to improve the quality and increase the volume of financial intermediation, as well as to increase the flow of credit to priority sectors, which it considers the key to promoting pro-poor growth. In this regard, the Bank of Bangladesh has adopted policy measures to meet these goals, including increasing efficiency through restructuring and privatization of state-owned banks; improving the regulatory framework for microfinance; and generally improving transparency and accountability in the financial sector.[42]

Private Sector and MSMEs

Overview

As of August 2008 the net domestic assets of the country's banking system were valued at BDT 1.9 trillion ($28 billion).[43] In June 2007, total assets stood at BDT 1.5 trillion ($21.8 billion), indicating annual growth of 26.1 percent (BDT 404.2 billion, $5.8 billion) in just one year.[44]

The total market size for loans to MSMEs is estimated to be nearly BDT 400 billion ($5.7 billion).[45] The total amount of SME loans increased by BDT 100.2 billion ($1.4 billion), or 40 percent, to BDT 350.4 billion ($5 billion) at the end of June 2008, in comparison to BDT 250.2 billion ($3.6 billion) at the end of June 2007. In terms of institutional categories, loans extended to SMEs increased from June 2007 to June 2008 among private banks (+53.5

[39] World Bank, 2007, "To the MDGs and Beyond: Accountability and Institutional Innovation in Bangladesh," World Bank Web site, World Bank, Washington, DC, http://www.worldbank.org.bd/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/BANGLADESHEXTN/0,,contentMDK:21221096~pagePK:141137~piPK:141127~theSitePK:295760,00.html (accessed August 2009).

[40] The Multi Fibre Arrangement (MFA, also known as the Agreement on Textile and Clothing, or ATC) governed world trade in textiles and garments from 1974 through 2004, imposing quotas on the amount of textiles that developing countries could export to developed countries. It expired on January 1, 2005.

[41] Feroz Ahmed, Secretary, Ministry of Commerce of Bangladesh, 2008, "Export Strategy of Bangladesh," PowerPoint presentation (May 2008), Ministry of Commerce, Dkaha, Bangladesh.

[42] Bangladesh Bank, 2008, *Financial Sector Review* III, no. 2 (June).

[43] See exchange rate note on Abbreviations page of this report.

[44] Bangladesh Bank, 2008, "Major Economic Indicators: Monthly Update," Volume 10/2008 (October 2008), Bangladesh Bank, Dhaka, Bangladesh.

[45] Aurora Ferrari, 2008, *Increasing Access to Rural Finance in Bangladesh: The Forgotten "Missing Middle"* (Washington DC: World Bank).

percent), nonbank financial institutions (+43.4 percent), state-owned banks (+32 percent) and specialized banks (+15.1 percent). However, SME loans extended by foreign banks decreased by 20.5 percent.[46]

MSMEs in Bangladesh are generally considered to be businesses with under 100 employees; more specific definitions for each size category are provided in box 1 below. The exact size of the MSME sector is difficult to quantify, particularly given the lack of recent data. The most recent comprehensive survey was conducted by the International Consulting Group (ICG) in 2003, which estimated the total number of MSMEs, excluding rickshaws, at six million enterprises (including informal enterprises). These enterprises employ 31 million people and account for roughly 25 percent of GDP.[47]

Breaking down the ICG survey data, about 75 percent of these enterprises were located in rural areas, reflecting the high proportion of the population residing in rural areas. Ninety percent of all MSMEs had fewer than 10 workers, and just 2 percent had between 51 and 100. Analyzing the data by sector, the survey found that 40 percent of MSMEs were in the wholesale and retail trade and/or repairs sector, followed by 22 percent in agriculture, and 14 percent in manufacturing, with each of the remaining sectors comprising less than 5 percent of MSME businesses.[48] According to World Bank estimates in 2004, 40 percent of the rural workforce was employed in nonagricultural activities, which constituted more than 50 percent of the income of rural households. MSMEs accounted for most of these activities.[49]

Box 1. Defining MSMEs in Bangladesh

There is no single official definition of microenterprise in Bangladesh. Key players in the microfinance industry apply the following working definition: an enterprise that has capital (i.e., total investment, including fixed assets and working capital) between BDT 30,000 and BDT 1 million ($430–$14,300) and less than 10 employees. Microenterprises generally have a single owner-operator structure, although some are structured as partnerships.

MFI microenterprise loans range from BDT 20,000 to BDT 500,000 ($287–$7,170), but most such loans range from BDT 20,000 to BDT 50,000 ($287–$717). Very few microenterprises receive loans greater than BDT 50,000. Maturities range from six months to two years.

The average MSME loan size by type of lender are as follows (figures are provided from the period 2003–2006):

- Average bank loan: 408,081 BDT ($5,851)
- Average MFI loan: 38,250 BDT ($548)

[46] Bangladesh Bank, 2008,"Major Economic Indicators."
[47] Lisa Daniels, 2003, *National Private-sector Survey of Enterprises in Bangladesh, 2003* (Dhaka, Bangladesh: International Consulting Group and Micro Industries Development Assistance & Services). Available on the Web site of "Jobs—Creating Opportunities for Bangladesh," http://www.jobsproject.org/programs/Sl%2033.%20Natinal%20Private %20Sector%20Survey.pdf (accessed August 2009).
[48] Ibid.
[49] Ferrari, 2008, "Increasing Access to Rural Finance in Bangladesh."

Small and medium enterprises (SMEs) are clearly defined by the Ministry of Industry of Bangladesh. Small businesses in the manufacturing industry are defined as those having fixed assets valued at less than BDT 15 million ($220,000),[50] excluding the value of land. Nonmanufacturing businesses with fewer than 25 workers are also considered small businesses.

Medium-sized businesses in the manufacturing industry are defined as having fixed capital valued between BDT 15 and BDT 100 million ($220,000–$1.4 million), excluding the value of any land or buildings. Nonmanufacturing medium-sized businesses are defined as employing between 25 and 100 workers.[51]

Obstacles to Growth

Financial constraints are the key obstacle faced by MSMEs in Bangladesh. MSMEs surveyed in the ICG study cited financial constraints more frequently than any other problem. According to World Bank data of 2003, over 50 percent of rural enterprises (including both agricultural and nonagricultural enterprises) cited access to finance as a "major or severe obstacle to their operations."[52] In its most recent "Financial Sector Review," Bangladesh Bank supported these findings, finding access to finance a critical constraint on SMEs, indicating that despite the age of the 2003 survey, its conclusions remain relevant.

Among the MSMEs in the ICG study that cited financial constraints as a key problem, lack of operating funds was the primary constraint of about 75 percent. Another 14 percent cited lack of investment funds; the remainder cited nonpayment of credit by clients. The second most frequently reported problem in the survey was marketing—described by MSMEs primarily as a lack of customers. Other key constraints highlighted by MSMEs were natural disasters, electricity, and road conditions.[53] Of note, recent Bangladesh Bank findings indicate improvements in the ease of entry and/or exit of SMEs.[54]

Informal sources were the largest source of credit for the MSMEs surveyed by the 2003 study, at 35 percent. Only 18 percent of MSMEs received credit from formal sources, primarily commercial banks. Another 17 percent received credit from nongovernmental organizations (NGOs) and semiformal sources. Interestingly, 73 percent of respondents had never had an informal loan and 70 percent had never had a formal loan. The top three reasons cited for not having loans were: (1) no need for credit; (2) fear of being unable to repay a loan; and (3) complicated application procedures.[55]

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[50] Government of Bangladesh, Ministry of Industry, 2005, *Industrial Policy 2005* (Dhaka, Bangladesh: Ministry of Industry of Bangladesh).
[51] Ibid.
[52] Ferrari, 2008, "Increasing Access to Rural Finance in Bangladesh."
[53] Daniels, 2003, *National Private-sector Survey.*
[54] Bangladesh Bank, 2008, *Financial Sector Review* III, no. 2 (June).
[55] Daniels, 2003, *National Private-sector Survey.*

SMEs—the "missing middle"—face additional hurdles to accessing finance. As discussed in the following sections, microfinance in Bangladesh has flourished. Microbusinesses can access finance through many microfinance institutions (MFIs) that offer Grameen-style group lending services. However, "graduating" micro clients, together with small and smaller medium enterprises—which generally seek loans ranging from BDT 20,000 to BDT 500,000 ($287–$7,170)—fall out of the target client range of MFIs. These loan sizes are considered too large and too risky by these institutions. Moreover, MFIs may lack the capacity to provide individual loans; personnel may not be trained in loan assessment for individuals and MFI procedures and systems may not be adapted for individual loans. Some MFIs, such as Grameen, BRAC, ASA, and Proshika, have begun to offer products for graduating clients, defined as clients who have been with the respective institution for more than three years.[56]

Banks are the largest source of funding for SMEs. As of March 2008, private banks accounted for 54 percent of SME financing and state-owned banks, 30 percent, followed by specialized banks (10 percent), other financial institutions (4 percent) and foreign banks (2 percent). BRAC Bank and the state-owned BASIC Bank are the key players in SME finance in the country. The South Asia Enterprise Development Facility, SEDF, has also facilitated the access of SMEs to formal financial services. The total SME loan portfolio reached BDT 350.4 billion ($5 billion) in June 2008 (provisional), representing growth of about 15 percent over the six-month period, January through June of that year (see table 2).

Table 2. SME Loan Portfolio, 2007–2008

	June 2008 (provisional)		December 2007	
	SME loans (BDT billions)	SME loans (% of total loan portfolio)	SME loans (BDT)	SME loans (% of total loan portfolio)
Private banks	198.90	19.7%	16,248.61	18.2%
State-owned banks	99.19	33.3%	9,577.60	22.7%
Specialized banks	32.50	22.9%	3,054.38	23.3%
Foreign banks	6.12	6.5%	427.00	5.1%
Nonbank financial institutions	13.68	19.7%	1,279.37	18.7%

Source: Meeting with Bangladesh Bank, Agricultural and Special Programs Department, summer 2008.
Note: Total SME loan portfolios declined over the period above; that is, SME lending did not increase by 10 percentage points, rather, the proportionate increase is mostly due to an overall decline in the size of the loan portfolio.

[56] Rashed Al Hasan and K.M. Zahidual Islam, 2008, "Bridging the Gap between Microfinance and SME Finance in Bangladesh: Unlocking the Potential," *Daffodil International University Journal of Business and Economics* [Dhaka, Bangladesh] 3, no.1 (2008): 11–15.

Despite increasing interest in the SME segment, many banks remain reluctant to serve this target group—particularly the smaller end of the spectrum. Lack of collateral, low levels of capitalization, and high mortality rates (due to natural disasters) contribute to the perceived riskiness of the target group segment.[57]

Demand for Financial Services

Retail MSME Finance: Potential Demand and Supply Gap

According to a 2007 World Bank study, financial penetration in Bangladesh is adequate for its current level of development.[58] While this level of development refers only to the formal financial sector, the use of formal financial sector services is higher in Bangladesh than in comparable low-income countries. Moreover, Bangladesh has the highest microfinance penetration rate in the world: 13 percent of Bangladeshis have a microfinance loan.[59]

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[57] See Bangladesh Bank, 2008, *Financial Sector Review* III, no. 2 (June), and Al Hasan and Islam, 2008, "Bridging the Gap."
[58] Mahajan, 2007, "Bangladesh: Strategy for Sustained Growth."
[59] Ibid.

Box 2. Microfinance in Bangladesh: Estimating the Gap

Estimating Demand

Calculating the demand gap for microfinance services in Bangladesh starts with the current number of creditworthy poor. According to the 2005 Bangladesh Bureau of Statistics Household Income Expenditures Survey (HIES), the total population of Bangladesh was 140.6 million. Based on a minimum average daily intake of 2,122 kilocalories, 40 percent of Bangladeshis (about 56 million) live below the poverty line. According to the same survey, the hard-core poor, or those living on less than 1,805 kilocalories per day, are estimated at 27 million.

It is difficult to estimate how many poor people in the country are actually creditworthy. A recent *CGAP Brief* on addressing microfinance demand estimates in the country cited a study of Indonesia in which 40 percent of poor households were deemed creditworthy. However, the *Brief* also points to other studies that suggest Bangladesh exclusion rates are significantly lower than in other markets. One study cited by CGAP estimated that 10 percent of Bangladeshi households, or about 14.1 million people, are too poor to utilize existing microfinance products.[a] Erring on the side of conservatism, the present study estimates the number of creditworthy poor people at 40 percent of the total poor population, or 22.4 million. Adjusting this number for population growth over the last two years (1.4 percent in 2006 and 2.1 percent in 2007) yields a current estimate of potential creditworthy poor clients of 23.2 million.

However, at any one point in time, not all creditworthy poor need a microloan, nor will all microentrepreneurs who need a loan have a loan outstanding. Studies that have examined take-up rates use widely varying estimates of how many creditworthy microentrepreneurs actually demand microloans. These estimates range from 5 percent to about 25 percent of potential clients.[b] Yet Bangladesh, with its exceptionally high market penetration rates, remains an anomaly, thus it is difficult to apply comparative evidence to the market.

Evidence from the four largest MFIs in Bangladesh indicates that five of every six members had an active loan; this rate was considerably lower for smaller MFI-NGOs.[c] These numbers, however, do not consider the estimated 40 percent of microentrepreneurs who have loans with more than one institution.

