

The Role of State Regulation in the Evolution of Microfinance Institutions in Bangladesh

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DOCTOR OF PHILOSOPHY

Lila Rashid



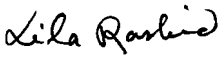
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DECLARATION

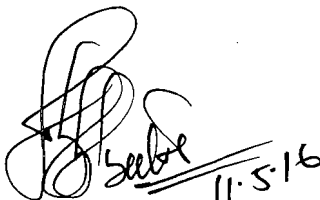
I hereby declare that the thesis entitled “The Role of State Regulation in the Evolution of Microfinance Institutions in Bangladesh” submitted by me for the award of degree of Doctor of Philosophy of Jawaharlal Nehru University is my own work. The thesis has not been submitted for any other degree of this University or any other university.



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CERTIFICATE


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LIST OF ABBREVIATION

AL	Awami League
ASARRD	Asian Survey of Agrarian Reform and Rural Development
APR	Annual percentage rate
BARD	Bangladesh Academy For Rural Development
BAU	Bangladesh Agricultural University
BB	Bangladesh Bank
BKB	Bangladesh Krishi Bank
BNP	Bangladesh Nationalist Party
BRC	Banking Reform Committee
CAMEL	Capital adequacy, Asset quality, Management depth and quality, Earning quality, and Liquidity
CDF	Credit and Development Forum
DB	Development Bank
DC	District Commissioner
DSS	Department of Social Services
FAO	Food and Agriculture Organization
FCB	Foreign Commercial Bank
FSRP	Financial Sector Reform Programme
GB	Grameen Bank
GBP	Grameen Bank Project
GoB	Government of Bangladesh
InM	Institution of Microfinance (Renamed as Institute for Inclusive Finance and Development)
IRD	Integrated Rural Development Programme
JB	Janata Bank

ME loan	Micro-enterprise loan
MFI	Microfinance Institution
MRA	Microcredit Regulatory Authority
NCB	Nationalised Commercial Bank
NGO	Non-Government Organisation
NGOAB	NGO Affairs Bureau
NGO-MFI	NGO-Microfinance Institution
NPL	Non-Performing Loan
PCB	Private Commercial Bank
PAR	Portfolio at Risk
PKSF	Palli Karma-Sahayak Foundation
PO	Partner Organisation of PKSF
RAKUB	Rajshahi Krishi Unnayan Bank
RFEP	Rural Finance Experimental Program
RFM	Rural Financial Market
SACP	Special Agricultural Credit Programme
SAP	Structural Adjustment Program
SCB	State-owned Commercial Bank
UNCDF	United Nations Capital Development Fund
UNDP	United Nation Development Program

GLOSSARY

Bhumiheen Samiti	Landless Association
Grahok	Client
Khudroreen	Microcredit
Kisti	Installment of a loan
Mohila Samity	Women Association
Samity	An association of similar type of people
Samity shava	Centre meeting
Shadosha	Member
Swanirvar Bangladesh	Self-reliant Bangladesh

CHAPTER 1

Introduction

1.1 BACKGROUND

‘Microfinance’ is often defined as financial services for poor and low-income clients without any physical collateral. It can be offered by different types of service providers. This phenomenon of microfinance is also widespread in Bangladesh and is mostly associated with the name of Grameen Bank and Professor Muhammad Yunus, who were jointly awarded the Nobel Peace Prize in 2006 “for their efforts to create economic and social development from below”¹ by using the instrument of microcredit and the organisation of Grameen Bank (GB). However, the initial idea of ‘microcredit’² in its present form, which originated in the late 70s in Bangladesh, has gone through different phases to reach its current mature form with changes in policies and practices. Over time, it has evolved as one of the most important policy and programme interventions in the international development community (Bateman, 1998) from the perspective of global finance. Bangladesh now has the largest number of microfinance organisations in the world³, has the highest number of microfinance clients⁴ as well, and is considered the birth place and pioneer of microcredit.

Problems related to providing financial services to different segments of the population, especially the poor and the marginally poor in rural markets, has been a long-standing debated issue among policy makers. Bangladesh has been involved in this debate from the very beginning. Like many other developing countries, many alternative attempts have been taken so far by the government of Bangladesh to meet the differential demands of the various sets of clients of this market in Bangladesh. This was done in order to ensure full financial inclusion of all segments of the population, to minimize the cost of providing credit services by micro-lenders, to prevent high pricing of that credit, to prevent the exploitation of poor clients by

¹Speech delivered by the Chairman of the Norwegian Nobel Committee in Oslo on 10th December, 2006.

² Microfinance is the expanded version of microcredit that includes other supplementary and complementary services like savings, insurance, and others. Here the term ‘microcredit’ is used interchangeably with ‘microfinance’ to refer to programmes that provide credit and other financial services to the poor.

³ At the end of 2014 there were more than 700 officially announced microfinance organisations.

⁴ It covers more than 25 million poor households.

service providers, and finally, to ensure an upward mobility for poor clients up the socio-economic ladder.

Bangladesh Bank (BB), the central bank of the country is in charge of managing the country's credit system as per Bangladesh Bank Order, 1972⁵. All commercial banks of the country were nationalized early in Bangladesh's history, immediately after independence in 1971. Not all these banks worked in rural areas. Loans and advances to the rural sector at concessional interest rates were made mainly through two specialized banks, namely a) Bangladesh Krishi Bank (an agricultural development bank established in 1960), b) Bangladesh Jatiya Samabaya Bank (a cooperative bank). Bangladesh Krishi Bank (BKB) gained particular government attention after the war of independence in consideration of the country's economic condition, then predominantly a rural economy. So, the adequate arrangement of institutional credit for the agricultural sector and other rural economic activities was essential for improving the post-liberation devastated economy as well as for ensuring food security of the country on an emergency basis. The government's policies during that period were mainly oriented towards pushing BKB to provide sufficient credit supply to the rural sector. Further policies were encouraging the establishment of new rural branches by nationalized commercial banks, and setting up special credit programmes targeting the rural financial market during the late 1970s, contributed to an increase in rural credit inflow through formal financial institutions.

A number of techniques were used in Bangladesh to encourage formal institutions to extend credit services to the poor, which included the nationalization of banks, loan quotas, loan size limits, rediscounting facilities, loan guarantee programmes, administrative commands, extensive agriculture credit supply, political programs, and others. However, regardless of these efforts and the goodwill and determination of policy makers, repeated natural catastrophes, other external shocks, and the consequent worsening of poverty alongside bureaucratic manipulation of credit flows towards wealthy farmers (Khalily & Meyer, 1993), subsequently compelled these banks to write off huge volumes of loans, primarily agricultural credit. The loan recovery rates of banks fell drastically, resulting in stagnation of rural credit supply that had developed over the late 1980s (GoB, 1995).

⁵ President's Order no. 127 of 1972 issued on 31st October 1972

Banking procedures were not in favour of poor people and the collateral requirement of banks to secure loans was identified as one of the major obstacles. Factors like the tiny size of loan amounts, poorly developed local infrastructure, the low literacy rate of borrowers, high impact of climatic conditions on business, and other such factors, raised the transaction cost and business risk dramatically for both lending institutions and their clients. Policymakers from all over the world had been searching for a viable technique to reduce the cost of credit for marginalized and poor borrowers. However, these various problems remain there in one form or another; debates persist. The major debate is around the question of how to serve the bottom end of the population at an *affordable price* with the help of *sustainable institutions*.

In the 70s, Bangladesh Bank engaged in some action research field experiments to find a viable model for solving the two main persistent problems, namely the problem of reaching the rural poor, and of making them economically viable⁶. The 'Grameen Bank Project (GBP)' was one of those early experiments that the Bangladesh Bank launched in 1979 with the initiative of Professor Muhammad Yunus of Chittagong University in Bangladesh. After successful implementation of the programme in some selected areas of the country this project later became 'Grameen Bank' in 1983, a specialized bank for the poor. Establishment of this bank under a special Ordinance⁷ introduced a new era of development in financing poor people through a formal institutional setup.

However, this government arrangement of establishing a separate bank for the poor was executed with the help of higher political authority, bypassing any direct involvement of the Bangladesh Bank and other banking concerns in the financial sector. In the Ordinance, Grameen Bank's connection with the Bangladesh Bank can be viewed in an isolated manner⁸. Bangladesh Bank was not given any monitoring or supervising authority as such. All the provision of control and power remained in the hands of the semi- autonomous board of Grameen Bank, nominated mostly by the government itself. Hence, Bangladesh Bank is not involved in any business or policy-making process related to Grameen Bank unless the government desires it. Grameen

⁶Foreword by A.K. Gangopadhyay in Bangladesh Bank (1979).

⁷The Grameen Bank Ordinance, 1983 (Ordinance No. XLVI of 1983)

⁸ The only connection can be seen with the Bangladesh Bank in section 5(2) of the Ordinance where it is mentioned 'The Bank may, with the approval of the Bangladesh Bank, open such regional and other offices as the Board may think fit'.

Bank was always in the good books of the central bank and received all kinds of financial and policy support from Bangladesh Bank when and where necessary⁹.

The pioneering success of Grameen Bank's innovative approach¹⁰ in delivering credit to the rural poor without collateral, encouraged many Non-Government Organisations (NGOs)¹¹ working in Bangladesh to provide microcredit to low-income groups. But these NGOs were registered under different laws of various departments of the government, where none of these rules¹² endorse 'microcredit' operation of the NGOs as such. The purpose of these laws was to establish 'societies' or 'non-profit companies,' or 'charity' type organisations engaged in the delivery of various kinds of services to poor people at the grassroots. NGOs have initiated microcredit operations as a marginal or additional part of their 'development' agenda under a legal structure of 'not for profit' organisation. They were able to enjoy more freedom during that early stage of flourishing microcredit operations in Bangladesh compared to that of Grameen Bank which, from the very beginning had formal legal bindings. In the absence of any direct state intervention, NGO-MFIs (microcredit provider NGOs) mushroomed, especially after the 1990s (Rashid, 2011).

Over time, many commercialized and specialized banks were also encouraged by the government and the Bangladesh Bank to introduce microcredit programmes, either as part of the social agenda, or to expand financial services to the rural sector. It has become a very popular and trendy development tool and the government itself has started microcredit operations from its different departments with the agenda of poverty alleviation. The central bank has also begun targeted programmes for fuller

⁹Awarded by the Bangladesh Bank in 1985 in recognition of the contribution in devising a new banking mechanism to extend credit to the rural landless population (<http://muhammadyunus.org/index.php/professor-yunus/awards?start=90>, accessed on July 9, 2014). The Bangladesh Bank provided all kinds of financial support till late 90s. Grameen Bank received all policy support from Bangladesh Bank in its early phases. Professor Yunus received special favour from most of the Governors of the Bangladesh Bank to solve problems (related documents of the Bangladesh Bank in ACD and BRPD & Yunus, 2006).

¹⁰ Major innovations are credit facilities for poor people without collateral, group guaranty, and peer monitoring systems to minimize risks, regular savings habit embedded with the credit facilities, and service at the doorsteps of borrowers.

¹¹ BRAC claims (in MRA database, & <http://www.brac.net/content/faq>, accessed on 11 December 2014) that it had started credit programmes in 1974; however no evidence as such was found in favour of this claim. Hulme & Mosley (1996, Vol-2) have cited (from Lovell, 1992) that during the first half of the 1980s, BRAC was experimenting with organizing low-income groups, and rural training and credit extension.

¹² The Societies Registration Act, 1860; The Trust Act, 1882; The Voluntary Social Welfare Agencies (Registration & Control) Ordinance, 1961; The Companies Act, 1913/ 1994.

financial inclusion of economically active segments, and the population underserved by formal financial institutions¹³. The banking sector has been encouraged by the central bank to establish linkages with NGOs to reach this population segment. As a result, NGOs have become another set of credit delivery organisations of sorts to channel funds to the rural economy from the formal banking sector, especially to poor people. Hence, these NGO-MFIs, alongside commercial banks and Grameen Bank, are now seen as another new instrument of monetary policy transmission.

Recent changes in RFM –Empirical study

Due to the emergence of the above mentioned two new organisation types, such as Grameen Bank and NGO-MFIs in the financial market, the structure or entire landscape of the rural financial market has changed dramatically. An empirical study of Hossain and Bayes (2010) illustrates those changes in the market over the last twenty years (1988-2008), which has been summarised in table-1.1. This study is based on household level data collected over four time periods (1987-88, 2000-01, 2004 and 2008) for some studies commissioned mainly by IRRI, BIDS, DFID, and BRAC.

Table-1.1: Changes in rural financial market in Bangladesh from 1988 to 2008

Sources of credit	Per cent of households borrowing from the source		Average loan for borrowing households (US\$)		Share of the source in total loan (%)	
	1988	2008	1998	2008	1988	2008
Banks	9.0	4.8	136	735	20.7	21.0
MFIs	3.8	34.1	102	184	6.7	37.0
Money lenders	14.6	4.6	155	537	39.0	14.8
Friends & Relatives	16.9	4.9	115	920	33.6	26.8
All sources	44.3	44.8	131	374	100.0	100.0

The table shows that microfinance institutions alone held the lions' share of the market by 2008, having held the lowest market share twenty years back in 1988. The government's recent Rural Credit Survey of 2013 has also supported this fact. It is also evident from the table that the percentage of households borrowing from banking

¹³ Monetary Policy Statement, January-June 2014, Bangladesh Bank. Recent circulars of the Bank related to 'Financial Inclusion'.

sources has declined, but its market share has remained almost unchanged due to the increased average loan size per borrowing household from the banking sector, which has increased more than five times during this period. It is interesting to note that both the market share of moneylenders and the percentage of households borrowing from them have declined drastically during this time, though the average loan size from moneylenders has increased over three times. Furthermore, the average amount of borrowing from the MFIs has not increased much during the same period. However, both the market share of MFIs and the percentage of households borrowing from these organisations have increased immensely.

Therefore in the static scenario of households' borrowing from different sources, which was a little over 44 per cent and has remained unchanged over the last twenty years, it is evident that the significant market share taken by the new sector (MFIs), is not only from moneylenders but also from the banking sector. Another recent survey conducted by the Institute of Microfinance (Berg et al. 2014) also confirms these findings. As the average loan size from NGO sources is smaller compared to the banking and the informal sector like moneylenders, it can be assumed that poor people may have a natural preference for borrowing from NGOs since there is no requirement for collateral security and the service is provided at the borrower's doorstep.

Regulatory responses of state agencies

Even with these remarkable changes in the market over a period of only twenty years, direct regulatory intervention from the state in response to the emergence of microfinance institutions, especially the entrance of NGOs in the market, was not seen before 2006. The Grameen Bank Ordinance was passed in 1983. However, after that, this law and its related time to time amendments remained as a stand-alone policy response exclusively for the purpose of Grameen Bank. Initially, the need for a regulatory requirement for NGOs was not felt as they were viewed as philanthropic endeavours, dedicated to social needs and upholding ethical standards.

But gradually, the situation began to change. While the microfinance sector continues to grow fast in terms of its client outreach, coverage, volume of microcredit and micro-savings, liquidity and credit risks are also growing. Domination of the market by a few giant MFIs has posed a systemic risk as well as an opportunity for oligopolistic collusion or monopoly, while profit and rents have arisen. As NGO-

MFIs have started accepting deposits, and these activities have risen considerably, that factor has also put legal obligations upon the government to safeguard people's deposits. The significant increase in NGO-MFIs' numbers, has raised the need to ensure appropriate fund utilization and curb exploitative pricing. To establish institutional structures that ascertain operational accountability and financial transparency called for the creation of a regulatory and supervisory environment in Bangladesh. NGOs also welcome a certain level of legal recognition because they also need a sound legal footing to gain access to varied fund sources.

The voluminous growth of the industry, deposit collection by the NGO-MFIs in the absence of any legal protection, charging higher credit interest rates than the banking sector, the risk of over-indebtedness of poor borrowers borrowing from multiple sources, the sustainability of these institutions in the absence of cheap capital fund sources such as donations and subsidies, ensuring good governance within institutions mandated to run as non-profit organisations, the issue of their transparency in operation and accountability to a central authority, all these various issues were identified in numerous follow-up research literature as well (Khalily & Imam, 2001; Akash, 2011; Khan et al., 2011; Rashid, 2011.) These issues became major points of concern for the government in later stages¹⁴, and they also called for different types of regulatory laws and rules in the late 90s.

A national committee¹⁵, headed by the Governor of Bangladesh Bank, was formed by the Ministry of Finance in 2000 under a Unit named 'MRRU'¹⁶. This unit played the primary role in formulating policies for microfinance. It was housed in the Bangladesh Bank. Transparency and accountability in the operation of NGO-MFIs, and bringing them under a uniform monitoring system, were two important terms of reference for the MRRU and the committee. The Committee prepared a draft proposal regarding the legal structure of NGO-MFIs in 2005 after a few years of participatory consultation with various stakeholders, including the MFIs. As a result, a parliamentary law was passed in the middle of 2006 on the basis of this draft, known

¹⁴ Rashid (2011) mentions about two studies conducted by the Bangladesh Bank in 1997

¹⁵ Members were selected from the government, policy makers, Bangladesh Bank, private practitioners (MFI representatives, network agencies) and researchers.

¹⁶ A proclamation of the Ministry of Finance issued on June 18, 2000 established the 'Microfinance Research and Reference Unit (MRRU)' in Bangladesh Bank. To administer the functions of this Unit, a Steering Committee consisting of 11 members under the Chairmanship of the Governor of Bangladesh Bank was formed.

as the ‘Microcredit Regulatory Authority Act, 2006,’¹⁷ which recognized NGO-MFIs as ‘organisations that provide credit facilities for poverty alleviation’. Enactment of this law was actually the first direct regulatory response of the state in the public domain addressing this new sector (NGO-MFIs) as one of the financial intermediaries in the financial market of Bangladesh. According to the law, a separate regulatory authority outside the central bank system¹⁸, namely the ‘Microcredit Regulatory Authority’ or MRA, was established in the country to monitor and supervise the operations of NGO-MFIs, considered to be a unique case in the history of microfinance worldwide¹⁹. It should be mentioned that Grameen Bank was again kept outside the jurisdiction of this new Authority specially designed for the microfinance sector.

According to the law's provision, the Microcredit Regulatory Authority (MRA) is authorized to monitor and supervise microcredit operations of NGOs under a full-fledged regulatory framework. Currently, there are over 700 NGOs that received licenses from the MRA till 2014 and more are in the pipeline. However, a few, very big NGOs dominate the microfinance market in Bangladesh where Grameen Bank as a single organisation also has a significant share²⁰ of the total market. The NGO-MFIs have already spent eight years in a regulatory environment until 2014. Hence, policies under this new law most likely have had at least some important catalytic role in changing the market dynamics. Experiences of this new Authority (Rashid, 2011) indicate there are some important issues that need to be addressed with caution; among them, service charges, sustainability of the sector, the problem of overlapping borrowers, establishing effective supervisory tools to monitor the sector, while new issues like foreign investment and technological changes are also arising. Consequently, the MRA went ahead in formulating a supplementary set

¹⁷ Act no. 32 of 2006, Bangladesh Gazette.

¹⁸ The governor of the Bangladesh Bank remains the chairman of MRA’s Board by designation [Section 6(1)(ka) of MRA Act 2006], which seems the only direct connection of the MRA with the central bank.