This study deducts an additional 10 percent from potential creditworthy poor customers to account for the factors noted above, yielding an estimate of approximately 20.9 million creditworthy poor people—about 37 percent of the total number of poor people in Bangladesh. This result is then multiplied by an average loan size of BDT 9,252, an estimate based on the averages reported by a number of institutions. (In 2007, the average loan size for PKSF partner institutions was BDT 9,278; for ASA, BDT 7,868; for BRAC, BDT 12,351; and for Grameen Bank, BDT 7,509.[d]) This calculation yields an estimated total loan demand of BDT 182.3 trillion. Finally, the estimate is divided by average household size which, according to the 2005 HIES, was 4.85. The result is a demand estimate of BDT 37.6 billion.

Estimating Supply

The actual loan portfolio of the microfinance sector at year-end 2007 was approximately BDT 281.4 billion. This figure is misleading, however, since it is aggregated from individual microfinance institutions. Therefore, no overlap is taken into account. In other words, embedded in this figure are the 2–3 loans held by 40 percent of clients. Therefore it is difficult to compare estimated demand on a monetary basis.

Another approach is to estimate supply based on the number of borrowers. As of June 2008, the total number of borrowers in Bangladesh was estimated at 27.5 million. Multiplying this number by the average loan size of BDT 9,252 yields a total supply of BDT 254.7 billion. However, this number does not take into account the estimated 40 percent overlap, since the number of borrowers is aggregated from the reports of individual institutions—there is no centralized database that can accurately count the number of unique borrowers. Therefore, accounting for overlap, the total number of unique borrowers is more likely closer to 16.5 million. Multiplying this figure by the same average loan size yields a total supply of approximately BDT 152.9 billion.

Estimating the Gap between Demand and Supply

Based on the estimates above, the microfinance market in Bangladesh is clearly oversupplied. The calculations cited here, however, are notoriously precarious, given the dearth of accurate, up-to-date data. Nevertheless, circumstantial evidence, points to a generally well-served microfinance target market.

Source: Author and consultant estimates; and Malika Anand and Richard Rosenberg, 2008, "Are We Overestimating Demand for Microloans?", *CGAP Brief* (April), CGAP, Washington, DC, http://www.cgap.org/p/site/c/template.rc/1.9.2724 (accessed August 2009).

Note: [a] Stephen F. Rasmussen et al., 2005, "The Changing Microfinance Sector in Bangladesh," unpublished draft, as cited in Anand and Rosenberg, 2008, "Are We Overestimating Demand for Microloans?"
[b] Anand and Rosenberg, 2008, "Are We Overestimating Demand for Microloans?"
[c] Ibid.
[d] Estimate of local expert Rashed Al Hasan in 2008, based on information from PKSF Annual Report 2007; Grameen Bank Web site, ASA Annual Report 2007, and BRAC Web site.

Unfortunately, little information is available on the SME finance market. Only recently has Bangladesh Bank begun to require separate reporting on the SME portfolios of banks. For reasons discussed in boxes 2 and 3, the microfinance and SME markets are strongly segregated in Bangladesh and have therefore been examined separately.

Box 3. SME Finance: Estimating the Gap

Given the lack of data on SMEs in Bangladesh, it's not possible to accurately and quantitatively assess the gap between the demand for and supply of SME finance. Studies conducted by ICG and the World Bank, although somewhat outdated, clearly indicate that access to finance is the number one financial constraint of SMEs in Bangladesh. More recent qualitative evidence from Bangladesh Bank and other local experts support these earlier conclusions. (See the section entitled "Private Sector and MSMEs" above.)

On the supply side, again, little data is available. As noted above, Bangladesh Bank has only recently required banks to report separately on their SME portfolios. According to the most recent data on SME lending from Bangladesh Bank, 7,598 SMEs have been financed through the government-sponsored SME finance program. This is a miniscule number compared to the roughly six million MSMEs and estimated 80,000 SMEs in the country, the vast majority of which are small.[a] These SMEs fall in between the target clientele of MFIs and banks: loan sizes demanded by "graduating"' microclients or small businesses are generally too large for MFIs and MSMEs are deemed too risky by banks. With two key exceptions (BRAC Bank and BASIC), banks that cater to SMEs dedicate only a small proportion of their portfolios to SME finance. Bangladesh Bank has recently initiated policies to encourage banks to lend to this segment, but these policies have yet to bear fruit.

Together, these factors indicate significant unmet demand for SME finance in Bangladesh.

Source: "Bangladesh Bank Report Says: Development of SMEs Can Curb Poverty," 2008, PovertyNews. Blogspot.Com, January 2, 2008, as published by the Web site of Next Billion, Washington, DC, http://www.nextbillion.net/newsroom/2008/01/02/bangladesh-bank-report-finds-smes-can-curb-poverty (accessed August 2009).

Note: The total number of SMEs is estimated at 79,754 establishments, of which 93.6 percent are small and 6.4 percent are medium-sized. The ICG 2003 survey estimated that about 6 million micro, small, and medium enterprises were defined as enterprises; these businesses each had fewer than 100 employees and collectively contributed around 20–25 percent of GDP.
[a] Daniels, 2003, *National Private-sector Survey*; and ADB data cited in Al Hasan and Islam, 2008, "Bridging the Gap."

Where exactly do the gaps lie?

First, despite indications that the microfinance market is well served, not all subsegments of this market are served equally. **The poorest of the poor lack access to both MFI savings and credit products**. Living on less than $0.50 per day, these people typically lack assets and depend on bondage labor or begging for survival. Although some MFIs, such as BRAC, Grameen Bank, and the partner organizations of PKSF, have initiated efforts to offer savings and credit products to this group, as well as employment-generation and safety-net services, demand remains largely unmet.[60]

Reflected in the calculations above, **the next tier of the microfinance market** (the poor, as opposed to the hard-core poor) **are well served in terms of credit products.** In terms of savings products, a provision of the Microcredit Regulatory Authority Act (MRAA) requires that MFIs have a minimum equity of BDT 500 million ($7 million) in order to offer certain savings products, such as contractual or long-term savings and deposit pension schemes. Therefore, these products are offered by only a few large MFIs and Grameen Bank, given its exceptional status.[61] Moreover, MFIs can collect savings only from group members. **Due to these restrictions, a significant portion of entrepreneurial poor people who own businesses and are willing and able to invest in longer-term savings products do not have access to diversified savings products.**

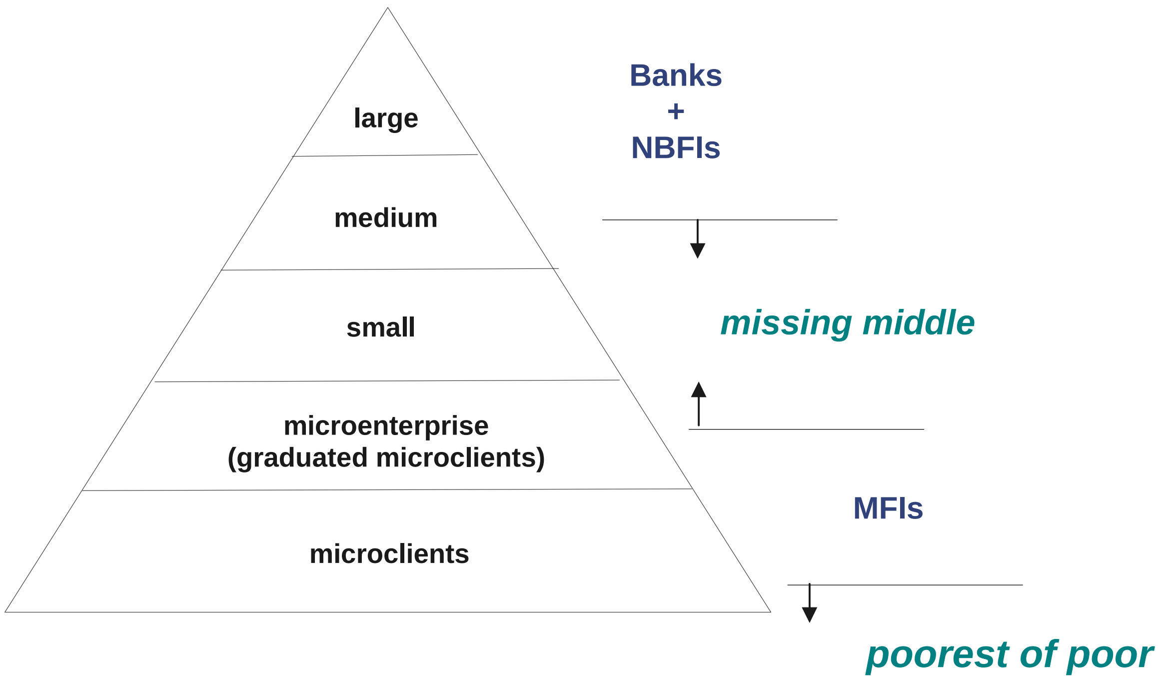
The second group lacking access to finance are "graduating" microfinance clients and smaller SMEs (both excluded from the demand calculations above), which together **form the "missing middle**." The MFI practice of providing consecutively larger loans to creditworthy clients is limited: when a microentrepreneur's business requires a loan size beyond the usual range, an MFI may be unable or unwilling to offer a larger loan. In general, MFIs are hesitant to offer a loan between BDT 50,000 and BDT 500,000 ($717–$7,170) to a first-time MSME client.

Additionally, MRA and PKSF[62] restrict lateral entry, as well as limit first-time loans. These restrictions may prevent MSMEs from accessing finance from MFIs. Banks and nonbanking financial institutions (NBFIs) are also reluctant to address these clients (see the section above entitled "Private Sector and MSMEs"), who are generally deemed risky, a reputation that is further aggravated by their low capitalization levels and lack of collateral. Therefore, MSME borrowers, particularly first-time borrowers, lack access to appropriate credit products.[63]

Geographically, unserved groups are scattered throughout the country. The majority of the poorest poor people live in northern Bangladesh, in particular, near the Jamuna River basin and in rural areas or urban slums.[64] MSME clients are scattered throughout the country, but are concentrated in rural, peri-urban, and urban growth centers.[65]

[60] Information provided by local expert Rashed Al Hasan.
[61] Ibid.
[62] Palli Karma Sahayak Foundation (PKSF) is a government-owned apex microcredit funding and capacity-building organization that provides microcredit to the poor through partner organizations. In English, PKSF means "Rural Employment Support Foundation." See its Web site at http://www.pksf-bd.org (accessed August 2009).
[63] Information provided by local expert Rashed Al Hasan.
[64] Specifically, the Rangpur, Dinajpur, Kurigram, Gaibandha, Lalmonirhat, Bogra, Jamalpur, and Sirajganj districts.
[65] Information provided by local expert Rashed Al Hasan.

Figure 1. Unserved Market Segments



Remittance Services Remittance services are provided by nationalized commercial banks, private commercial banks, and informal channels, including the *hundi* system.[66] Formal channels account for about half of remittance transfers, and the *hundi* system accounts for most of the remaining 50 percent. While banks have increasingly moved into the remittance transfer business, the *hundi* system, despite being illegal in Bangladesh, remains popular because it is fast, relatively inexpensive, and accessible. Moreover, NGO-MFIs, which have wider branch networks than banks, particularly in poorer rural areas, are prohibited from engaging in transfer services, which may effectively encourage microfinance clients in particular to use informal channels for remittance transfers. Among MFIs, only BRAC, through its sister institution, BRAC Bank, provides remittance transfer services through an agreement with Western Union.[67] While the gap between demand and supply is difficult to quantify, the current system effectively directs remittance transfers of poorer or rural clients toward informal channels, excluding their funds from the formal system; the system may exclude potential microfinance clients as well, who might otherwise take advantage of complementary services provided by microfinance institutions.

[66] The *hundi* system is a trust-based system. The foundation of the system is a loose network of traders who use their trading relationships to settle exchanges among themselves.
[67] Rashed al Hasan, 2006, "Harnessing Remittances."

Refinancing: Potential Gap between Demand and Supply

Microfinance

The primary sources of refinancing for MFI providers are equity, deposits, and funding from PKSF.[68] A breakdown of current microfinance refinancing sources is provided in table 3 below.

Table 3. Refinancing Sources for MFIs

Sources of funds	BDT millions	Percentage
Equity	36,000	31.3%
Savings	35,550	30.9%
PKSF	24,114	21.0%
Banks & NBFIs	16,525	14.4%
Others	2,811	2.4%
Total	**115,000**	**100.0%**

Source: Assumptions and calculations based on information provided by PKSF and other large and medium MFIs; and MRA, 2006, "Bank-NGO-MFIs in Bangladesh."

Other funding sources include loans or grants from donors and international organizations, such as the Anukul Foundation/CARE, Stromme Foundation, Swiss Development Cooperation, and Plan Bangladesh, among others. International financial institutions currently represent only a small source of funding for MFIs.