¹⁹ “This is the first time a separate legal entity has been created for the purpose of regulating the microfinance sector. In other countries microcredit is part of the central bank activity. We were debating whether it should be left with the central bank or whether it should be separated out.” Comments made by Professor Muhammad Yunus in the International conference on Microfinance Regulation arranged by the MRA in March 2010 (Rahman & Rashid, 2011, P.279)

²⁰ As of December 2014, GB’s share in total (NGO+GB): Branch-14.43%, member- 25.38%, Borrower- 24.77%, Savings- 46.58%, & loan outstanding – 21.34% (Bangladesh Microfinance Statistics, CDF, 2014).

of rules²¹ and circulated a number of policy guidelines²² to give the NGO-MFIs an institutional shape.

As mentioned earlier, the Grameen Bank Ordinance, 1983, has also been amended a number of times, mostly in the 1990s, to redefine the power of its Board and the Managing Director. All the amendments of 1986 and the 1990s, incrementally empowered the Board further and reduced government control over the Bank, as was desired by Professor M Yunus (2004, P.156-165). The Board also took advantage of the reduction of the government's share (Grameen Bank, 1987, P. 14)²³ in the bank in the form of extra capital injection without any legal amendment to the original law. This was a thorny issue and has remained unclear, if not unresolved. Gradually, this issue of share distribution and some other managerial and personal issues involved Grameen Bank in some arguments with the government in 2010. It was a surprise move by the state after a long time of uninterrupted, more or less autonomous, and free operation of Grameen Bank. Professor Yunus, even in the late 80s was quite happy with the government's attitude towards Grameen Bank and at that time expressed his satisfaction regarding the government's attitude towards Grameen²⁴ (Grameen Bank, 1987, P. 40).

In consequence of a legal battle between the state and Professor Yunus, finally, the Bangladesh government removed Professor Yunus from his position at Grameen Bank in March 2011. Bangladesh's High Court affirmed the removal on 08 March 2011. Afterwards, the government further amended some clauses of the original Ordinance²⁵ to regain its share and control over the bank. In the new version of the law, the Bangladesh Bank was empowered and instructed to perform some duties such as appointing the Managing Director and monitoring the financial statements of the Bank, though the Bangladesh Bank had not been given the usual administrative authority to take any follow-up corrective and punitive actions against Grameen Bank Board members or employees.

²¹ Microcredit Regulatory Authority Rules, 2010 published in December 2010, and Depositors' Protection Fund Rules, 2014.

²² MRA issued 28 circulars by December 2014 (www.mra.gov.bd).

²³ Professor Yunus mentioned in a telephone press conference in Washington DC on July 22, 1987 (with editorial writers from 40 newspapers across the USA) that 'we are trying to get the Government's share out, persuading the government to release that share'. This conference was organized by RESULTS, a grassroots lobby dedicated to creating the political will to end hunger.

²⁴ In the same telephone press conference mentioned above in the footnote he said '*they (the government) have so far shown great respect for the organisation and have been very appreciative of our work*' (Grameen Bank, 1987; P: 40; italic by the researcher).

²⁵ The Grameen Bank Act, 2013 published on November 10, 2013

To date, ‘microcredit’ and ‘Grameen Bank’ are almost synonymous, at least in Bangladesh, though many new types of formal and informal MFIs have emerged in the meantime²⁶. Therefore, public views (political too) towards Grameen Bank matter a lot for the microcredit sector. Microcredit research without addressing Grameen Bank related issues, presents only a partial picture. I have thus addressed Grameen Bank issues in parallel to NGO-MFI issues as necessary to clarify the background and views (public and government), though the major focus of this study is on NGO-MFIs.

Against this backdrop, this research would like to trace the historical role of state regulation and the role of regulating agencies, especially the role of Bangladesh Bank and the Microcredit Regulatory Authority in the evolution of microfinance institutions in post-independence Bangladesh. What rules did they impose, what did they wish to control and achieve, and how successful were their efforts?

1.2 INSTITUTIONAL RULES: THE GAP IN OUR KNOWLEDGE

Microfinance studies on Bangladesh mainly focus on impact analysis and programme performance, and a few studies have been done on the governance and sustainability of microfinance institutions. These studies broadly included outreach, efficiency, sustainability, impact on borrowers and market structure²⁷. Very few research papers are available on the regulatory and policy issues of microfinance in Bangladesh, especially the role of rules and the state in influencing MFIs.

There is voluminous literature on Grameen Bank at home and abroad. Hossain’s (Hossain, 1984 & 1988) studies are considered to be the earliest comprehensive works among them. In the studies, he critically analysed programme performance on the basis of household surveys in the early days of Grameen Bank, where he mentioned its novelty and possibility of replication by others. He pointed out that this programme was costlier than general banking programmes, and that it was crucially dependent on the direct involvement of its founder, Professor Yunus.

²⁶ The common features with respect to microcredit between Grameen Bank and the same of the NGOs like ASA and BRAC are: group formation, individual credit, weekly repayment, mandatory savings, and targeting women. However, there are also some minimal differences such as ASA has dispensed with the group guarantee and added voluntary savings, BRAC provides credit plus facilities (such as health, education, legal, etc.) to its clients (McGuire, & Conroy, 2000; Rashid, A. K. M. A., 2001; Nabi & Ahmed, 2001). Considering the above, we can conclude that the basic credit mechanism or model pioneered by Grameen Bank were subsequently followed by the other organisations without much modification

²⁷ For example see Khandker et al. 1995; Khandker, 1996; Khandker, 1998; Khalily et al. 2000; Hulme 2007; Sinha 2011

Khandker's studies (Khandker et al. 1993; Khandker, 1995) are considered as other well-known works that investigated whether Grameen Bank was a sustainable financial institution for poverty alleviation. According to Khandker (1995), though Grameen Bank depended heavily on the committed leadership of Professor Yunus, and it received initial funding in the form of both subsidies and grants, it was potentially sustainable without such help. The Grameen Bank as an innovative organisation, has been studied by many authors and researchers from different perspectives such as empowering poor people (Holcombe, 1995), empowering women (Todd, 1996), poverty alleviation (Khandker, 1993, 1998), sustainable rural finance programme (Rahman & Hossain, 1986), new development programme (Counts, 1996) and others.

However, the issue of its governance and internal management has not been discussed much. Especially the law that gave it institutional shape has never been a part of any research; it came into focus in 2010 after the government's intervention in Grameen Bank's operations, by using the various original clauses of the Grameen Bank ordinance. However this issue has once been discussed by Professor Yunus himself in his biography (Yunus, 2004; P: 163) from an opposite perspective and later in many of his other publications. He repeatedly raised at least four such issues related to the "privatization" of Grameen Bank (Yunus, 2004: Part-3, Chapter 23) such as: a) the distribution of shares between borrowers and the government, b) composition of board members, c) appointment of Managing Director, and d) appointment of Chairman. According to him, the first three issues were being resolved with the government after a prolonged wait and challenging attempts reflected in amendments to the original law in 1986 and the 1990s, but the last one remained unresolved. Some issues related to governance came up in informal discussions regarding Grameen Bank's composition of Board members, and their method of selection, as well as their capability to contribute to Board meetings. However, no serious investigative report²⁸ or published research is available on these important issues of the governance of Grameen Bank. In this context, Akash (2011) has raised some critical points related to the effectiveness of the Board of Grameen Bank,

²⁸ Recently a special Commission formed by the Bangladesh Government has published an interim report on Grameen Bank in February 2013 that has addressed some of the legal issues (URL: http://www.mof.gov.bd/en/budget/gb/Grameen_Bank_Interim_Report.pdf)

though he has taken it for granted that Grameen's members were all formally enjoying the rights of ownership of the bank. He says:

Like any other shareholding company, Grameen Bank is also susceptible to the general agency problem. The problem seems to be more acute here because of the very low capacity of its poor principals/ owners. Thus the strategic guidance of the organisation largely depends on the benevolent character of its other educated and powerful board members. The question has been raised: what would happen if the charismatic benevolent leadership of the organisation ceases to exist? And whether the poor owners of the rich bank will really be able to protect their own interest in such a case. (P.207)

The general view of all the published literature is that Grameen Bank is an organisation which evolved independently as an isolated case with the sincere efforts of its charismatic founder, Professor Muhammad Yunus. It is generally viewed as a single person driven programme under some dedicated rules of the government that evolved without any link to the broader socio-political context and interactions. Therefore, the whole process of transformation of this Bank and the political economy behind it remained a matter of less importance or ignorance. Hulme and Moore (2006) have shed some light on this issue while discussing 'The Political Economy of Success' of microfinance in general. They mention:

With specific reference to the Grameen Bank, it has to be observed that it has been skilfully managed since inception so that it is both embedded in Bangladeshi society and able to leverage changes in that society. Professor Yunus has been able to use and build on his personal status, as a member of Bangladeshi's elite with a PhD from the USA, to steer Grameen Bank around potential obstacles in the country's political economy. While the country was under authoritarian rule, Yunus negotiated Grameen Bank's progression to be a statutory organisation. This gave Grameen Bank the freedom to escape having to lend as part of a patronage system, to set its own interest rates, and to be officially regulated in ways that did not constrain the institution. Subsequently, Grameen Bank has been able to avoid challenges from the country's various democratic governments..... (P.21)

The two issues of ownership and governance related to the political economy of Grameen Bank, and the formal rules that ensure the rights of ownership of the bank by its poor members, have not received much attention from researchers, not even from groups who generally criticize the operation of microfinance and Grameen Bank from a 'left' or Marxist perspective. Over time, these two fundamental policy issues have surfaced and have now become the deciding factors for Grameen Bank's future and its continued smooth operation.

The general issue of rules and regulations related to microfinance came into focus much later after NGOs' entered the market, both at home and abroad. NGOs have demonstrated a widespread success in building an alternative institutional framework that efficiently reaches the poor, bypassing public bureaucracy (Quddus et al. 2009). Before their entrance into the financial market, no one could think about 'non-profit' financial organisations. Practically there were only three types of financial organisations in Bangladesh; they were a) state owned, b) privately owned, or c) collectively owned cooperatives, and there was a whole set of fully-defined rules for all these organisations.

Grameen Bank is a unique, mixed type of organisation that has all the characteristics of a 'state owned' body but also simultaneously enjoys certain privileges in common with any 'privately owned' or 'cooperative' type organisation. It had started operations under a clear charter of the government, so no confusion was there regarding its nature. On the other hand, NGOs are another type of organisation, neither 'private' nor 'public', as they emerged 'from growing distrust of the government and big business' as the 'third sector' in favour of ordinary people (Cairncross, 1995)²⁹. This new type of organisation outstripped the Grameen model of microfinance after the 1990s (Bateman, & Chang, 2012) because they were far more flexible than Grameen Bank, and their operations matched the changing features of global policy paradigms after the 1990s. As stated by Bateman & Chang (2012):

By the early 1990s, a thoroughly 'neoliberalized' for-profit model of microfinance was being ushered in as the 'best practice' replacement for the original subsidized Grameen Bank model. (P.15)

Quddus et al. (2009) also supported this argument of a for-profit model; they mentioned, "*In an effort to lessen the financial dependence of NGOs on donor funds, the donors have been pushing for NGO self-reliance since the 1990s*" (P.19). On this perspective, Quddus et al. (2009) have cited from a World Bank paper (2006) where the bank has emphasized NGO reforms leading to greater self-sufficiency, transparency, and accountability, 'to create a level playing field with the private sector' in Bangladesh. Therefore, NGOs have shifted their attention to credit delivery and other business that is mainly the result of a market-led approach. However, their legal structure and institutional form remained scattered and sometimes unstructured,

²⁹ As cited in Quddus, et al. (2009)

as they were initially registered under different laws of the state as ‘non-profit’ organisations and those laws were not updated enough to incorporate their credit operations. Hence, it creates the confusion. The major confusion was regarding-a) what kind of financial organisations are they?, b) what is their nature?, c) how will they be treated?, d) are they like a bank or not?, and e) are they permitted to collect savings like Grameen Bank?. All these dilemmas continued for over a decade, waiting to crystallise into some pointed questions regarding the nature of NGO-MFIs.

All the countries that have gone through the same experiences of NGOs’ entering the financial market have been facing the same enigmatic dilemmas regarding legal issues. But, the issue of regulation is important, both from a ‘public interest view’ (Barth et al., 2006; Llewellyn, 1986; Francies, 1993) and a ‘private interest view’ (Stigler, 1971; Posner, 1974; Peltzman, 1976). As for other FIs, similar reasons have been posed for the regulation and supervision of MFIs, with the overall objective of achieving financial system stability and deposit protection. In response to this, the nature of the regulatory structure of MFIs varies widely, depending on the country context and evolutionary process of the institutions in those countries. Therefore, debates around different modes of regulation continue, not only in Bangladesh, but also worldwide (Rahman & Rashid, 2011³⁰).

Initially, most of the discussions were based on ‘no regulation’ or ‘non-prudential regulation’ (CGAP, 2002),³¹ comparing the MFIs insignificant amount of total assets in the overall financial system (Berenbach & Churchill, 1997) and the non-deposit nature of their operations (Churchill, 1998). However over time, ‘prudential regulation’ for the sector has been gaining more importance on the ground that massive sustainable delivery of financial services to the poor can only be achieved in a regulated setting (Christen et al., 2000 & 2003; Robinson, 2001).

Hence, with gradual changes in market size and policy outlook, more and more countries have been coming forward with formal rules and regulations with the expectation of mainstreaming these new types of financial institutions³², and Bangladesh has followed the same path. Chiumya (2006) from Zambia has identified four different approaches to regulating and supervising MFIs while surveying literature, such as: a) self-regulation approach, b) delegated supervision approach, c)

³⁰ Microfinance Regulation: Background and Overview

³¹ CGAP website on microfinance regulation provides more information on this issue.

³² Experiences of microfinance regulation from Bangladesh, Cambodia, India, Ethiopia, Uganda, Zambia, Bolivia and Mexico can be seen in Rahman and Rashid (2011)

existing law approach and d) special law approach. On the other hand, Khalily et al. (2012) from Bangladesh divides the regulatory approach into three broad categories, which are: a) MF regulation with existing law, b) MF regulation through a separate act, and c) MF regulation through a discrete regulatory body. Among these, Bangladesh has taken the special law approach through a discrete regulatory body after 2006.

Therefore, the literature on the regulatory aspects of microfinance is mostly theoretical in nature. Recently, a few studies have been conducted on the impact of regulation on MFIs (Chiumya, 2006; Hubka & Zaidi, 2005). Chiumya has completed a detailed empirical study on Zambia as a relevant case study where she used a Regulatory Impact Assessment (RIA) framework. She made a final comment saying that the introduction of legislation was not enough to produce viable institutions if effective implementation measures did not accompany the legislation. In the case of Bangladesh, a few papers (Khaled, 2001; Khalily & Imam, 2001) also brought forward issues of regulations and the range of regulations for public discussion.

There are a few research studies focusing on some areas of recent regulations in Bangladesh, sponsored by the MRA in the process of formulating rules,³³ to get a better understanding of the market. These studies are mainly on the issues of granting a license, ownership & governance, savings mobilization, auditing, and insurance. Among them, two are published papers (Akash, 2011; Khan et al., 2011) in Rahman and Rashid (2011). In addition to these, there are two jointly conducted recent studies by the MRA and InM³⁴ on the “Impact of MRA Regulation on the Cost Efficiency of Microfinance Institutions in Bangladesh” (Khalily et al., 2012) and the “Effectiveness of MRA Regulations in the Microfinance Sector: The User Perspective” (Latif et al., 2013).

All these researchers reflect a comparatively static view of the impact of regulation on the microfinance sector of Bangladesh. They have produced useful insights, but they cannot unfold the complex dynamics of the industry, the interaction between the regulators and the regulated. These research works have not viewed the development of microfinance in Bangladesh from the perspective of the changing role

³³ Microcredit Regulatory Authority Rules, 2010

³⁴ Institute of Microfinance (recently renamed as Institute for Inclusive Finance and Development), an ‘institution not for profit’, in Bangladesh for research, training and knowledge management in microfinance and poverty that has been created with the technical help of PKSF, and financial help of UK-AID (former DFID). For details visit URL: <http://www.inm.org.bd>.

of the state and hence they fail to reflect the political economy of microfinance in the country.

Considering the limited scope of the above mentioned studies with regard to my particular focus area, and also since there has been no research till now on the overall outcome of the new Act, rules and regulations in building new institutions in Bangladesh, especially from the perspective of the evolving role of such institutions, this research aims to fill that gap.

1.3 OBJECTIVES OF THIS STUDY AND RESEARCH QUESTIONS

Given this historical context, this paper tries to investigate the various kinds of state regulations and interventions initiated by different regulatory institutions like the Bangladesh Bank and the MRA to regulate microfinance institutions in the financial market of Bangladesh, especially from 2006 onward.

This study also tries to analyse the institutional structure of microfinance that evolved over time under the impact of the special Ordinance for Grameen Bank³⁵, as well as MRA rules³⁶ and other guidelines of the Bangladesh Bank³⁷. In this thesis, I am not treating the MFIs as mere objects controlled by regulating agencies, but rather as active subjects continuously responding to different regulations introduced from above. Thus, the evolution of the MFIs, their responses and adjustment strategies are an important matter for analysis.

As part of background study for the development of MFIs, the study also traces the process of their historical emergence and the national political-economic basis of these microfinance institutions. This historical-political-economic investigation will primarily attempt to explain the emergence of the pioneer institution, Grameen Bank, and also to examine the initial set of rules and regulations developed before 2006, around the Grameen Bank of that time. I am also presenting a few observations about the relatively less significant role of Bangladesh Bank as state representative in dealing with issues related to Grameen Bank at that time. It needs to be noted that the MRA had not yet been formed then.

These aforesaid issues raised some concrete research questions to make a final assessment of how far the regulations and rules were successful in enhancing the

³⁵ Grameen Bank Ordinance, 1983 and Grameen Bank Act, 2013

³⁶ Microcredit Regulatory Authority Act, 2006 and thereafter other related rules and circulars of the MRA.

³⁷ Guidelines of Bangladesh Bank for rural financial market.

development of a viable, inclusive, affordable, and pro-poor model of microfinance in Bangladesh.

Working hypothesis and research questions

Almost all kinds of states have had an age-old desire to find a viable model for rural financial markets serving poor people at affordable prices. Bangladesh has been providing regulatory and other support to microfinance institutions since their inception, sometimes in a proactive manner, sometimes in reactive ways to achieve the goal of serving the financing needs of poor people. Has that goal been achieved? Do MFIs in Bangladesh in their current form show that hope? Over this extended period of time, how much have they achieved? On the basis of these broad questions my hypothesis here is that the state's regulatory role is important in the evolution of MFIs in Bangladesh. However, it is still not sufficient to achieve the stated goals of the regulation. MFIs are yet to show their efficiency and yet to find their path to prove themselves as operationally viable. The question of fund sources is still a big issue for their viability; parallel to that, their operational efficiency is another area that could be questioned. They are swinging between two missions of viability and serviceability to the poor, the same old problem of efficiency versus equity. State rules neither give direction nor have any sound monitoring mechanism to ensure efficiency. The Bangladesh government's consistent support for a regulatory agency has not always yielded desirable results. The affordability of these programmes for the clients is another grey area that remained unuttered in state rules because they, the clients, are the weak and uninformed participants of these programmes, and their problems remain submerged at the bottom. The clients' protection, their rights and decision-making process, are other areas of concern that remain fragile.

The broad objectives of this research mentioned earlier in this chapter, can be spelled out more explicitly under the following three specific sub-heads, each of which can again be further developed by listing the related, more specific, research questions which are as follows:

Objective-1: To obtain an in-depth understanding of the role of Bangladesh Bank in supporting and facilitating the microfinance sector in Bangladesh.

It is especially important to understand the views and position of the Bangladesh Bank, whose duty is to provide direction and guidelines to the financial markets as a

whole. It is necessary to understand how Bangladesh Bank fits itself into the regulatory regime of the microfinance sector and its attitude towards the emergence of these new institutions. In this regard, the establishment of Grameen Bank, the emergence of a new regulatory body outside the Bangladesh Bank system, and its role in developing the sector needs to be analysed thoroughly. This research objective can further be tuned with the following specific research questions.