Looking ahead over the next three years, the current funding allocation is expected to change. Based on information from local experts, this study makes the following assumptions:

1. Equity will increase 10 percent each year over the next three years. This estimate is based on the trend in MFI profitability in Bangladesh (MIX Market data) for the two years, 2006–2008.
2. Savings will decline by 5 percent each year. Due to higher inflation levels, poor people have begun to withdraw savings to maintain their standard of living. Moreover, due to increasingly flexible savings products, these clients can withdraw their savings more easily.
3. PKSF funding will increase by 20 percent annually, as it has introduced new microfinance programs to provide MFIs additional funding. This estimate is based on the five-year average growth rate of funding to MFIs, 2002–2007.
4. Banks and NBFI funding will increase by 10 percent annually. Bangladesh Bank has recently initiated policies to encourage banks and NBFIs to increase agricultural and SME funding. To meet these targets, most banks are providing funding to MFIs for agricultural credit.
5. The remainder of the microfinance market will remain static.

[68] This section is based on information provided by local expert Rashed Al Hasan.

It has been assumed that MFIs in Bangladesh can maintain their growth rates (that is, loan portfolio growth rates) based on current refinancing options. However, it will difficult for them to do so. As the demand for larger loans increases and the refinancing source of savings decreases, it will difficult for MFIs to meet demand. Existing refinancing sources are thus not adequate to help MFIs serve the growth of existing clientele.

The average annual growth rate in the microfinance industry in Bangladesh over the last five years was 23 percent.[69] It is expected to reach 25 percent annually over the next three years (2009–2012) as a result of growing demand for larger loan sizes. Moreover, more MSME clients will be established during these three years.

Since MRA regulations prohibit dividend distribution that discourages equity investments, all external funding is generally debt financing. This funding is in local currency, since borrowing in foreign currency is effectively prohibited (it is allowed, but only at a 0 percent interest rate).

Table 4. Refinancing Terms for MFIs

Funding source	Maturity period	Interest rate
PKSF	For large MFIs: 5 years with a 1-year grace period For small and medium MFIs: 3 years with a 6-month grace period	For large MFIs: 7% per annum For small and medium MFIs: 1–4.5% per annum
Banks and NBFIs	1–3 years	6%–14.5% per year
Others	1–3 years	6%–10% per year

Source: Local Bangladesh microfinance expert Rashed al Hasan.

SME Finance

As noted above, little data exists on the retail market for SME finance; even less data is available for the refinancing market, making the refinancing gap impossible to quantify. Table 5 presents the most recent available information from Bangladesh Bank on its SME refinancing facility, which is supported by the World Bank and the Asian Development Bank. Three banks—BRAC, Eastern, and Dhaka—accounted for more than 50 percent of the facility. Beginning in July 2008, the facility (called the SME Foundation) planned to disburse an additional BDT 2 billion in refinancing for SME lending, 80 percent of which was targeted at small businesses. Despite these funds, Bangladesh Bank has issued a clear call for additional support, noting that its current resources are not sufficient to close the gap in SME financing.

[69] Calculation based on information on MFI loan portfolios of PKSF partners for the five years, 2002–2006 (PKSF, various years, "Summary of Foundation's Loan Program," PKSF, Dhaka, Bangladesh, http://www.pksf-bd.org/Lending%20Activities%20of%20pksf.htm [accessed August 2009]), together with information provided by the following MFIs on their loan portfolios, 2004–2006: BRAC, ASA, Grameen Bank, BURO Bangladesh, and Shakti Foundation.

Table 5. Bangladesh Bank SME Refinancing Facility

Name of banks or Fis	Amount refinanced (BDT millions)				No. of beneficiaries	Average amount refinanced per enterprise (BDT millions)
	Working capital	*Medium term*	*Long term*	*Total*		
Banks						
NCC/Bank Ltd.	21.6	155.0	14.8	191.4	796	0.2
Jamuna Bank Ltd.	164.8	29.3	15.4	209.5	152	1.4
National Bank Ltd.	15.0	0.0	0.0	15.0	4	3.8
ONE Bank Ltd.	197.1	141.8	14.8	353.7	445	0.8
Premier Bank Ltd.	239.0	24.5	9.3	272.8	227	1.2
BRAC Bank Ltd.	48.6	637.8	0.0	686.4	1,736	0.4
Southeast Bank Ltd.	81.2	3.2	3.5	87.9	86	1.0
Dutch Bangla Bank Ltd.	100.8	1.3	0.0	102.1	56	1.8
Mercantile Bank Ltd.	0.8	34.2	0.0	35.0	344	0.1
Eastern Bank Ltd.	113.8	262.1	240.3	616.2	581	1.1
Dhaka Bank Ltd.	326.5	149.8	0.0	476.3	553	0.9
Trust Bank Ltd.	17.6	0.4	0.6	18.6	15	1.2
Prime Bank Ltd.	198.1	10.7	6.9	215.7	234	0.9
Bank Asia Ltd.	0.3	10.0	0.0	10.3	21	0.5
Bank subtotal	**1,525.2**	**1,460.1**	**305.6**	**3,290.9**	**5,250**	**0.6**
Financial institutions						
Uttara Finance & Investment Ltd.	8.7	123.1	360.5	492.3	279	1.8
Prime Finance & Investment Ltd.	22.5	19.0	14.3	55.8	31	1.8
MIDAS Financing Ltd.	0.7	325.7	168.0	494.4	776	0.6
IDLC of Bangladesh	7.7	317.9	82.9	408.5	348	1.2
Phoenix Leasing Co. Ltd.	11.6	54.1	71.7	137.4	129	1.1
United Leasing Co. Ltd.	60.1	124.9	140.4	325.4	209	1.6
Vanik Bangladesh Ltd.	0.3	0.5	0.0	0.8	2	0.4
Bay Leasing	2.5	5.1	4.7	12.3	8	1.5
Fidelity Assets & Securities Co. Ltd.	0.0	9.0	234.5	243.5	143	1.7
Islamic Finance and Investment Ltd.	6.1	120.7	23.2	150.0	125	1.2
Peoples Leasing and Financial Services Ltd.	4.0	28.9	196.1	229.0	123	1.9
Bangladesh Finance and Investment Ltd.	0.0	12.6	59.3	71.9	25	2.9
IIDFC	17.0	29.3	58.9	105.2	67	1.6
GSP Financing	5.0	0.0	20.8	25.8	6	4.3
National Housing Ltd.	4.0	7.6	9.1	20.7	12	1.7
Oman Bangladesh	0.0	1.2	4.0	5.2	21	0.2
International Leasing	4.6	31.8	24.3	60.7	26	2.3
Union Capital	5.0	3.5	9.5	18.0	7	2.6
Fareast Finance and Investment Ltd.	0.0	1.3	0.0	1.3	2	0.7
Premier Leasing	0.0	11.4	6.7	18.1	9	2.0
FI subtotal	**159.8**	**1,227.6**	**1,488.9**	**2,876.3**	**2,348**	**1.2**
Grand total	***1,685.0***	***2,687.7***	***1,794.5***	***6,167.2***	***7,598***	***0.8***

Source: Bangladesh Bank, 2008, *Financial Sector Review* III, no. 2 (June).

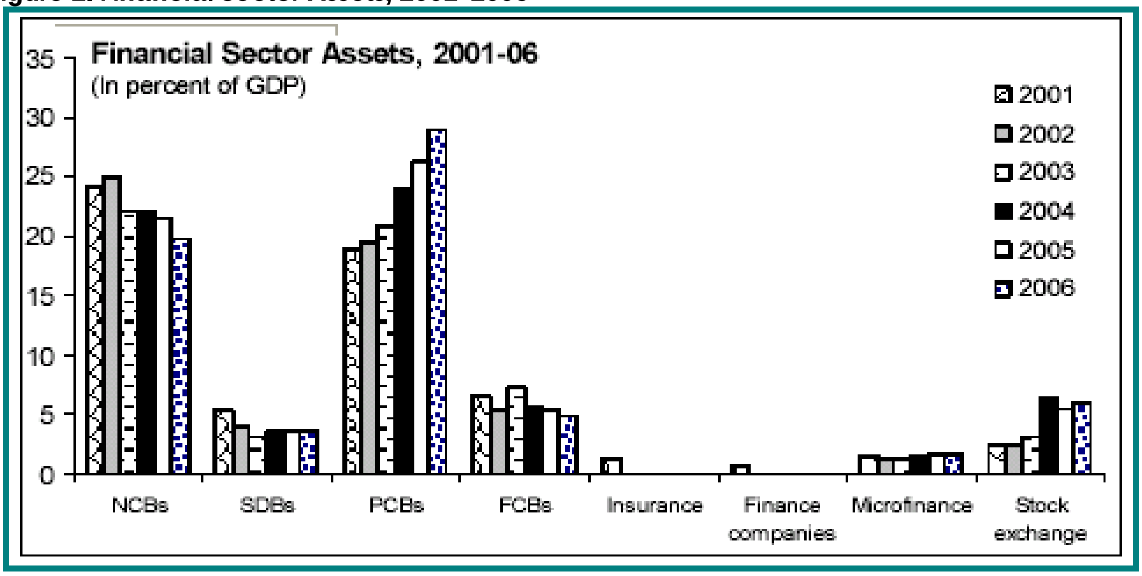
Financial Sector Overview

Number and Type of Financial Institutions

The financial sector consists of the central bank, Bangladesh Bank, 4 state-owned commercial banks, 5 government-owned specialized (development) banks, 30 domestic private commercial banks, 9 foreign-owned commercial banks, and 29 NBFIs. In terms of both industry assets and deposits, private commercial banks command the greatest market share. Additionally, 298 microcredit organizations are licensed by the Microcredit Regulatory Authority (MRA). Insurance companies, stock exchanges, and cooperative banks comprise a smaller part of the financial system.[70]

In late 2006, financial sector assets totaled roughly 69 percent of GDP. The banking sector accounted for the majority of these assets, at 58 percent, followed by the securities market, which accounted for another 6 percent of GDP. The remainder of financial sector assets were in nonbank financial institutions (NBFI), insurance companies, and microfinance institutions.[71]

Figure 2. Financial Sector Assets, 2001–2006



Source: IMF, 2007, "Bangladesh: Selected Issues."

[70] See "Financial System," n.d., Bangladesh Bank Web site, Dhaka, Bangladesh, http://www.bangladesh-bank.org/fnansys/fnansys.html (accessed August 2009).
[71] IMF, 2007, "Bangladesh: Selected Issues."

Banks

Together with foreign-owned commercial banks, private commercial banks have gained market share since 2001 at the expense of the less efficient state-owned commercial and specialized banks.[72]

In 2006, the four **state-owned (or nationalized) commercial banks** had assets of BDT 786.7 billion, or 33 percent of total banking sector assets. They then controlled 35 percent of deposits and operated 3,384 branches—roughly half of the total number of bank branch outlets in Bangladesh.[73] These banks have traditionally focused on lending to state-owned enterprises.

The six **development finance institutions,** or **specialized banks,** as they are also known, have total assets of BDT 187.2 billion—roughly 8 percent of banking assets. They control just over 5 percent of total banking sector deposits and have a network of 1,354 branches.[74] **The specialized banks, like the nationalized commercial banks, require restructuring;** operational efficiency lags and nonperforming loans are rampant among them. The government has initiated efforts to merge two of the specialized banks, Bangladesh Shilpa Bank and Bangladesh Shilpa Rin Sangtha, to improve efficiency.[75] Another two of these banks, Bangladesh Krishi Bank and Rajshahi Krishi Unnayan Bank, were established to provide credit to the agricultural sector, while the two being merged were mandated to provide loans to the industrial sector.

Although the specialized banks generally provide agricultural-related financial services, the **Bangladesh Small Industries and Commerce Bank Limited (BASIC)**, is one of the key players in SME financing in the country. It provides a full range of commercial banking services, including term loans and technical assistance, to mainly smaller-scale businesses. BASIC also provides microcredit to the urban poor through linkages with NGOs.[76]

Private commercial banks have experienced the fastest growth in the banking sector, benefiting from the liberalization of the sector in the 1990s. From 2001 to 2006, the assets of these banks grew by 10 percentage points, to 29 percent of GDP, reaching BDT 1.1 trillion in 2006.[77] As of that year, these banks held about 50 percent of banking sector assets overall and about 50 percent of total deposits. Their branch network is less extensive that that of their state-owned counterparts, however, totaling about 1,776 branches in 2006.

As noted above, private commercial banks are the leading providers of financial services to SMEs in Bangladesh. Noteworthy players in this market

[72] Bangladesh Bank, 2007, "Banking Sector Performance, Regulation, and Bank Supervision," chapter 5 of "Annual Report 2006–2007," Bangladesh Bank, Dhaka, Bangladesh.
[73] Ibid.
[74] See statistics for five of the six state banks in Bangladesh Bank, 2007, "Banking Sector Performance."
[75] Bangladesh Bank, 2008, *Financial Sector Review* III, no. 2 (June).
[76] See the BASIC Bank Web site, http://www.basicbanklimited.com/bank.htm (accessed August 2009).
[77] IMF, 2007, "Bangladesh: Selected Issues."

segment include **BRAC Bank, Eastern Bank, and Dhaka Bank**. (See the earlier sections "Private Sector and MSMEs" and "Demand for Financial Services.")