- What roles has the Bangladesh Bank played in the emergence of the original pioneer microfinance institution, Grameen Bank?
- How does the Bangladesh Bank respond to Grameen Bank related issues where it does not play a direct role in monitoring and supervising Grameen Bank as it does other banks?
- What are the policies and instructions of Bangladesh Bank (if any) that address the issue of new NGO-MFIs in the financial market?
- Why has it become necessary to establish a separate regulatory authority for the newly developed microfinance sector (NGO-MFIs), bypassing the Bangladesh Bank?
- How does the Bangladesh Bank view the intervention of the MRA since 2006 in regulating MFIs, bypassing the direct involvement of Bangladesh Bank?
- How do Bangladesh Bank and the MRA correlate in the development process of MFIs in the RFM of the country?

Objective-2: To obtain an in-depth understanding of the new regulatory regime of the MRA in building the microfinance sector.

The new regulator, the Microfinance Regulatory Authority (MRA), came into force after more than two decades of semi-spontaneous operation of NGO-MFIs in the market. So the particular problems or situations of this sector which have invited the role of a separate regulatory authority need to be understood. There is also a need to understand the specific areas of regulation defined by the law and other rules formed from time to time, under which the MRA works. In this connection, considering the size of the NGO-MFI sector and its institutional locations in remote areas, it is important to understand and assess the capacity of this authority, the MRA, to exercise the power of regulation and its implementation procedures. A critical examination of the scope of its controlling functions needs to be understood well. So the following questions are posed.

- What are the important considerations in formulating the new laws?
- How does the new law address diversification among the NGO-MFIs?
- How are MFI views and features being dealt with in the law and the subsequent rules?
- What is the comparative advantage of the MRA over the Central Bank in regulating MFIs?
- What are the core areas of the law and rules that help microfinance institutions to be efficient, transparent, and accountable to the MRA?
- How is the MRA benefiting client, what are the policies to protect clients and to ensure their rights?
- How does the MRA provide overall or macro guidance and direction to the sector?
- Is the MRA capable enough to handle this huge sector in Bangladesh? What are its strengths, weaknesses, threats, and opportunities?

Objective-3: To assess the outcome of state regulation of the microfinance sector.

One of the objectives of this study is to evaluate the outcome of rules, regulations, and the MRA on the microfinance sector in building an effective and efficient financial market and thus reaching a larger population segment of the country, as well as advancing self-sustainability of NGO-MFIs . This would lead to mainstreaming the sector with the broader financial market. Thus, this research objective leads to the following more specific research questions.

- What are the benefits and incentives the law has provided the MFIs? Why would MFIs want to be regulated?
- What are the policies most affecting MFI operations, and how?
- Has the efficiency and sustainability of MFIs improved under the new regulatory settings? How is the MRA helping MFIs to be efficient and sustainable?
- Do clients make informed decisions? What mechanisms are available to them to be informed?
- Are MFI operations more transparent to stakeholders since the law's enactment?
- How do different stakeholders perceive the operations of the MRA?

1.4 LAYOUT OF THE THESIS

This thesis is arranged into ten chapters. The first chapter explains the research agenda, its purpose, and research questions. Being the first chapter, it presents the background of this research and describes the changes in overall policies along with the knowledge gap related to rules and regulations applicable to MFIs in Bangladesh. It states key research questions and the working hypothesis as well.

The overall conceptual framework of this research and research methodology is the central agenda of chapter two. It clears the concept of ‘institution’ and ‘institutional analysis’ since this thesis has chosen an institutional approach to analyse microfinance regulation. In this context, the basic concept of game theory and Institutional Analysis framework (IAD framework) have been explained here to clarify how these are going to apply in this research. Identification of variables and the relationship between them has also been discussed in this chapter. As a complex analytical tool, the IAD framework demands that variables interact with each other to generate certain outcomes in certain conditions. Therefore, this chapter presents a list of expected outcomes and their evaluating criteria. It also describes data sources, data gathering, and data analysis procedures.

Chapter three provides an overview of the rural financial market from a changing global political economy perspective. The very purpose of this chapter is to set the thesis within the context of a policy shift in the global financial market because the emergence of microfinance is not merely a ‘homemade’ issue. Rather, it is very much linked to global issues. This chapter describes the changing role of the state under different paradigms, especially for rural financial market. Finally, it explains how various models of microfinance have emerged in different countries with changing, evolving views.

Brief overviews of the macroeconomic indicators, and the financial market of Bangladesh, are the main topics that have been covered in chapter four. It discusses how the country’s policies for the financial market have changed with changes in political power throughout the entire period of this study. In this connection, the discourse around the financial sector liberalisation programme undertaken by the government of Bangladesh, and its impact on the rural financial market, has been presented in this chapter. This discussion provides a background for understanding the emergence of different types of microfinance institutions in Bangladesh.

Chapter five discusses new experiments undertaken mainly by the Bangladesh Bank in the 70s in the hope of finding an ideal institutional model to provide financial services to the rural poor. This chapter helps with understanding the role of state regulatory agencies like the Bangladesh Bank in the evolution of the microfinance sector in the early years of Bangladesh. It also explains how finally some new ideas converged in favour of Grameen Bank in its early phases of experiments under the Bangladesh Bank.

The Grameen Bank is the central issue in chapter six. How the first microfinance organisation evolved in Bangladesh as a formal bank with the help of a Martial law government, how the Bangladesh Bank was kicked out from the picture, the legal structure of Grameen Bank, its topsy-turvy relationship with the government and so on, have been discussed in this chapter. In this context, this chapter presents an analysis of the recent debates around this bank as well. These discussions revolving around Grameen Bank help in understanding the role of Bangladesh Bank and the changing views of the state towards microcredit. It also provides a clue as to why Grameen Bank was kept outside the monitoring and supervisory system of Bangladesh Bank.

Chapter seven provides a detailed background of the historical emergence of the new law for the NGO-microfinance sector under which the new regulatory authority, the MRA, was created in 2006. This background is helpful in understanding the shift of a regulatory role from the Bangladesh Bank to the MRA, information essential to understand the necessity of establishing a separate authority outside the regulatory system of the Central Bank. Hence, interaction among the different participants during the formulation process of the new law, their pattern of interaction, and the changing behaviour of the participants, are the primary areas of discussion in this chapter.

The new law, its structure, major features, other subsequent rules, and circulars, etc. comprise the major part of chapter eight. This chapter also presents a section on the formation of the Microcredit Regulatory Authority (MRA) as a case study. It presents an analysis of stakeholder opinions regarding the new regulation and the new authority. This chapter also contains a SWOT analysis of the MRA and its current position. It provides valuable insights into the pattern of interaction between two important participants, i.e. the MRA, and the NGO-MFIs, in their implementation

of the law. Answers related to questions for a better understanding of the MRA can be found here.

Answering research questions related to the outcomes of the new law is the primary content of chapter nine. It presents an evaluation of policy outcomes after the enactment of the new law. In this context, it provides pre and post regulation analysis of information of the NGO-MFIs on the basis of empirical data collected on the sector from the MRA as well. It also presents an analysis of client awareness from the perspective of client protection on the basis of field survey data. Feedback of this evaluation process furnishes insights into possible future changes in the market.

The final chapter synthesises the whole thesis, presenting a summary of main findings, conclusions and policy recommendations.

CHAPTER 2

Conceptual Framework and Research Methodology

2.1 INTRODUCTION

Any market is an economic institution (Williamson, 1985) with particular rules of the game and participants, and a market changes shape the way society evolves through time (North, 1990). Over time, rules of the game change, participants change, and as a result, interaction patterns among participants also change, bringing forth new outcomes. Figure-2.1 presents a simplistic view of this idea. As mentioned in Furubotn and Richter (1997; P. 8), an institution is an equilibrium of a recurrent game that is repeatedly played by n-number of players using n-types of strategies. This is indeed a simple abstract concept of the institution, but I propose to begin my analysis from this simple concept, taking an institutional approach to analysing microfinance regulation in this thesis.

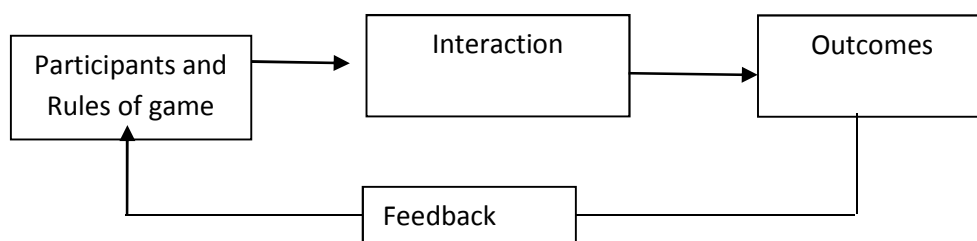


Figure-2.1: Institutions as outcome of a recurrent game

Grounded in this fundamental concept of institutional change, based on the very general game theory³⁸, this chapter describes the analytical framework and research methodology of this study. The primary focus of this study is to understand the role of state regulation or policy in shaping microfinance institutions in Bangladesh. Policy in this sense,

“...arises from the existing institutional framework (social, political, economic and cultural) as a response to emergent changes or existing lacunae. Policies can either represent growth (evolutionary continuity) or herald new directions (a

³⁸ Game theory is the study of how participants behave in strategic situations, in which each participant must consider how others might respond to that action (Mankiw, 1998).

radical break with the past). The processes by which policies emerge are dynamic and complex” (IFAD, 2008).

Any regulatory policy is a rule of the game of sorts influencing participants and the framework under which the institution (a more holistic notion which includes policies, players, games, equilibrium outcome, etc.) works and evolves. As such, an institutional analysis approach on the basic game theory assumption, helps this study to identify the dominant strategies of each participant under different situations, and finally to identify the role of the state's regulatory responses in the evolution of microfinance institutions in Bangladesh.