Foreign-owned commercial banks were also big winners of liberalization. Their combined assets of BDT 285 billion account for roughly 12 percent of total banking sector assets. These banks also command approximately 8 percent of total deposits; their combined branch network consists of 48 outlets.[78]

Microfinance

Despite its significant outreach—estimated at 60 percent of all Bangladeshi households—microfinance assets remain less than 2 percent of GDP, having increased only marginally relative to GDP since 2001. Yet the number of microfinance institutions more than doubled during this period.[79] The total loan portfolio of the microfinance sector is estimated to exceed BDT 135 billion and total borrowers, to exceed 30 million (see table 6). Although it is difficult to estimate the unique number of microfinance borrowers, taking into account their **cross-indebtedness to different microfinance providers—estimated at 40 percent of total borrowers—**it is likely the number is just over 18 million. Of this number, it is estimated that just over 60 percent have incomes below the poverty line.[80]

Overview of Microfinance Players

Microfinance services in Bangladesh are provided by a range of NGO-MFIs, microfinance banks (such as the Grameen Bank), government programs, nationalized commercial banks, and private commercial banks.

Table 6. Microfinance Players

Organization	*No. of borrowers*	*Outstanding loans (BDT millions)*
NGO-MFIs (June 2006)	18,415,878	78,930.6
Grameen Bank (June 2006)	6,908,704	33,235.5
Government program (December 2005)	1,997,240	7,710.1
Subtotal	**27,621,573**	**120,493.5**
Nationalized commercial banks (December 2005)	2,311,150	32,783.5
Private banks (December 2005)	164,113	1,106.5
Subtotal	**2,475,263**	**33,889.9**
Grand total	**30,096,836**	**154,383.43**

Source: MRA; Grameen Bank; Bangladesh Bank, n.d., "Table 1. Coverage of Microcredit Program," Web site of Bangladesh Bank, Dhaka, Bangladesh, website: http://www.bangladesh-bank.org/, choose "Financial System," then "Micro Finance Institutions (MFIs)" (accessed August 2009).

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78 Bangladesh Bank, 2007, "Annual Report, 2006–2007."
79 IMF, 2007, "Bangladesh: Selected Issues."
80 Bangladesh Bank, n.d., "Microfinance Institutions," NGO-MFIs, Vol. 3, Bangladesh Bank, Dhaka, Bangladesh, http://www.bangladesh-bank.org, choose "Financial System," then "Micro Finance Institutions" (accessed August 2009).

NGO-MFIs

According to Bangladesh Bank estimates, NGO-MFIs, which are estimated to number 5,000, are the largest providers of microfinance services in Bangladesh–serving 61 percent of all borrowers.[81] A striking 90 percent of MFI clients are women and the average loan size is about BDT 4,000 ($57).[82] A 2006 microcredit mapping exercise conducted by PKSF indicates that all districts in Bangladesh have access to microcredit services.[83] On one hand, the low average loan size, an orientation toward women, and geographical outreach indicate adequate development impact; on the other hand, the same low average loan size calls into question the use of loans for investment purposes.

Growth of the sector has been strong. Year-over-year from 2005 to 2006, the number of borrowers increased by about 23 percent, and loans outstanding, by approximately 34 percent—although these numbers may not reflect the cross-indebtedness of microfinance clients.[84]

Table 7. Categorization of MFIs in Bangladesh, 2006

Number of members/ borrowers	No. of MFIs on the basis of members	% of MFIs on the basis of members	No. of MFIs on the basis of borrowers	% of MFIS on the basis of borrowers	Remarks
<10,000	483	75.35	521	81.28	Very small
> or =10,000 but <50,000	123	19.19	92	14.35	Small
> or =50,000 but <100,000	20	3.12	15	2.34	Medium
> or =100,000 but <1,000,000	12	1.87	10	1.56	Large
>1,000,000	3	0.47	3	0.47	Very large
Total	**641**	**100.00**	**641**	**100.00**	

Source: Microcredit Regulatory Authority, 2006, "NGO-MFIs in Bangladesh", Vol. III (June), MRA, Dhaka, Bangladesh. Available on the Web site of Bangladesh Bank, choose "Publications," then "All," then "NGO-MFIs in Bangladesh" (accessed August 2009). A total of 641 MFIs were classified by this study.

The MFI market is concentrated, with the top 20 institutions accounting for 80 percent of the outstanding MFI loan portfolio.[85] The Microcredit Regulatory Authority, or MRA, classifies MFIs into 5 categories, based on size, as shown in table 7 above. The 35 MFIs classified as very large, large, and medium are the primary MFI players in Bangladesh. Indeed, it is

[81] See Bangladesh Bank, n.d., "Microfinance Institutions."
[82] Ibid.
[83] PKSF, 2006, "Maps on Microcredit," PKSF, Dhaka, Bangladesh. For a "Map of Upazillawise Distribution of MFIs (December 2005)," see http://www.pksf-bd.org/bangladesh_map05/maps%20on%20microcredit7.html; for a map showing the distribution of microcredit borrowers in Bangladesh, see http://www.pksf-bd.org/bangladesh_map05/maps%20on%20microcredit3.html. (All URLS accessed August 2009).
[84] MRA, 2006, "NGO-MFIs in Bangladesh," Vol. III (June), MRA, Dhaka, Bangaldesh. Available on the Web site of Bangladesh Bank, www.bangladesh-bank.org (choose "Publications," then "All," then "NGO-MFIs in Bangladesh"). (Accessed August 2009.)
[85] See Bangladesh Bank, n.d., "Microfinance Institutions."

estimated that these 35 players account for 80 percent of microsavings. Three MFIs, ASA, BRAC and Proshika Manobik Unnayan Kendro (PMUK), have countrywide networks and are classified as very large. Together, they account for 56 percent of savings mobilization in the sector.[86]

Services provided by MFIs generally include both savings and credit. According to Bangladesh Bank estimates, MFIs offer clients an average interest rate on savings of 5 percent; the service charges on credit range from 10 to 20 percent for flat collection; PKSF partners charge 12.5 percent.[87] Group-based lending methodologies prevail.

MFIs usually follow a special form of group lending in the country: they form a group in order to establish bonds among group members and then lend to individual members. The loan installments and savings are collected by the MFIs during group meetings, which usually take place once a week.[88]

Collateral-free group-based lending, that is, social collateral and mobilization of savings, even in small amounts, have helped microfinance programs counter the problems of weak outreach and high loan default costs. While nonperforming loans (NPLs) remain low within the microfinance sector, the transaction costs associated with maintaining credit discipline via social pressure and monitoring remain high.

The four main players in Bangladesh in terms of MFI members and market share are Grameen Bank, BRAC, ASA, and Proshika.

Grameen Bank ("Grameen") is an MFI that is 95 percent owned by its members, who are primarily women, and 5 percent by the Bangladesh government. As of July 2008, Grameen borrowers totaled 7.5 million, 97 percent of whom were women. According to recent estimates, the bank alone serves 24 percent of all microfinance borrowers.[89] At year-end 2007, Grameen Bank's assets totaled BDT 60 billion and its deposits stood at 44 billion. The bank has a network of 2,521 branches that spans the country, covering more than 98 percent of the villages in Bangladesh.[90]

Begun in 1974 as an experiment by recent Nobel-prize winner Professor Muhammad Yunus, who initially invested his own money to lend to the poor, today Grameen Bank has turned into one of the most successful MFIs worldwide. It is well known to the microfinance community all over the globe. Since 1995 Grameen Bank is no longer dependent on external financial support, but claims to operate solely on the basis of credit

86 MRA, 2006, "NGO-MFIs in Bangladesh," Vol. III (June).
87 See Bangladesh Bank, n.d., "Microfinance Institutions."
88 Information provided by local expert Rashed al Hasan.
89 See Grameen Bank Web site, http://www.grameen-info.org/(accessed August 2009).
90 Ibid.

repayments. It has diversified its product range, which now includes a current housing loan product for families.

The Grameen Bank group of companies comprises a range of diversified companies, including mutual funds; a trust company; and telecommunications, rural power, communications, education, textiles, and Internet services companies.[91]

BRAC (Bangladesh Rural Advancement Committee) was founded in 1972 and initially focused on resettling refugees returning from India. Today, BRAC is one of the world's largest NGOs, with over 5 million borrowers in 170,277 village organizations whose microfinance programs serve 69,421 villages and 1,716 urban slums in all 64 district of Bangladesh. More than 20,000 out of 95,898 total BRAC personnel (72 percent of whom are women) work for the microfinance program in its 3,054 offices, which provide coverage to an estimated 110 million people. BRAC offers a broad range of services to its clients with a special focus on its core programs, which as of late 2008 included economic development; health, education, and social development; and human rights and legal services.

BRAC is especially active in the area of poverty reduction. One of its actions in this area was the initiation of the program, "Challenging the Frontiers of Poverty Reduction—Targeting the Ultra Poor (CFPR-TUP)" in 2002. The subsidized program targets the poorest 15 percent of the very poor population**, who are offered income-generating assets, training, and health care services.** This part of the population is believed to be too poor to be eligible even for microcredit; **the CFPR-TUP scheme offers them opportunity ladders to help them transition into BRAC's mainstream microfinance programs**.. The program was believed to have reached 100,000 households in 2006. BRAC also runs the "Income Generation for Vulnerable Group Development (IGVGD) Program," which targets women between 18 and 49 years old who are divorced, separated, or have a disabled spouse and assets of 15 decimals of land or less.

In 2006, the average BRAC loan size was $164.25 and the MFI's outstanding loan disbursements were $626.7 million, with a repayment rate of 99.5 percent and a cost per U.S. dollar lent as low as $0.1. In 2006, the savings of BRAC members amounted to $115.8 million, with $358.2 million outstanding (i.e., savings that are no longer earning any interest).

Of note, BRAC has been expanding its activities internationally in such countries as Afghanistan, Tanzania, Sri Lanka, and Uganda.[92]

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[91] See Grameen Bank Family Web site, http://www.grameen-info.org/index.php?option=com_content&task=view&id=465&Itemid=547 (accessed August 2009).
[92] All information is excerpted from BRAC, 2007, "Annual Report 2006," BRAC, Dhaka, Bangladesh, http://www.brac.net/downloads_files/BRAC_Annual_Report_2006.pdf (accessed August 2009); and S.R. Osmani et al., 2003, "Macroeconomics of Poverty Reduction: The Case Study of Bangladesh," paper commissioned by the UNDP

ASA began in 1979 with an initial mission to empower the oppressed through "peoples organizations" mobilized for social action against exploitation, as well as through legal aid to fight social injustice. In 1984, ASA operations shifted focus to the basic social unit—the family—a shift that recognized the critical role that women must play in development. In the late 1980s, ASA began to incorporate training in management skills for income-generating projects and to stress the importance of savings in development education efforts. At this point, microcredit delivery became a natural extension of its successful development education for poor rural women in Bangladesh.

In July 2006 ASA's cumulative loan disbursement was $2.7 billion, total loans outstanding were $349 million, and the MFI had 4.72 million borrowers. At the end of 2005 ASA's operational self-sufficiency (OSS) was 275 percent, financial self-sufficiency was 170 percent, and its loan recovery rate was 99.88 percent. ASA conducts operations in over 2,502 branches located in 64 administrative areas all over Bangladesh. In recent years the organization has also been active in the development of a variety of saving products. For example, ASA now offers customers liquid, semi-liquid, and high-return savings options that have attracted around $49 million in deposits. The MFI is currently involved in several countries worldwide, providing ASA experts to help develop financial sectors that are inclusive of low-income groups.[93]

Together with SEQUOIA, a private equity company from the Netherlands, ASA has partnered with **CMI (Catalyst Microfinance Investors),** a microfinance fund managed by microfinance practitioners, to help launch ASA-MFIs in developing countries in Asia and selected parts of Africa. CMI's goal is to invest in emerging microfinance institutions with promising potential. CMI has selected a number of countries, including India, Sri Lanka, Cambodia, Philippines, Pakistan, Ghana, and Nigeria, where it seeks to invest its fund. CMI's raised initial capital of $3 million in August 2005. In October 2007 it announced that it had achieved total initial commitments of $50 million from leading institutional and private investors in the United States and Europe. In 2007, CMI had total equity of $125 million.[94]

Proshika officially started operations in 1976. Its name is an acronym of three Bangla words that stand for training, education, and action. Its mission is to create self-employment opportunities for the poor in order to both bring households out of poverty and increase literacy. Initially it fulfilled its social intermediation objectives through group formation and consciousness raising, rather than service provision. Among its activities today are skills and

Asia-Pacific Regional Programme on Macroeconomics of Poverty Reduction, UNDP, New York, http://www.ipc-undp.org/publications/reports/Bangladesh.pdf (accessed August 2009).

[93] See the ASA Web site, http://www.asa.org.bd/ (accessed August 2009).

[94] See the Web site of CMI, Utrecht, The Netherlands, http://www.catalyst-microfinance.com/ (accessed August 2009).

management development training, hands-on technical advice, and marketing assistance.[95]

According to data from 2006, PROSHIKA was active in 23,475 villages and 2,101 urban slums in 57 districts of Bangladesh. The organization now works with nearly 2.75 million members.[96]

In the 1990s, the Bangladesh government decided to set up the **Palli Karma Sahayak Foundation (PKSF)**. PKSF was created as a wholesale agency to provide financing and institutional development services (training) to MFIs. Since its inception, PKSF has been and is still today a major force in the development of the microfinance market in Bangladesh. It is supported by many leading multinational donor agencies, such as the World Bank, European Union, Asian Development Bank, and International Fund for Agricultural Development.[97]

Table 8. Source of Funds for Microcredit Lending (in %), 1996–2000

	1996	1997	1998	1999	2000	2001	2002
Member savings	26.5	17.1	22.6	27.4	27.6	26.2	29.6
PKSF	11.8	17.1	23.2	26.0	24.0	24.6	24.2
Donors	58.8	34.2	28.0	20.6	20.4	18.9	16.6
Interest income	0.0	15.4	13.4	13.5	17.2	17.7	18.9
Commercial banks	2.9	16.2	12.8	12.6	10.8	12.6	10.7

Source: CDF, 2002, "CDF Microfinance Statistics," CDF, Dhaka, Bangladesh, as cited in Hassan Zaman, 2004, "The Scaling Up of Microfinance in Bangladesh: Determinants, Impacts, and Lessons," World Bank Policy Research Paper, no. 3998, World Bank, Washington, DC.

Nevertheless, transaction costs remain high, as MFIs maintain credit discipline among borrowers through group pressure and monitoring borrowers' behavior. As a result, many MFIs rely on donors to sustain their operations.[98]

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95 Proshika, 2008, "Annual Report 2007," Proshika, Dhaka, Bangladesh, http://www.proshika.org/ar_2007.pdf (accessed October 2008).

96 Credit Development Forum, 2008, "Bangladesh Microfinance Country Profile," CDF, Dhaka, Bangladesh. Available on the CGAP/ Microfinance Gateway Web site, CGAP, Washington, DC, http://www.microfinancegateway.org/p/site/m//template.rc/1.9.27395 (accessed August 2009).

97 For more information on its donors, see the following topics on the PKSF Web site, "Microcredit Operation" (http://www.pksf-bd.org/mo.html) and "About PKSF" (http://www.pksf-bd.org/about_pksf.html) [both accessed August 2009].

98 R. Sahidur Khandker, 2005, "Microfinance and Poverty: Evidence Using Panel Data from Bangladesh," World Bank Policy Research Working Paper, no. 2945, World Bank, Washington, DC, http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2003/02/15/000094946_03013104041165/Rendered/PDF/multi0page.pdf (accessed August 2009).

Challenges in Microfinance

- **Targeting the poorest versus achieving financial stability.** [99] To date, the majority of MFIs have not managed to supply financial products, including credit, in a financially sustainable way to very poor households.
- **Widening the target group.** MFIs in Bangladesh are currently concentrating mostly on horizontal expansion, meaning they are trying to attract new customers. Considerable scope remains for progress in this direction, however, a focus on vertical expansion would be desirable in order to tackle graduated borrowers with more mature financial needs. As a prerequisite to pursuing this strategy, new products and new financial technologies must, of course, be put in place.
- **Internal and external governance.** Currently not enough attention is given to the education of new leadership staff who could shape further developments in microfinance
- **Service charges.** The typical rate of interest is somewhat higher than what prevails in the formal financial sector, but considerably lower than the rates charged by traditional village moneylenders.[100]
- **Accessing non-donor sources of funding.** To counter the expected decrease in donor enthusiasm over time, MFIs need to seek alternative sources of funding, such as deposit taking and the formal financial sector, which would lead to commercialization of the sector.
- The passing of the Microcredit Regulatory Act was a good first step in the regulatory reform of microfinance in Bangladesh. **Challenges in the regulatory milieu**, however, remain, including limitations on the transformation of MFIs into regulated entities, refinancing, and the relatively limited number of registered MFIs. In addition, improvements in corporate governance, reporting, and transparency are necessary.

New Trends in Microfinance

The microfinance sector of Bangladesh has now reached the maturity stage. With the increase in competition, the credit market has become segmented, with at least four distinct client segments: moderately poor, extremely poor, small and marginal farmers ("nearly poor"), and microentreprenuers (mostly nonpoor) clients. The largest number of MFI clients, about 25 million, belong to the first category; the last two categories are new, but expanding.[101]

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[99] This section relies on excerpts from Osmani et al., 2003, "The Macroeconomics of Poverty Reduction."
[100] This is an interesting statement, since the research conducted for this study shows that the interest rates charged by MFIs are somehow justified by high repayment rates and the low percentage of nonperforming-loans across MFIs.
[101] Dewan A.H Alamgir and David L. Wright, 2007, "Inclusive Financial System Reforms: What Works, What Doesn't and Why?" GTZ, Dhaka, Bangladesh.

Among recent trends in the sector are:

- Most MFIs are offering insurance products, such as loan protection and life insurance. A few institutions are offering health, asset, and livestock insurance products.
- Some MFIs are offering innovative financial products, especially credit products for small and marginal farmers and microentreprenuers, as well as long-term savings products.
- Some MFIs, such as BRAC, Thengamara Mahila Sabuj Sangha (TMSS), and BURO Bangladesh, are involved in remittance transfers through partnerships with formal sector banks.
- Along with financial services, some MFIs are offering nonfinancial services, especially capacity-building training, to clients.
- All MFIs that have received a license from the MRA now submit regular reports about their microfinance programs.
- The transparency and accountability of MFIs in the country are gradually improving. Moreover, governance of the sector is gradually improving due to the regulation of the MRA.
- MFIs are now focusing on human resource development due to increasing competition
- Very recently, the microfinance sector faced a new challenge: overdue and bad loans. Due to high inflation, the poor were using most of their loan income for household consumption and thus had problems repaying their loans regularly.[102]

Microsavings

Using savings mobilized from the public as a means of refinancing MFIs is a controversial topic in Bangladesh. Due to regulatory constraints, most MFIs are not allowed to accept savings from the general public. Commercial banks may accept savings, but they do not regard the typical rural microfinance client as part of their target clientele and are unlikely to change this attitude in the near future. Based on recent data, commercial banks in Bangladesh have outreach to about 25 percent of the total number of potential savings account holders.[103] The remainder of the market is still untapped and thus does not have formal access to saving services, as reflected in client data. A survey from 2006 shows that the average credit per microfinance borrower is 3.5 times higher than their average savings.[104]

In the past, when the regulatory framework was more relaxed, some MFIs started to offer contractual savings and fixed deposits, but such products are no longer possible. The costs of mobilizing savings as a refinancing

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102 Based on the assumptions of Rashed al Hasan and his discussions with MFIs and microfinance sector experts in Bangladesh, summer 2008.

103 S.M. Rahman, 2008,"Strengthening Savings Services in the Microfinance Sector of Bangladesh," *Financial Express*, Dhaka, July 27, 2008

104 MRA, 2006, "NGO-MFIs in Bangladesh."

instrument, moreover, far outweigh the costs of other refinancing measures. As the major funding source of MFIs, PKSF offers funding with interest rates between 0.5 and 4.5 percent to small MFIs, whereas the average interest rate on savings in the country currently stands between 5 and 6 percent.[105] Therefore the incentive for MFIs to mobilize savings instead of choosing PKSF as a refinancing source is considerably low, at least from a short-term perspective.

The solution to this dilemma demands a change in the sociopolitical environment in the country. Undoubtedly there is huge demand for saving services that is currently unmet by commercial banks because of their lack of interest in microsavings clientele. It is also unmet by MFIs due to the regulatory environment. A possible solution would be to (i) allow at least those MFIs that manage to successfully register under the Microfinance Regulatory Act to accept deposits and (ii) to convince MFIs of the long-term benefits of cultivating savings as an additional source of refinancing. PKSF is generally known for its strict requirements, therefore MFIs could operate more independently if they depended on savings acquisition.

Actions towards a more liberalized regulatory environment for savings would thus be desirable for the future progress of financial market development in Bangladesh.

Leasing Companies

The first leasing companies introduced themselves to the Bangladeshi financial market in the 1980s, presenting an alternative source of financing. Since then they have slowly but steadily achieved considerable growth. Currently there are 11 operating leasing companies that offer a diversified range of products, among them:

Industrial Development Leasing Company of Bangladesh Ltd.
IDLC
United Leasing Company
Uttara Finance & Investment Company Ltd.
Phoenix Leasing Company Ltd
Bay Leasing & Investment Ltd.
International Leasing & Finance Company Ltd.
GSP Finance Company (BD) Ltd.
Prime Finance & Investment Ltd.
Vonike
Prime Bank Ltd.

[105] PKSF, 2008, "Annual Report 2007"; MRA, 2006, "NGOs-MFIs in Bangladesh." Information on interest rates of different banks and NBFIs were collected from the borrowing rates published in the "Annual Report 2007" and "Audit Report 2007" of various MFIs, especially BRAC and BURO Bangladesh. Other information was collected through discussions of lending methodologies with Anukul Foundaten, CARE, and Stromme Foundation, summer 2008.

This number is expected to increase in the future, if political stability and general economic development continue.[106]

Insurance Companies/ Microinsurance

The insurance sector is regulated by the Insurance Act of 1938, with regulatory oversight provided by the Controller of Insurance of the Ministry of Commerce. Currently a separate Insurance Regulatory Authority is being planned.[107] General insurance is provided by 21 companies and life insurance, by 6. The industry is dominated by two large, state-owned companies—SBC (general insurance) and JBC (life insurance)—which together command most of the total assets of the insurance sector.[108]

According to figures from 2007, up to 94 percent of the population of Bangladesh does not have access to microinsurance.[109] Although Bangladesh's figures are better then its neighbors India and Nepal, this number is still alarmingly high and shows that there is a lot to be done in this market. MFIs and NGOs started to enter the insurance scene only very recently—in the early 2000s. Today microinsurance products are offered by the big players in the microfinance market, such as BRAC, Grameen, ASA, Proshika, Gonoshashtho Kendra, Sajida Foundation, Shakti Foundation, Dushtha Shasthya Kendra, the Integrated Development Foundation, and the Society for Social Services.

Life insurance companies are also offering microinsurance products. The biggest of these companies is Delta Life Insurance, which entered the microfinance market in 1988 as the first private regulated insurance company in Bangladesh. Delta launched a microinsurance product named Grameen Bima, or village insurance. With the tremendous success of Delta Life Insurance, other private life insurance companies came forward to offer microinsurance products to poor people. As of this writing, among the 18 life insurance companies registered in the country, 13 offer microinsurance products.[110]

These companies currently offer diversified, simple products at affordable rates, short maturities, and with comprehensive coverage options, such as loan protection and life insurance. The positive aspects of the products

[106] "Financial Statement Analysis of Leading Leasing Industry in Bangladesh," n.d., Report BD.Com: Website for Students and Educators, Dhaka, Bangladesh, http://www.reportbd.com/articles/23/1/Financial-statement-analysis-of-leading-leasing-industry-in-Bangladesh/Page1.html (accessed October 8, 2008).
[107] Bangladesh Bank, n.d., "Financial Sector in Bangladesh," Bangladesh Bank, Dhaka, Bangladesh, http://www.bangladesh-bank.org/mediaroom/tenders/fsectorinbb.pdf (accessed August 2009).
[108] See the Bangladesh Bank Web site: http://www.bangladesh-bank.org/, choose "Financial System," then "Insurance" (accessed August 2009).
[109] Jim Roth, Michael J. McCord, and Dominic Liber, 2008, "The Landscape of Microinsurance in the World's 100 Poorest Countries," MicroInsurance Center LLC, Appleton, Wisconsin, http://www.microinsurancecentre.org/UploadDocuments/Landscape%20study%20paper.pdf (accessed October 8, 2008).
[110] Rashed al Hasan, 2007, "A SWOT Analysis of Microinsurance in Bangladesh," INAFI PowerPoint presentation, July 3, 2007, INFAFI Asia, Dhaka, Bangladesh, http://www.inafiasia.net/events_ar/Material/SWOT%20Analysis%20of%20Microinsurance%20in%20Bangladesh.ppt (accessed August 2009).

include easy premium payment (either all at once or weekly), relatively low administrative costs, and a simple claim settlement process. The staff of the various insurers are generally motivated and the providers offer a broad network. Very often microinsurance products can be integrated with microsavings and microcredit. On the negative side, however, the products are largely generalized, meaning the individual premium rate is not calculated on the basis of the specific probability of risk. In addition, there are no diversified products in terms of the sum insured, the premium, or the maturity. There is also a lack of insurance education and awareness among clients, as well as a lack of appropriate insurance knowledge among insurance company staff selling the products.