This chapter is organized as follows. The very next section below, presents the basic concepts of institution, game theory, and a brief discussion on institutional analysis framework. For a concrete conceptualisation the third section describes the legal structure of the microfinance market in Bangladesh, identifying the participants and the rules under which they have been operating. The fourth section provides a framework for the historical emergence of basic institutions and the framework for their development, decay, and historical evolution over time. It also presents the relevance of the application of game theory tools in this study. Section five describes the expected outcomes and suggests some evaluative procedures. Data gathering and data analysis methods are in section six and seven respectively. Section eight discusses limitations of the thesis and the final section concludes the chapter.

2.2 INSTITUTIONS, INSTITUTIONAL ANALYSIS AND GAME THEORY

Institutions, organisation, and game theory

Generally, the term ‘institution’ and ‘organisation’ are used interchangeably to refer to any organisation, which could either be a service provider or be an enabling agency. However, a fundamental difference exists between these two terms. Though the term ‘institution’ is used to mean both the ‘rules of the game’ (North, 1990) and ‘organisation’, the former sense of the term has become more prevalent with the development of ‘Institutional Economics’ and ‘New Institutional Economics (NIE)’. From an academic point of view, the term ‘institutions’ is defined as a set of rules, regulations, norms, and values that help to reduce uncertainties by establishing a stable structure to human interaction, and hence improving productivity and economic activity. On the other hand, ‘organisation’ refers to players or participants of the game (North, 1990) responsible for implementation or enforcement of the rules. Game

theory has special relevance in this context; it provides strategic choices to players where one player's choice depends on the choices of the others. In this paper, the idea of game theory has been used in its simplest interpretation.

An institutional view of economic development is now getting increasing attention from both academicians and policy makers. It has been seen as a holistic view of development which addresses issues in a country context, its technological changes and community involvement, in addition to policy changes in a dynamic situation. In light of this, many policy making and development institutions have been considering an institutional approach to analyse policy impact for effective and sustainable intervention. However, considering the difficulties and complexities involved in the application of a multi-player multi-strategy game to explain the historical evolution of an institution, Furubotn and Richter (1997) propose the use of comparative statistics to identify 'institution-as-an-equilibrium-of-a-game'. Therefore, imitating their approach (Furubotn & Richter, 1997³⁹) this study takes the view that game theory provides an analytical framework within which we can analyse the relationship between institutionalised rules and rules guiding behaviour, where behaviour produces outcome and feedback responses, and in this way the original institution refashions itself until an equilibrium institution has emerged and stabilized. In this study I use the term 'institution' to mean both the conventional rules of the game, as well as the broad rule based organisation of microfinance.

Institutional Analysis and Development (IAD) Framework

Institutional analysis is focused on the systemic study of the collective behaviour of all agencies involved in the process. Analysing institutions and integrating it with economic performance is not an easy task (North, 1990). It needs the right kind of framework which covers all related physical and material conditions which institutions are subject to. All relevant rules and regulations that set the policy situation, identify the characteristics of the community for whom they are. They also identify (both direct and indirect) participating organisations in the process, and the way they interact, evaluating the outcomes, capturing a picture of how institutions change over time, and can finally conceptualise the whole system in a dynamic situation (Ostrom, 2007).

³⁹Introductory observations

This section is mainly based on Ostrom (2005, 2008, 2011), and Polski & Ostrom (1999). The Institutional Analysis and Development (IAD) framework is a useful theoretical tool that has been used for a large number of empirical studies, including common pool resource (CPR) management (Ostrom, 1990). This framework has been developed on the basis of a successful application of ‘game theory’ and ‘rational choice theory’⁴⁰ where multiple interdependent participants are thought to be acting in an organised manner. The behaviour and the final outcomes of these participants are affected by some external components, and they act on the basis of bounded rationality⁴¹. It depends on the positions of the players, the real field situation, their control over the choices of strategies, on the information they have, and also on the cost and benefit they perceive for the outcomes that are likely to happen. In a real life game, many players repeat the game over and over which decides the pattern and sequence of strategies they would take at different stages of the game. It is a kind of multi-tier conceptual mapping (Ostrom, 2005) process of how rules, regulations, norms, values, culture, and other elements which constitute an institution, evolve over time and take certain stable equilibrium shapes in a dynamic historical situation.

Figure-2.2 is a basic flow diagram of the framework, which shows how the action arena, the central point of analysis, is affected by the exogenous variables and generates outcomes. According to this framework, the action arena is the central conceptual space of the whole system that consists of participants and the action situation. Participants are the decision-making entities who play a certain role and who are capable of selecting actions from a set of alternatives available in a decision process, and the action situation is a space where participants interact, exchange goods and services, dominate each other, or fight on the basis of their preference and situation. The interaction between participants and action situation produces the

⁴⁰ An economic principle that assumes individuals always make prudent and logical decisions that provide them with the greatest benefit or satisfaction and that are in their highest self-interest. Most mainstream economic assumptions and theories are based on rational choice theory (<http://www.investopedia.com/terms/r/rational-choice-theory.asp>, accessed on 03 September 2014).

⁴¹ Bounded rationality is the idea that when individuals make decisions, their rationality is limited by the available information, the tractability of the decision problem, the cognitive limitations of their minds, and the time available to make the decision. Decision-makers in this view act as satisficers, seeking a satisfactory solution rather than an optimal one. (URL: http://en.wikipedia.org/wiki/Bounded_rationality, accessed on 07 August 2014).

outcomes that in turn again affect both of them. The three main usefulness of the IAD framework are:

- a. It identifies factors in each area that influences the behaviour of participants in policy action;
- b. It identifies the pattern of interactions that are logically associated with behaviour in the action arena; and
- c. It evaluates the outcomes of interaction.

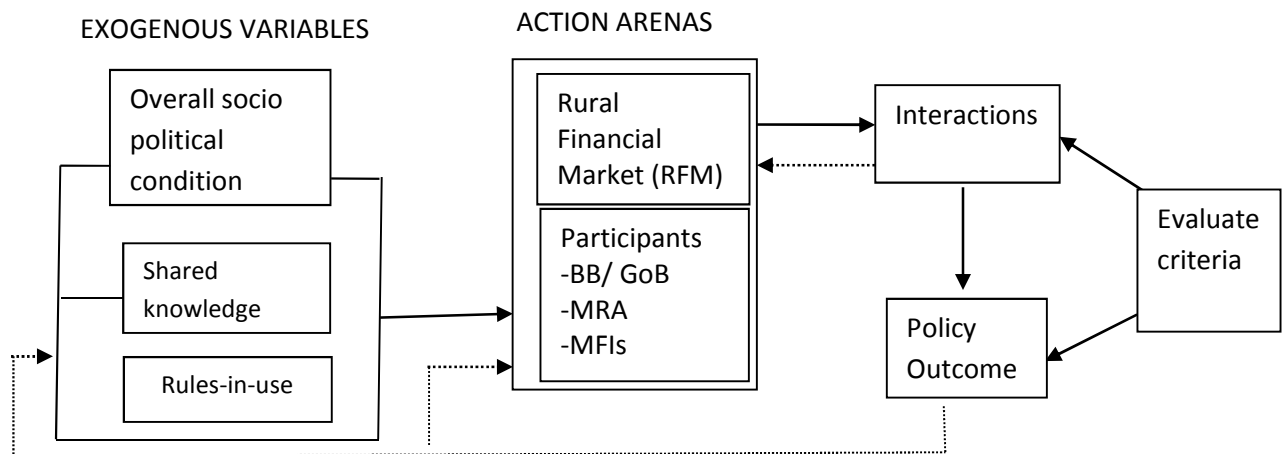


Figure-2.2: Basic diagram of IAD framework⁴²

Factors under exogenous variables

Three types of exogenous variables have been identified in this framework that influence the action situation; they are; a) bio-physical or material condition, under which the action arena is situated, b) attributes of the community, and c) the rules-in-use that set incentives in an action situation. The bio-physical or material condition could be the overall socio-economic condition under which institutions work, economic nature of the activity, the state of the financial system, the sources of fund, the ways service are produced and provided, kind of technology use, and so on. Attributes of the community include the demographic features of the community; the way a community perceives a policy situation, their shared knowledge, information about strategies, action, and outcomes. The rules are seen as the rules-in-use instead of just written rules. These rules can be analysed at three levels; the operational level is the first level that affects day-to-day operation, the collective-choice level comes

⁴² Drawn from Ostrom (2005) and customised by the researcher

next, determining the eligibility of participants who can take active roles in changing operational rules, and the constitutional level is the final level that decides how these rules will change. The sources of rules are also important factors for analysing rules at different levels.

None of these exogenous variables are constant as generally assumed in the modelling of economic factors; rather, they change, depending on the level of analysis and situation. Therefore, identifying configured equilibrium relationships among the variables is an important factor for institutional analysis.

Action arena and patterns of interactions

The action arena is a dependent variable that varies with the physical and material condition, attributes of the community, and rules-in-use. Two sub-categories of these variables are the participants, and the policy situation. The policy situation determines the patterns of interaction among the participants, which in turn generate outcomes.

If the situation is repeated and participants learn about the strategies chosen by others, and their outcomes, then adaptation, imitation, and learning may lead to significant changes in behaviours and outcomes over time. The multilayer interactions under different action situations create a pattern of interaction that gradually takes a shape approaching equilibrium outcomes. The process is reiterative, as whatever the outcome, it will affect the contextual variables as well as the action arena in future interactions. A few evaluative criteria used in evaluating the outcomes and the pattern of interaction are 1) efficiency, 2) sustainability, 3) equity, 4) accountability and 5) conformity to general morality. There could be different kinds of outcomes depending on the pattern. Linking a set of particular patterns with a set of particular outcomes can provide insights about the desirable or goal equilibrium, and thereby chart a course for reaching the efficient and expected outcome from any given set of non-optimal policies or rules that are in place.