To conclude, there is clearly huge unmet demand for microinsurance products in Bangladesh that is not yet addressed. That is, product designs are not being offered based on individual client needs and demands. There is still big room for both horizontal and vertical expansion of microinsurance. In order to achieve this expansion, however, the problem of uneducated staff needs to be addressed first.[111]

Market Structure

Banking Sector

The banking sector in Bangladesh has grown quickly since about 1995, with annual average growth rates of between 11 and 23 percent between 1995 and 2005. The banking sector grew faster than national GDP during this period. (See table 9 for a snapshot of the banking sector from 2007 through 2008.) Despite this impressive growth, the total number of deposits and loans grew only moderately. In comparison, in India between 2001 and 2005, deposit accounts per 1,000 people grew from 417 to 432, and loan accounts, from 51 to 71. Bangladesh saw a much smaller growth rate: deposits per 1,000 people grew from 232 to 237, and loans, from 57 to 60. This data shows that both access to deposits and loans has room to grow.[112]

Performance

Performance of the Financial Sector

The liberalization of the financial sector in the 1990s and the implementation of prudential banking regulation in Bangladesh have facilitated growth since 2000. Inefficiency, however, continues to keep the cost of financial intermediation high, reflected in high—albeit declining—interest rate spreads. Overall lending rates remain high within the South Asian context.[113]

[111] Ibid.
[112] Ferrari, 2008, "Increasing Access to Rural Finance in Bangladesh."
[113] IMF, 2007, "Bangladesh: Selected Issues."

The weak performance of nationalized commercial banks and specialized banks continues to hamper financial sector competitiveness. Very high levels of NPLs—in the range of 30 percent—and high interest rates, which can be seen as both a cause and effect of high NPLs, are primarily the result of past government interventions and continued poor management. Provisioning remains weak and high levels of NPLs are also reflected in a return on assets that is close to zero.[114]

The restructuring of nationalized commercial banks, long on the agenda of the central bank, has finally begun. In fiscal year 2008 (FY08), three of these four banks (Sonali, Janata, and Agrani) were transformed into public limited companies. Rupali Bank may also be privatized. The newly restructured companies have begun to reorganize and initiate efforts to improve the quality of their respective portfolios. The positive impacts of these measures have, however, yet to flow through to improved efficiency and performance.[115]

[114] Bangladesh Bank, 2008, *Financial Sector Review* III, no. 2 (June).
[115] IMF, 2007, "Bangladesh: Selected Issues."

Table 9. Snapshot of Bangladesh Banking Sector, June 2007–August 2008 (in BDT crore)

Particulars	Outstanding Stock			Changes in outstanding stock				
	June 2007	June 2008	August 2008	FY 2007-08	July – August 2008	August 2008 over August 2007	July – August 2007	August 2007 over August 2006
	1	2	3	4	5	6	7	8
A. Net foreign assets of banking system	32,888.40	37,845.40	36,712.30	4,957.00	1,133.10	3,688.20	135.70	10,047.80
				(+15.07)	(-2.99)	(+11.17)	(+0.41)	(+43.73)
B. Net domestic assets of banking system	178,615.90	210,949.50	218,146.20	32,333.60	7196.70	38,052.90	1,477.40	18,988.20
				(+18.10)	(+´3.41)	(+21.13)	(+0.83)	(+11.79)
a) Domestic credit	205,672.50	248,767.80	253,274.30	43,095.3	4,506.50	45,980.20	1,621.60	25,677.20
				(+20.95)	(+1.81)	(+22.18)	(+0.79)	(+14.14)
Public sector	53,495.40	58,632.00	58,205.60	5,136.60	-426.40	5559.10	-849.90	4,626.20
				(+9.60)	(-0.73)	(+10.56)	(-1.59)	(+9.63)
Government (net)	36,040.00	469,990.60	46,302.30	10,959.60	-697.30	11,806.80	-1,544.50	1,956.70
				(+30.41)	(-1.48)	(+34.23)	(-4.29)	(+6.01)
Other public	17,455.40	11,632.40	195,068.70	37,958.70	4,932.90	40,421.10	2,470.50	21,051.00
				(-33.36)	(+2.33)	(-34.42)	(+3.99)	(+17.24)
Private sector	152,177.10	190,135.80	195,068.70	37,958.70	4,932.90	40,421.10	2,470.50	21,051.00
				(+24.94)	(+2.59)	(+26.14)	(+1.62)	(+15.76)
b) other items (net)	-27,056.60	-37,818.30	-35,128.30	-10,761.70	2,690.20	-7,927.30	-144.20	-6,689.00
C. Broad Money (A + B)	211,504.30	248,794.90	254,858.50	37,290.60	6,063.60	41,741.10	1,613.10	29,036.00
				(+17.63)	(+2.44)	(+19.59)	(+0.76)	(+15.77)
i) Currency outside banks	26,643.80	32,689.90	33,309.70	6,046.10	619.80	5,366.20	1,299.70	4,289.40
				(+22.69)	(+1.90)	(19.20)	(+4.88)	(+18.13)
ii) Deposits	184,860.50	216,105.00	221,548.80	31,244.50	5,443.80	36,374.90	313.40	24,746.60
				(+16.90)	(+2.52)	(+19.64)	(+0.17)	(+15.43)
a) Demand deposits	23,524.20	27,159.90	26,022.80	3,635.70	-1,137.10	2,814.60	-316.00	4,302.70
				(+15.46)	(-4.19)	(12.13)	(-1.34)	(22.76)
b) Time deposits	161,336.30	188,945.10	195,526.00	27,608.80	6,580.90	33,560.30	629.40	20,443,90
				(+17.11)	(+3.48)	(+20.72)	(+0.39)	(+14.45)

Source: Bangladesh Bank, 2008, "Major Economic Indicators—Monthly Update; Monetary and Credit Developments" (August), Bangladesh Bank, Dhaka, Bangladesh.
Note: A crore (abbreviation "cr") is equal to 10 million (10,000,000).

Table 10. Comparative Returns on Bank Assets in Bangladesh, 2006–2007 (%)

Type of bank	Dec 07	Jun 07	Dec 06	Jun 06
State-owned commercial banks	0.0	0.0	0.0	0.0
Specialized banks	-0.3	0.7	0.9	0.5
Private commercial banks	1.3	1.2	1.0	1.0
Foreign commercial banks	3.1	2.5	2.8	2.6

Source: Bangladesh Bank, 2008, *Financial Sector Review* III, no. 2 (June 2008), 48.

Table 11. Comparative Returns on Bank Equity in Bangladesh, 2006–2007 (%)

Type of bank	Dec 07	Jun 07	Dec 06	Jun 06
State-owned commercial banks	0.0	0.0	0.0	0.0
Specialized banks	-3.4	-2.1	-2.1	-12.3
Private commercial banks	16.6	16.5	10.2	10.8
Foreign commercial banks	20.4	13.2	14.4	13.2

Source: Bangladesh Bank, 2008, *Financial Sector Review* III, no. 2 (June), 48.

Essential to the long-term health of nationalized commercial banks and the banking sector overall is reform of national energy policy. Subsidization of domestic energy prices engendered the largest proportion of NPLs in the banking sector, which accrued to the state-owned Bangladesh Petroleum Corporation (BPC). The government provided some relief to BPC in the form of a large public bond to finance its nonperforming loans, improving the balance sheets of the nationalized commercial banks, at least on paper. As part of restructuring efforts, lending to non-public sector entities by these banks has been limited, which may in part explain their declining market share in favor of private commercial banks, as well as their declining overall lending rates, given that their lending to state-owned enterprises also tended to be below market rates..[116]

The performance of private and foreign commercial banks is stronger, the nonperforming loans of which remain relatively low within the Bangladesh context—roughly 5.5 percent and 1.5 percent, respectively. Provisioning and capital levels of these two categories of banks are also stronger than those of their state-owned competitors. Their return on assets is also positive: 1.3 percent for private and 3.1 percent for foreign commercial banks at year-end 2007.[117]

Within the nonbank financial sector, the Dhaka Stock Exchange trended upward during FY08, although increased volatility has given regulators some concern. Mutual fund demand is growing fast and

[116] Ibid.

[117] Bangladesh Bank, 2008, *Financial Sector Review* III, no. 2 (June).

outpaces supply. The bond market remains underdeveloped and is dominated by government issues. NBFIs—primarily leasing companies—are a bright spot in the nonbank financial sector, given their strong asset growth, financial innovation, and relatively good profitability and portfolio quality.[118]

Performance of the Microfinance Sector

Performance in the microfinance sector remains relatively strong. The four "large" MFIs (Grameen, BRAC, ASA, and Proshika) continue to dominate the market with approximately 80 percent of total microfinance disbursements. Total disbursements have increased steadily for all four institutions since 2005, although Proshika's disbursements declined in the second half of FY08. In fact, the historically strong portfolio quality of these four MFIs declined in FY08 due to the effects of two floods and a cyclone. Nonperforming loans ranged between 4 and 7 percent since 2005, reaching about 10 percent of the combined outstanding portfolios of the big four MFIs in the second half of FY08.[119]

Performance data for the numerous smaller MFIs in Bangladesh is scarce, although recent results provided by the Microcredit Regulatory Authority for the whole sector provide a mixed picture. Sectorwide, loan recovery rates are generally above 90 percent, although the effects of recent natural disasters most likely has reduced this rate. Borrower-to-member ratios generally trend around 70 percent, although some MFIs have performed quite poorly, with ratios hovering around 50 percent. Some MFIs also have savings in excess or close to the value of their loan portfolios, which concerns the Microcredit Regulatory Authority and will be considered in licensing decisions. Finally, many MFIs have very low average outstanding loan amounts (for example, BDT 1,000), which calls into question the income-generating potential of these loans.[120]

Financial Infrastructure

Capital Market

In Bangladesh all capital market activities are regulated and supervised by the SEC (Securities and Exchange Commission), which was established under the SEC Act of 1993. **The SEC oversees the issue of new capital, as well as monitors the issuance of stock and the operation of the stock markets.** It also protects the interests of investors. In the future, the SEC's role in financial markets may be further strengthened. In addition to the SEC,

[118] Ibid.
[119] Ibid.
[120] MRA, 2006, "NGO-MFIs in Bangladesh."

Bangladesh Bank regulates institutions active in the financial market, including leasing and venture capital companies.

The capital market consists of two stock markets, the Dhaka Stock Exchange (DES) and the Chittagong Stock Exchange (CSE). DSE was established as a public limited company in April 1954, and CSE, in April 1995. While the CSE is already operating on an automatic basis, the DSE had, as of this writing, yet to automate.[121]

As of this writing, 27 institutions were licensed by the SEC to operate on the Bangladesh capital market. Among them, 19 were merchant bankers and portfolio managers; the remaining 7 were issue managers and one, an issue manager and underwriter.

The Investment Corporation of Bangladesh (ICB) was founded in 1976 with the aim of enlarging the base for industrial investment. The ICB is responsible for the underwriting of securities issues, provision of substantial bridge financing, maintenance of investment accounts, and management of closed-end and open-end mutual funds. Today the ICB operates as a dealer on the DSE and CSE.

The **specialized banks**—Bangladesh Shilpa Bank, Bangladesh Shilpa Rin Sangstha, and BASIC Bank Ltd.—together with certain foreign banks and nationalized commercial banks, are engaged in long-term industrial financing.[122]

Payment System

Cash is the predominant payment method for transactions in Bangladesh, followed by the national domestic check clearance system—the second most important transaction medium. The number and amount of checks used in the financial system has been continuously growing in recent years. Whereas the industrial and commercial sector mainly uses checks and payment orders of commercial banks, checks of the Bangladesh Bank are widely used by commercial banks for interbank transfers and government payments.

Currently there are four payment and settlement systems operating in Bangladesh: Bangladesh Bank's Clearing Houses in Dhaka and its branches in seven other cities; the clearinghouses of Sonali Bank in 31 towns where there are no Bangladesh Bank braches; the Bangladesh Bank large-value check settlement system; and the Bangladesh Bank foreign currency system in Dhaka (which clears and settles checks and payment orders in foreign currencies). In recent

[121] "Capital Market of Bangladesh," Web site of the Sustainable Development Networking Programme, Dhaka, Bangladesh, http://www.sdnbd.org/sdi/links/capital_market_of_bangladesh.htm (accessed August 2009).
[122] See the Bangladesh Bank Web site: http://www.bangladesh-bank.org/, choose "Financial System," then "Banks & FIs" (accessed August 2009).

times, Bangladesh Bank has focused on the development of modern payment systems in the country. The National Payment System Council (NPSC) is in particular responsible for the improvement of the national payment system.[123]

A 2006 survey found that there were a total of 478 automatic teller machines (ATMs) in urban areas and 800,000 holders of debit and credit cards. Private commercial and foreign banks mostly offer ATM cards, as well as the ATMs themselves and point-of-sale (POS) outlets.[124]

Interbank money market

The money market is regulated by Bangladesh Bank. To maintain adequate liquidity in this market, it intervenes through repo auctions and reverse repo auctions, if needed.[125]

Deposit insurance

A deposit insurance system has existed in Bangladesh since 1984. For all commercial banks, including foreign and specialized banks, membership is compulsory. However, NBFIs are still not included in the system. Current coverage for savings protected under the insurance system is BDT 100,000 ($1,478) per depositor per bank.[126]

Accounting Standards

Bangladesh Accounting Standards (BAS), which are not legally binding for companies, have been published by the Institute of Chartered Accountants of Bangladesh. The national standards were developed within the framework of International Accounting Standard (IAS) rules and combined with specific local requirements. Currently there are no implementation guidelines for the use of either BAS or IAS, nor is there a mandatory rule that IAS be used to prepare statutory financial statements. Some disclosure requirements regulated by the Company Act of 1994 are, in fact, incompatible with IAS.

In addition, the accounting and disclosure requirements of the Bangladeshi SEC, which are mandatory for listed companies, are inconsistent with the requirements of the Company Act of 1994. Although already in 2000 the SEC issued a rule stating that auditors

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[123] The NPSC is run by representatives of the Ministry of Finance, Ministry of Commerce, Controller General of Accounts, Bangladesh Telecommunication Regulatory Commission, and chaired by the Deputy Governor in charge of the currency management and payment system of Bangladesh Bank.

[124] Bangladesh Bank, 2007, "Payment Systems" in "Annual Report, 2006–2007"; and 2006, *Financial Sector Review* II, no. 2 (June 2007).

[125] Bangladesh Bank, 2007, "Annual Report, 2005–2006," and 2008, "Annual Report, 2006–2007."

[126] See the Bangladesh Bank Web site, http://www.bangladesh-bank.org/, choose "Regulations & Guidelines," then "Deposit Insurance Scheme" (accessed August 2009).

should verify the preparation of financial statements in accordance with IAS, this rule apparently does not have the force of law.[127]

Regarding nonperforming loans, according to the regulations of Bangladesh Bank, banks must maintain provisions at the following rates: 20 percent for substandard loans, 50 percent for doubtful loans, and 100 percent for bad debts. Provisions for short-term agricultural loans and microcredits must be maintained at 5 percent for all lending except bad debts, that is, for doubtful, substandard, irregular, and regular loans) and 100 percent for bad debts.[128]

Audit & Legal Services

All listed companies under the Company Act of 1994 are required to have their financial statements audited by a chartered accountant within 120 days of the end of their annual accounting period. Both sole practitioners and partnership firms can act as auditors. The SEC requires auditors to be rotated every three years. Foreign companies and their local subsidiaries are mainly audited by international firms, whereas local firms service public sector enterprises and small- and medium-sized businesses in Bangladesh.[129]

Rating and Credit Services

In term of credit, the public registry covers only seven-tenths of one percent of the total credit issued on the financial market. Private bureaus are nonexistent and the World Bank gives the country a low ranking on its credit information index, indicating a low level of information sharing.[130]

In 1992, the government established a Credit Information Bureau (CIB) supervised by Bangladesh Bank As of this writing, 49 banks and 27 financial institutions were supplying input data to the bureau. CIB users are the banks and financial institutions who provide the data, the central bank, the Government of Bangladesh, and others, such as the IMF. Borrowers cannot access, that is, view, their own data. The minimum loan size for inclusion is BDT 50,000 ($847). The institution is protected by a comprehensive legal framework that governs its operations on credit registry, sets requirements for banks and financial institutions to provide data, and mandates data protection and legal penalties for reporting inaccurate data. Yet there is no legal requirement that the CIB respond to customer

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[127] World Bank, 2003, "Report on the Observance of Standards and Codes (ROSC), Accounting and Auditing," World Bank, Washington, DC.

[128] Government of Bangladesh, 2005, "Bangladesh: Prudential Regulations for Banks—Selected Issues" (updated through August 7, 2005), Dhaka, Bangladesh. Available on the Web site of CGAP/ Microfinance Gateway, http://www.microfinanceregulationcenter.org/content/article/detail/38071 (accessed August 2009).

[129] World Bank, 2003, "Report on the Observance of Standards and Codes."

[130] World Bank, 2007, *Doing Business 2008* (Washington, DC: World Bank).

complaints.[131] Further, the bureau has several shortcomings, among them, lack of computerization and lack of historic information on past payment performance.[132]

Apex Banks for Microfinance

In addition to the funding provided by PKSF described earlier (see section entitled "Microfinance"), the Grameen Fund provides high-risk capital for SMEs and MSEs. This capital includes equity finance, loans, and promotion and development of export or import substitution industries. Its microenterprise lending in this sector is in amounts between BDT 50,000 and BDT 500,000 ($700–$7,170) for terms of one to three years with a 20 percent interest rate. From January to August 2007, 134 microenterprises in rural areas received a total of BDT 15.18 million ($218,000) in loans under this scheme. Subsectors that were financed included poultry, dairy, fishery, engineering, agriculture, auto engineering, services, and handicrafts.[133] Other Grameen projects are run by private entrepreneurs and organizations, such as Grameen CyberNet Limited, Grameen Gitek Limited (electronics), Grameen Solutions Limited (software), Grameen IT Park Limited (Internet Service Provider that offers data transmissions, network, and online services to corporate clients), and Grameen Star Education Ltd. (computer and IT education).

Financial Industry Associations

There are a number of financial industry associations in the country, such as the Bangladesh Association of Banks, a representative body for private commercial banks, and the Association for Bankers Bangladesh (ABB), a platform for managing directors of banks.

The **Bangladesh Insurance Association** was formed in May 1988 under the Companies Act of 1913. Registered with the Registrar of Joint Stock Companies, the association has 30 members and aims to promote, support, and protect the interests and welfare of member companies.[134]

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131 Jasim Uddin Ahmad, 2004, "Credit Information Bureau: Bangladesh Experience Highlights," PowerPoint presentation of Bangladesh Bank, Dhaka, Bangladesh. Available on the CGAP/ Microfinance Gateway, Washington, DC, http://www.microfinancegateway.org/gm/document-1.9.25224/34146_file_07.pdf (accessed August 2009).

132 Thorsten Beck and Md. Habibur Rahman, 2006, "Creating a More Efficient Financial System—Challenges for Bangladesh," World Bank Policy Research Working Paper, No. WPS3938, World Bank, Washington, DC, http://econ.worldbank.org/external/default/main?pagePK=64165259&piPK=64165421&theSitePK=469372&menuPK=64166093&entityID=000016406_20060607101704 (accessed August 2009).

133 The information regarding the Grameen Fund are excerpted from the Grameen Fund Web site, Dhaka, Bangladesh, http://www.grameen-info.org/grameen/gfund/index.html (accessed August 2009).

134 "Insurance," Banglapedia (online information resource), Dhaka, Bangladesh, http://banglapedia.search.com.bd/
HT/I_0077.htm (accessed August 2009).

The **Bangladesh Institute of Bank Management** was founded in 1974. Its main focus is providing training to officials of banks and financial institutions to strengthen their knowledge and skills. After more and more banks decided to open their own training institutes, the Institute decided to broaden its services and now offers research in the area of banking, a master's degree in bank management, and general on-the-job training.[135]

The **Institute of Bankers Bangladesh** is a professional body of banks and financial institutions that has been registered since 1973.[136]

INAFI (International Network of Alternative Financial Institutions) is an association that counts the major players in the MFI sector in Bangladesh as its members. Its activities in Bangladesh focus on capacity building of microfinance NGOs-MFIs through tailored training, thematic conferences, seminars, conferences, credit ratings, and self-regulation. The network devotes continuous research and development to product innovations and best practices.[137]

Training, Education, and Consulting

Given that financial education is not widely recognized as being an important measure for improving the country's development, there are currently no noteworthy, broadly applied nationwide financial education programs in Bangladesh. Bangladesh Bank has, however, established a training academy to develop professionals in the banking sector.

Rather than outsource their staff training, most of the big, well-known microfinance institutions provide internal training in their own training centers. BRAC, for example, has 22 staff training and resource centers throughout the country.[138] PKSF also runs its own training center. And the Credit Development Forum offers training to small- and medium-sized MFIs. Only recently has the Institute for Microfinance been established by the government; it conducts research in microfinance and is due to become involved in capacity building of the entire sector. Another institute with a microfinance training program is INAFI.

Technology

Although the banking sector in Bangladesh was one of the first sectors of the economy to be computerized—starting some eight years ago—the current level of computer usage in banks is still low. Although foreign banks have taken the lead in trying to computerize

135 See the Institute's Web site at http://www.bibm-bd.org (accessed August 2009).
136 See the Institute's Web site at http://ibb.org.bd/(accessed August 2009).
137 See the INAFI Asia Web site, http://www.inafiasia.net (accessed August 2009).
138 BRAC, 2006, "Annual Report 2006," BRAC, Dhaka, Bangladesh.

their branches, this process is progressing rather slowly. Only very recently has the network of ATMs grown, but wide parts of the country remain without ATMs. Fully computerized bank branches, in Dhaka as well as in the regions, are still an exception. The high cost and great effort required for computerization are the most important obstacles. A 2007 study showed that even up-to-date Bangladesh banks are still reluctant to use full Internet-based banking activities.[139] Private and foreign banks are also taking the lead on this issue, whereas nationalized commercial banks are lagging behind.[140]

Figures from 2006 show that 478 banks were equipped with ATMs; 26 had both ATMs and POS outlets; 22 had issued payment cards; 800,000 bank cards had been issued; and 29 banks were conducting Internet banking.[141]

Consumer Financial Education

Concerning financial education programs, Bangladesh still lacks an initiative from the major financial players to start specialized programs to increase the financial knowledge of the public. Neither the government nor the central bank nor the major banks have joined such an initiative. Currently there are `only isolated actions from single institutions aimed at improving the situation. One example of this type of action is a project of Citigroup Foundation, which in 2006 launched a project with Grameen Bank to offer small loans to Bangladesh beggars. The program offers the beggars training in basic literacy and financial education in order to enable clients to understand their loan terms.[142]

Legal, Regulatory, and Policy Framework

Regulation and Supervision of Banks and NBFIs

Bangladesh Bank is responsible for the supervision and regulation of all banks and nonbank financial institutions (NBFIs) in Bangladesh. Other parts of the financial system are regulated by dedicated bodies: insurance companies, by the Ministry of Commerce, although this function is currently being transferred to the Ministry of Finance; the stock exchanges, by the Securities and Exchange Commission; and

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139 Syed Shah Alam et al., 2007, "Development and Prospects of Internet Banking in Bangladesh," *Competitiveness Review* [Emerald Group Publishing, Bingley, United Kingdom] 17, no. 1 (January): 56–66. Available on the AllBusiness.com Web site, http://www.allbusiness.com/banking-finance/banking-lending-credit-services-electronic/5500432-1.html (accessed August 2009).

140 Ibid.

141 Bangladesh Bank, 2006, "Survey on Commercial Banks" (December), and 2007, *Financial Sector Review* II, no. 2 (June).

142 Waliur Rahman, 2006, "Loans Deal for Bangladesh Beggars," BBC News (online version), February 7, 2006, http://news.bbc.co.uk/2/hi/south_asia/4687032.stm (accessed August 2009).

cooperative banks, by the Ministry of Local Government, Rural Development, and Cooperatives.

Bangladesh Bank is responsible for awarding licenses to banks and NBFIs. The establishment of an apex institution, which must be registered as an NBFI, also requires a license from the central bank, and the regulatory hurdles are significant. In general, obtaining a license from Bangladesh Bank is difficult and the process, demanding.

The central bank has sought to adopt best industry practices. A minimum capital-to-risk-weighted assets ratio of 10 percent is required and minimum core capital is 5 percent. The Bank has also outlined an implementation plan for Basel II guidelines, which are due to be adopted by the banking system by January 2009. Relevant aspects of banking and NBFI regulation are summarized below:

- **Refinancing from offshore investors.** Banks and NBFIs may borrow in foreign currency, providing the effective interest rate does not exceed LIBOR plus 4 percent and the maturity of the facility does not exceed 7 years. NBFIs face additional restrictions. Specifically, the repayment of interest in foreign currency is prohibited for NBFIs (the repayment of the loan principal in foreign currency is allowed). These restrictions may impede banks and NBFIs from accessing important potential sources of international financing—and thus from expanding their SME loan portfolios, given the reported dearth of SME refinancing facilities reported by Bangladesh Bank.
- **Transformation.** Transformation of a bank into an NBFI requires a capital increase from BDT 100 million ($1.4 million) to BDT 2 billion ($28.7 million), and eventually to BDT 4 billion ($57.4 million), beginning in June 2009.
- **Foreign direct investment.** There are no significant hurdles to foreign direct investment in existing banks and NBFIs in Bangladesh. Regarding greenfield operations, foreign investments may be made independently or through joint ventures, although a license must be received for any greenfield operation.

Bangladesh Bank's reform agenda in the banking sector and NBFI subsector is focused on strengthening competitiveness, specifically, resolving the sector's maturity mismatch and nonperforming loan problems. Items on the reform agenda include restructuring the specialized banks to improve their operational efficiency and alleviate their portfolio quality problems; improving the functioning of the secondary market for bonds and securities; and generally strengthening regulation and supervision.[143]

The central bank recently provided updated guidelines to banks to promote SME lending. These guidelines include requiring banks to inform the central bank of the target SME loan portfolio each year; dedicating a minimum of 40 percent of the targeted amount to small businesses; establishing a dedicated SME function; and reporting on the SME portfolio on a quarterly basis.[144]

Microfinance

Microfinance activities in Bangladesh are regulated by the **Microcredit Regulatory Authority Act of 2006,** which established the oversight body for microfinance activities, the **Microcredit Regulatory Authority (MRA).** The goal of the Act is provide an all-encompassing regulatory framework for microfinance within Bangladesh and improve transparency and accountability within the sector.