Benefits and Criticism of IAD framework

The IAD framework emphasises careful consideration of contextual factors; it draws attention to a full range of transaction costs, and uses a variety of criteria to assess institutional performance (Imperial & Yandle, 2005). This framework helps to organise the analysis by directing attention to the rules-in-use instead of the rules on paper, and it is based on a dynamic view of the policy process.

However, there are some criticisms too. Ostrom (2005) herself has mentioned the following difficulties in applying this framework in different situation:

- a. Definition of institution itself is a complex issue,
- b. Identifying and measuring an institution is tough because institutions are shared concepts,
- c. It demands a multi-disciplinary approach,
- d. It is a complex analysis that deals with macro to micro level decisions,
- e. Isolating one variable from another is not possible, so identifying relationships between variables is a difficult issue.

Beside this, Cole et al. (2013) mention that many concepts in the IAD framework are not well specified, and in the dynamic system of the framework, the 'exogenous variables' are conditioned and preceded by 'interaction' that creates confusion in the analysis. One of the challenges of applying this framework to policy environments identified by Basurto et al. (2009) is, translating key concepts into reliable observations or evidence.

2.3 MARKET STRUCTURE: PARTICIPANTS AND RULES

This study tries to use the concepts and framework of analysis mentioned above to explain the evolution of the institution of microfinance in Bangladesh, though it does not consider all aspects of the IAD framework discussed here. To begin with, first of all, it tries to identify major participants in the market. It treats the microfinance market as a specific evolving institution and looks into its evolution, and last but not the least, it looks into the state's rules built to support and steer the microfinance market to a desirable outcome. Formal state rules evolved over the years, based on existing formal and informal practices in the market and through an interactive process between participants, subject to a global policy paradigm and the local political economy. It follows the process of how those rules were developed in the given context and the feedback from the field, for which the rules were issued. Therefore, gaining insight into global policy shift related to the state's role in rural financial markets and the local political economy related to financial markets, identification of the participants, understanding the action situation, understanding historical knowledge on the issue, and the rules under which the game was played, are essential parts of this framework. Figure-2.3 presents the legal setup and the current

market structure of microfinance institutions in Bangladesh that helps identify the relevant players in the market and their respective roles.

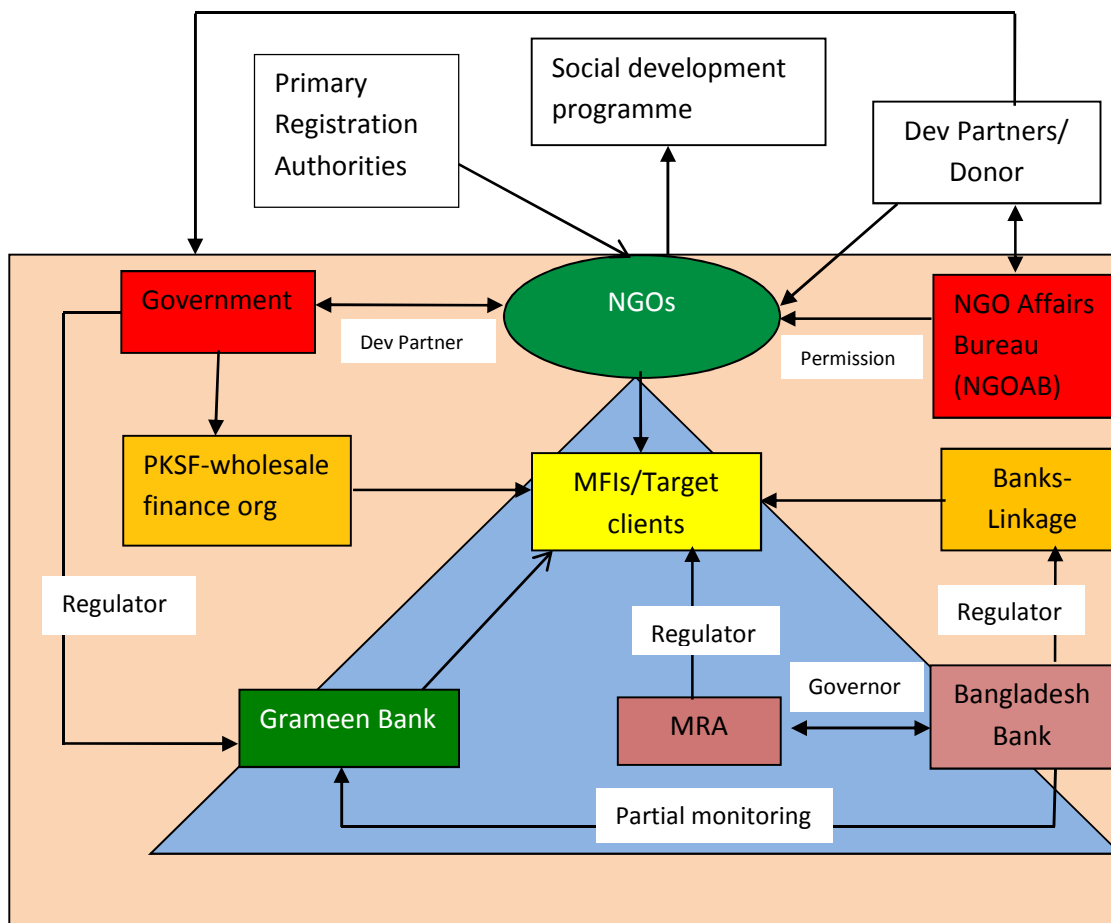


Figure-2.3: Current legal and funding structure of microfinance market in Bangladesh

There are two major types of service providers in the market such as the Grameen Bank and the NGO-MFIs, though NGOs may have other social activities as well. Both types of organisations received local and foreign grants or concessional funds as initial capital, so the direct influence of local and foreign agencies on these organisations cannot be ignored. NGOs which receive foreign funds, need to seek permission from the NGO Affairs Bureau (NGOAB), a special department created by the government in 1990 under the Foreign Donations (Voluntary Activities) Regulation Ordinance, 1978. Foreign funds are also being channelled through different government mechanisms. A significant amount of local and foreign funds dedicated to microfinance operations has been delivered through the PKSF, the only wholesale apex body created by the government in May 1990.

The banking sector also has microcredit operations, but mostly under linkage programmes with the NGOs, which are on the rise. Microcredit operations of banks are guided by the rules and regulations of Bangladesh Bank; there are specific guidelines for them. As per the Grameen Bank Ordinance, Bangladesh Bank does not have any role in supervising the Grameen Bank like other banks. However, it conducts an on-site inspection on a regular basis under some special guidelines⁴³ of the bank, and that started in 1997/98.

Microcredit activities of NGOs were not under any specific authority of the government before the enactment of the Microcredit Regulatory Authority Act, 2006. After the enactment of this Act, NGOs' microfinance operations fell under the monitoring and supervision system of the Microcredit Regulatory Authority (MRA). The MRA, however, is not the primary regulatory authority for them, though it has significant power over NGO-MFIs' operations. Primarily, NGOs are under different registration authorities such as the Joint Stock Company (the Societies Registration Act, 1860), Ministry of Social Welfare (The Voluntary Social Welfare Agencies Ordinance, 1961), Ministry of Law (the Trust Act, 1882), and that decision depends on their need. The Bangladesh Bank is not directly involved with policy and financial matters of NGO microcredit operations⁴⁴.

Under these circumstances, I am bringing the shaded area and coloured players or boxes (especially the pink) in figure-2.3 into this research, where the triangular, blue shaded area will get significant attention. Though the target clients of microfinance operations, an integral part, have not been shown in this figure separately, they remain silently under the operation of microfinance like their faint voice that remains unheard from the outside or at the top. They still remain passive participants in the process of rule formulation. The two active participants are the regulators, the state agencies like Bangladesh Bank and the MRA (the two major dark pink boxes), and the MFIs (the two dark green boxes) themselves. Other agencies like PKSF, development partners, funding agencies, civil society, and network agencies, all contribute here as catalysts, and some of them play vital roles.

⁴³ The regular risk-based strict guidelines applicable for other banks are not followed in the case of Grameen Bank.

⁴⁴ Recent refinance programme of the Bangladesh Bank with an NGO (BRAC the largest NGO of the country) to provide microcredit to the sharecroppers, is an exception.

2.4 FRAMEWORK OF THE RESEARCH

Based on the above conceptual framework and market structure, I assume that the initial idea of microfinance is the outcome of many interactions and experiments⁴⁵ in the past, where participants like banks, cooperatives, private organisations and initiators, clients, as well as regulators like the Bangladesh Bank, were involved. Figure-2.4 is a flow diagram of the historical emergence of microfinance in Bangladesh. The basic idea of microfinance, such as a collateral free loan, service at the client's doorstep, group liability, and capital formation, crystallised over time from many local level successful and unsuccessful initiatives, as well as from ideas originating beyond national boundaries. It flourished with the enabling environment provided by the government, both directly and indirectly. It follows the parallel history of the rise of neoliberal ideas in the global financial market and also with the implementation of a financial liberalisation programme in Bangladesh. Changes in the political economy of the country, its poverty situation, all contributed positively to emerging ideas and policies at the initial stages and helped it flourishing later stages as well.