The Act stipulates that all MFIs must obtain a license before carrying out microfinance activities. As of February 2007, 4,236 MFIs had applied for a license. Minimum criteria require that an MFI have either a minimum of 1,000 borrowers or BDT 40 lacs (BDT 400 million) in loan principal outstanding. Institutions that do not meet these criteria have until June 30, 2009, to fulfill them.[145] As of May 2008, approximately 250 MFIs had received licenses and applications from 705 institutions were being considered.

Under the Act, MFIs are allowed to provide loans, advice, and support to poor people; accept deposits from their members; provide insurance services and other social development-oriented loan products for clients; and receive refinancing.

The Act limits two important potential MFI funding sources: equity investments and deposits. First, the Act specifically prohibits MFIs from distributing dividends, which deters potential equity investment. (Equity investments in MFIs are also directly prohibited.) Second, it specifically prohibits MFIs from accepting deposits from anyone other than a member of the MFI, which limits an important and relatively stable potential funding source and limits institutions' potential target group for diversified savings products.

Other important aspects of microfinance regulation are summarized below:

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143 Bangladesh Bank, 2008, *Financial Sector Review* III, no. 2 (June).
144 Ibid.
145 MRA, 2006, "An Overview of NGO-MFIs in Bangladesh."

Refinancing from offshore investors. Foreign currency financing is effectively prohibited. MFIs are allowed to accept foreign currency loans with 0 percent interest; interest-bearing foreign currency loans are prohibited. As described earlier in this report (see the "Demand for Financial Services" section), MFIs in general have access to a wide range of domestic funding sources that seem adequate to meet their current needs. However, current refinancing sources may not be sufficient for future client growth. **Diversification of funding sources would also benefit MFIs from an asset-liability management perspective and may facilitate knowledge transfer from abroad**.

Transformation. MFIs are prohibited from transforming into a bank or an NBFI. They may, however, establish sister banks, following the BRAC Bank example. Bank regulations, such as a minimum public placement of 20 percent of shares, must be followed. Grameen Bank is an exception: it received a banking license through an extraordinary parliamentary act, the Grameen Bank Act, and 6 percent of its shares are held by the government. **The restrictions on transformation may impede the provision of diversified savings products and remittance services to existing MFI clients, which according to MRA regulations, cannot be provided by MFIs.**

Areas for further regulatory reform include improving corporate governance, and especially, financial transparency and reporting. The MRA is currently working on updated regulations; in addition, regulations targeting transparency and accountability in operations are under development.[146]

Corporate Governance

Bangladesh Bank has played and continues to play a strong role in promoting good governance practices in the banking and NBFI sectors in Bangladesh. The governance of private commercial banks and NBFIs is generally stronger that that of state-owned banks.

MFI governance, on the other hand, is generally weak in Bangladesh. Board members serve on a voluntary basis only and are not compensated. The Microfinance Regulatory Authority has expressed its intention to address this weakness in the sector but has yet to issue concrete guidelines.

Legal Environment

Enforcement of contracts is very weak in Bangladesh. On average, the process requires 41 procedures, 1,442 days, and costs

[146] See the Bangladesh Bank Web site: http://www.bangladesh-bank.org/, choose "Managing Core Risk in FIs" (accessed August 2009).

approximately 63 percent of the value of the contract. Unsurprisingly, the World Bank's annual *Doing Business 2008* ranked Bangladesh 175th out of 178 countries.[147]

Bankruptcy proceedings are relatively cumbersome in the country. To close a business requires four years and the recovery rate of firms that file to close their business is estimated at about 23 percent.

Registration of property is also burdensome. It requires, on average, 8 steps, 425 days, and costs about 10 percent of the total property value, which may pose a hurdle to entrepreneurs seeking to use property as collateral for loans.

Overall, however, the *Doing Business 2008* survey evaluated specific borrower and creditor rights with regard to collateral and bankruptcy laws as relatively strong. Bangladesh ranked 7th out of the 178 countries surveyed on this item. The country also ranked well (15th) in terms of investor protection.

On the other hand, lack of credit bureau information may impede efficient credit allocation and risk management. Expansion of the credit bureau database and improved access for all institutions—including microfinance institutions—may help reduce the overlap of microfinance clients in Bangladesh, estimated at 40 percent, as well as the potential negative impacts of cross-indebtedness.[148]

Clearly, the legal system needs reform, particularly in the areas of bankruptcy proceedings, enforcement of contracts, registration of property, and credit registry coverage.

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[147] World Bank, 2007, *Doing Business 2008*.
[148] World Bank, 2008, *Doing Business 2008*.

Gap Analysis

Summary of Gaps

Data

Similar to many emerging markets, there is a **dearth of accurate, up-to-date data on the MSME market in Bangladesh.** Recent data on the SME sector is particularly lacking, although recent efforts by Bangladesh Bank to encourage banks to report on their SME portfolios on a quarterly basis are promising. The lack of data impedes the ability to quantify demand for SME financing at both the retail and refinancing levels. In addition, there is a lack of consolidated data on the microfinance sector, which is an obstacle to accurately assessing, for example, the total number of unique MFI clients and aggregate demand, given the aforementioned high estimates of overlap in the sector. In general, up-to-date audited financial statements and timely information are lacking from MFIs; very often the information published by them is outdated by many years.

Regulatory gaps

- **Banks and NBFIs.** Banks and NBFIs may borrow in foreign currency, providing the interest rate does not exceed LIBOR plus 4 percent and the maturity of the facility does not exceed 7 years. The repayment of interest in foreign currency is prohibited (repayment of the loan principal in foreign currency is allowed). **These restrictions may impede banks and NBFIs from accessing important potential sources of international financing—and thus from expanding their SME loan portfolios**.
- **MFIs.** First, foreign currency financing is effectively prohibited, given that MFIs are allowed to accept foreign currency loans only at 0 percent interest—in other words, interest-bearing foreign currency loans are prohibited. MFIs in general have access to a wide range of domestic funding sources that seem adequate to cover current funding needs, however, funding in the future might become problematic. Diversification of funding sources would benefit MFIs and could facilitate knowledge transfer from abroad.

  Second, MFIs are prohibited from transforming into banks or NBFIs. They may, however, establish sister banks, following the BRAC Bank example. Bank regulations, such as a minimum public placement of 20 percent of shares, must be followed. **The restrictions on transformation may impede the provision of diversified savings products and remittance services to**

existing MFI clients, which according to MRA regulations, cannot be provided by MFIs.

- **Improvements in corporate governance, reporting, and transparency are necessary.**

<u>Demand-Supply Gap</u>

- **Retail microfinance.** The supply and demand estimates provided earlier in this paper, as well as microfinance penetration rates and other industry data from Bangladesh, point to **a generally well-served retail microfinance market. This does not, however, preclude the existence of specific gaps within the market**.
    - ✓ Although there is generally a good supply of credit, **two groups remain underserved in Bangladesh: the poorest of the poor and "graduating" microfinance clients**. While some MFIs have begun to offer savings and credit products to the former, demand remains largely unmet. "**Graduating" microfinance clients fall in between the traditional target groups of MFIs and those of banks and NBFIs.**
    - ✓ Given the regulatory limitations on the product offerings of MFIs noted above, **there is a lack of flexible, diversified savings products, insurance products, and remittance services on the market.** The inability of MFIs to provide remittance services may prompt clients to use or continue to use informal options for remittance services.
- **Retail SME finance.** As discussed earlier, **there is significant unmet demand for retail SME financial services in Bangladesh.** Retail loan sizes demanded by this group—**the "missing middle"**—which includes graduating microfinance clients mentioned above, are generally too large for MFIs. MFIs, moreover, do not have the human resources or systems capacity to offer individual loans. Banks and NBFIs have also been hesitant to address these clients, given their perceived higher risk, which is compounded by lack of collateral and low capitalization levels. While Bangladesh Bank has recently initiated efforts to encourage banks and NBFIs to increase lending to this market segment, these efforts have yet to bear fruit.
- **Refinancing.** Current funding sources for MFIs are relatively well diversified. The sources of refinancing are overwhelmingly domestic and, given restrictions on foreign currency financing, are exclusively in local currency. **Retained earnings, savings, and the PKSF remain the key sources of funding for MFIs.** It is expected that MFIs will grow with their clients and

eventually start offering larger loan sizes. This will result in increased growth rates; **existing refinancing sources may be insufficient to help MFIs keep up with the growth of their clients.**

- **Refinancing for SME retail lending** stands in stark contrast: while lack of data makes quantification of the exact gap impossible, **current refinancing options for providers of SME finance are limited**. Bangladesh Bank has issued a clear call for additional support, noting that its **current resources are not sufficient to close the gap.**
- There is **significant demand for MSME financing among banks and NBFIs** willing to engage in downscaling. As with the case of MFIs, however, regulatory hurdles may impede opportunities for direct debt investments. Any debt facility priced at market prices would, for example, need to be offered in local currency. In terms of equity investments, there are no significant hurdles to foreign investors.

Donor Activities

Bangladesh became a member of the **International Finance Corporation (IFC)** in 1976. As part of the World Bank Group Country Assistance Strategy for Bangladesh, the IFC is providing direct support to the private sector in a variety of areas. It is concentrating on local capital market development and the creation of a competitive banking sector through direct investments and institution building. Aiming to strengthen SME development, the IFC has set up a regional SME project, the South Asia Enterprise Development Facility (SEDF), which focuses on providing technical assistance to SMEs, professional service firms supporting SMEs, and financial intermediaries.

As of the end of first quarter 2007, the IFC portfolio in Bangladesh comprised 11 projects valued at $179.8 million. Out of this total, $153.6 represented IFC investments and $26.2 million, investments of B-loan participants. In FY08, the total IFC portfolio reached $157 million. The range of projects spanned power, telecommunication, cement, and financial markets. As of this writing, the IFC is running a Global Trade Finance Program in which three banks from Bangladesh are participating: BRAC Bank ($3 million), Dhaka Bank ($5.3 million), Eastern Bank ($10 million). In the future, two more banks are expected to join: Jamuna Bank ($12 million) and Southeast Bank ($5 million). Other possible sectors of interest for the IFC are agribusiness, manufacturing, financial services, and trade finance.

Finally, the IFC is providing local currency funding to BRAC, one of the world's largest NGOs. This funding will enable BRAC to enlarge its outreach to the poor, especially women borrowers. The IFC and

BRAC already have a long and successful working relationship which has produced successful results in, among other areas, SME lending and housing finance.[149]

In 2006, **KfW** reduced the major part of its activities in Bangladesh due to a decision of the German Federal Ministry for Economic Cooperation and Development. This decision resulted in a redefinition of the focal areas of the German Development Cooperation, one that excluded the Bangladeshi financial sector as a focal area. As of this writing, all KfW activities can only be funded by KfW's own sources. KfW has issued a $180 million guarantee for BRAC securitization, with another guarantee of $55 million extended to Standard Chartered Bank by various donors to back a BRAC refinancing facility.[150]

GTZ's projects in Bangladesh are mainly focused on three areas: health care, human rights/democracy/participation/good governance, and renewable energy. Since 2002 GTZ has also been providing, together with a number of other international donors, technical assistance directly to micro and small enterprises in order to strengthen their economic environment. Another large GTZ area of focus is poverty reduction measures.[151]

Activities of the **Department for the International Development (DFID)** in Bangladesh are mainly focused on governance, poverty, vulnerability, and increasing jobs and incomes. Regarding the latter, DFID ran a program with BRAC to provide raw material to women who set up their own small businesses.[152]

The Asian Development Bank (ADB) is planning projects in a number of different areas, among them, technical and vocational education, gas sector development, SME sector development, and various capacity-building programs.[153]

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[149] See information on the IFC Web site on its Bangladesh investments and strategy at: http://www.ifc.org/ifcext/southasia.nsf/Content/Bangladesh_Investments; http://www.ifc.org/ifcext/southasia.nsf/Content/Bangladesh_Strategy; and http://www.ifc.org/ifcext/annualreport.nsf/AttachmentsByTitle/AR2008_Chapter3/$FILE/AR2008_Chapter3.
pdf (all URLs accessed August 2009).

[150] Information received directly from KfW.

[151] See the GTZ (German-language) Web site for more information on its Bangladesh investments: http://www.gtz.de/de/weltweit/asien-pazifik/bangladesch/20173.htm (accessed August 2009).

[152] See the DFID Web site for more information: http://www.dfid.gov.uk/countries/asia/bangladesh.asp (accessed October 2008); http://www.dfid.gov.uk/Where-we-work/Asia-South/Bangladesh/(accessed August 2009).

[153] See the ADB Web site for more information: http://www.adb.org/Documents/CSPs/BAN/default.asp (accessed August 2009).

Swiss Agency for Development and Cooperation (SDC) aims to promote a sustainable reduction in poverty in Bangladesh. SDC programs emphasize two main themes: jobs and income, as well as local governance. Gender and HIV/AIDS are a second focus.[154]

Canadian International Development Agency (CIDA) is focusing on social development (health and education), governance, and private sector development in the country. Major program objectives include enhancing the quality of basic education, improving delivery of health services, strengthening governance, and supporting the development of the private sector.[155]

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154 See the SDC Web site for more information: http://www.sdc.admin.ch/en/Home/Countries/South_Asia_Himalaya/Bangladesh (accessed August 2009).

155 See the CIDA Web site for more information: http://www.acdi-cida.gc.ca/bangladesh-e (accessed August 2009).

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