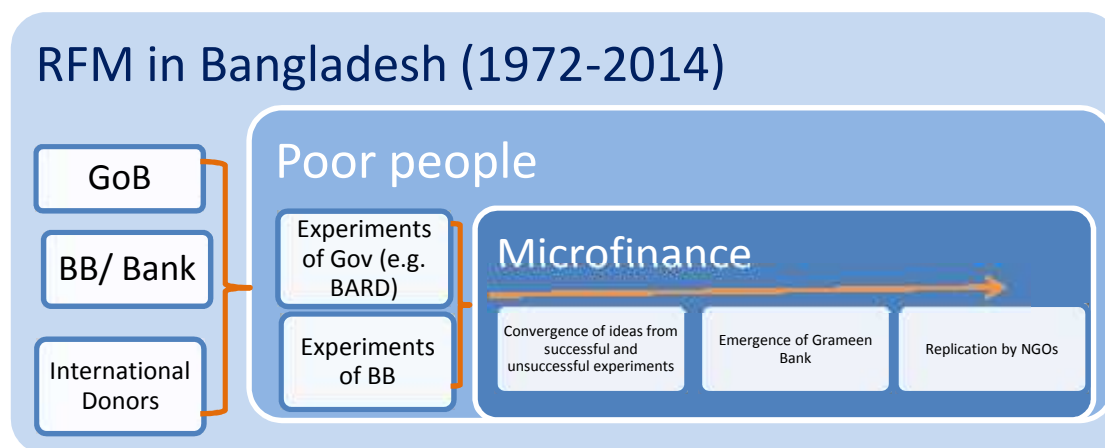


Figure-2.4: Historical Emergence of MFIs

Experiences from many experiments converged into the central idea of Grameen Bank, and with the favourable rules and regulations of the government it became a formal legal organisation. This official recognition and initial success of

⁴⁵ Such as, 1) Cooperative farming project in Comilla and IRDP of sixties, 2) Small farmers and landless labourers development project of early 70s, 3) Special agricultural credit programmes of the government in late 70s, 4) Rural finance experimental project of late 70s, and 5) Grameen Bank Project of Bangladesh Bank in late 70s.

Grameen Bank, inspired many NGOs to replicate the model all over the country with financial and policy support from state and outside donors.

Figure-2.5 shows the microfinance game as a decision tree. In the early period, while the game was between Grameen Bank and the Government, Grameen chose the path of ‘favouring regulation’ from the very beginning. The government offered separate regulations to the Grameen Bank under the Ministry. Grameen Bank accepted, but considered the framework costly, cost was perceived in terms of loss of freedom. So, in the later period it attempted to amend the law in order to empower its Board by bringing it out from the Ministry.

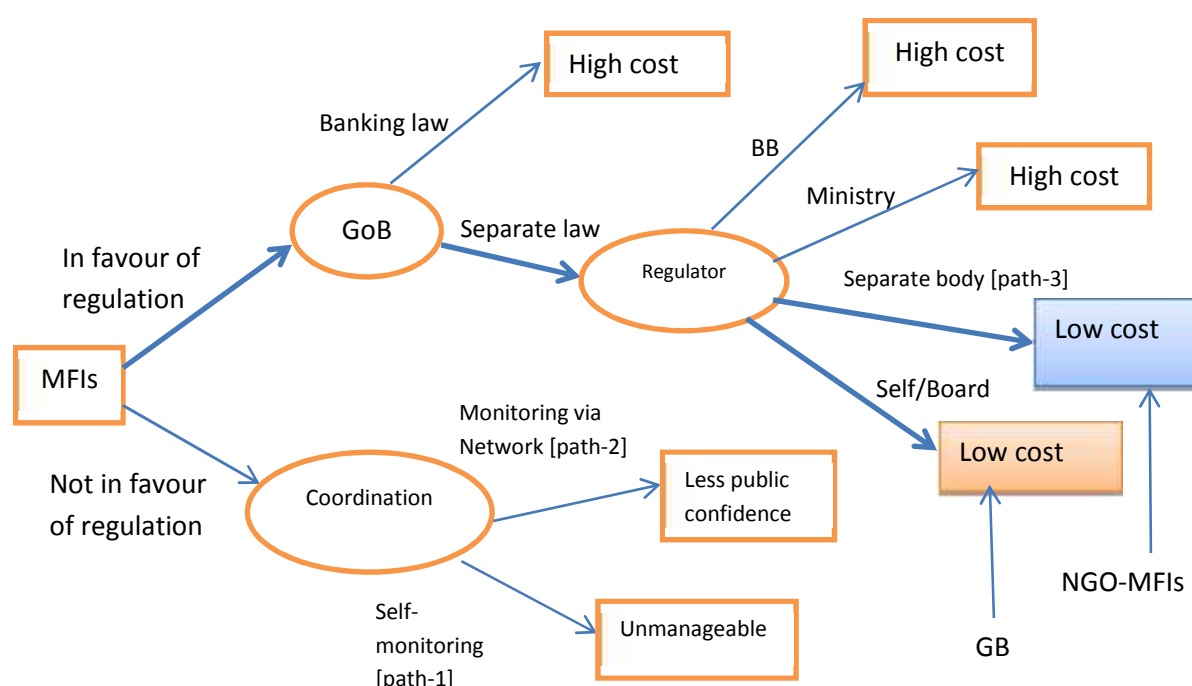


Figure- 2.5: The microfinance game as a decision tree

In the second phase of the game between the NGO-MFIs and the government, the NGO-MFIs went through many trial and error processes to find a suitable framework for themselves. Initially, they followed ‘not in favour of regulation’ in a self-managed coordination system [path-1], but that system proved unmanageable after a while. So, in the second phase, they developed a network mechanism for better coordination [path-2] since there were various types of numerous organisations. This mechanism failed to support their growing need for gaining public confidence to build sustainable institutions. To strengthen their hand, they demanded some sort of

regulatory support from the government in the third phase. The government responded with two options, banking type regulations or special regulations. The NGO-MFIs showed a preference for special regulations over banking regulations, considering those to be more flexible. The NGO-MFIs had two options under this separate or special type of regulatory framework; they could choose Bangladesh Bank as the regulator, or they could have a separate regulator. Considering costs (loss of freedom), they chose a separate regulator [path-3].

2.5 EXPECTED OUTCOMES AND EVALUATIVE CRITERIA

What outcomes were expected from this type of state regulation? How will this research evaluate these outcomes by institutional analysis? Which factors influenced the outcome most? Answers to this different set of questions have been given in the final stage of the analysis, where client perceptions have also been considered in substantiating the answers. Hence, outcomes are expected at two levels, the organisational and the client level.

Expected outcome at organisational level

Applying for a license to the MRA within six months of the promulgation of the law⁴⁶ was mandatory for all existing NGO-MFIs. The MRA developed a set of application forms⁴⁷ that required the last three years' financial information, operational information, and management information, besides other ancillary information. Accordingly, it received 4241 applications within the scheduled date. The Authority set the minimum criteria for getting a license such as an organisation's depth of field operations, financial soundness, and the compatibility of its governance and management with laws and rules. It is assumed those organisations which received licenses in the initial years were better performers compared to organisations which received licenses at a later stage.

Till 2014, the MRA issued licenses to around 700 organisations out of several thousand applicants. Among these 700 NGO-MFIs, there were only 3 organisations that captured the lion's share of the market. Only about 6 per cent of the large organisations dominated near about 86 per cent of the total market, leaving little scope for fair competition. The interest rate on the microcredit of NGOs was not based on

⁴⁶ Circular no. 05 dated 10 November 2010, MRA

⁴⁷ Microcredit Regulatory

the cost structure. Rather, it was largely decided by leaders of the sector where other small MFIs were price takers only. The method of interest rate calculation, widely known as the 'flat method'⁴⁸, was also vague for many. The MRA's rule changed this calculation method and also set a cap on interest rates. The institutionalisation process of the sector strengthened all in their compliance with rules, financial reporting, and monitoring. These factors are important in ensuring the sector's accountability and transparency, the main objective of the law. Improvement in efficiency and sustainability, breaking the monopoly of a few, and the standardisation of interest rate calculation are considered important outcomes of regulation at the organisational level. Figure-2.6 exhibits the above mentioned four outcomes in summarised form.

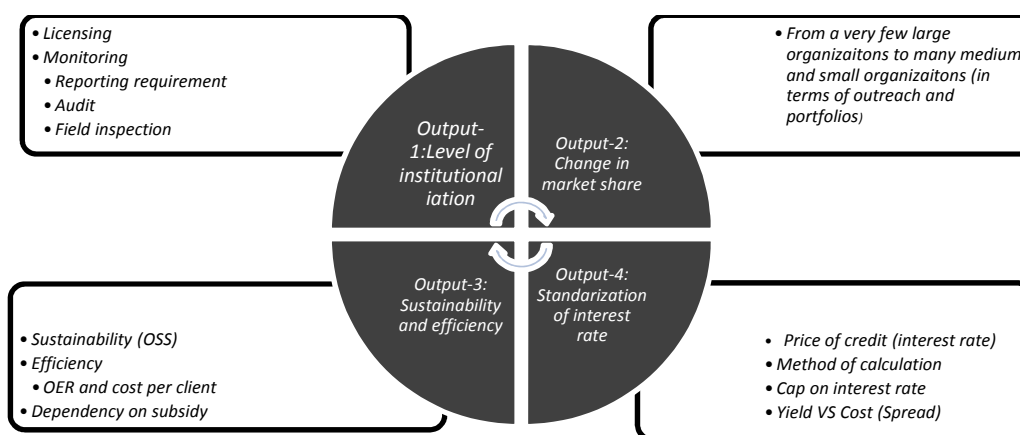


Figure-2.6: Expected outcomes and evaluating criteria

Outcome-1: Level of institutionalisation

In this paper I have assessed organisations and their level of institutionalisation, meaning the degree to which rules become an integral part of an organisation, by two major indicators: licensing, and monitoring. In this part, I shall analyse licensing criteria and procedures. I shall also investigate MRA monitoring tools like reporting requirements, auditing, how these tools function, and how effective they are. Field inspection is one of the important mechanisms for monitoring and supervising MFIs, so my queries have extended into seeing how frequently that job is done, what are the

⁴⁸ Interest is calculated as a percentage of the initial loan, not based on the outstanding amount after payment of each installment, though client repays the loan through weekly or monthly instalments. Interest is calculated by multiplying the initial loan amount by the nominal interest rate irrespective of the repayment plan (CDF, 2011).

criteria, and how the MRA managed to conduct field visits to a few hundred organisations operating all over the country.

Outcome-2: Change in market share

How successful the MRA was in transferring market share from 3 large organisations to other medium and smaller organisations in the last few years, after taking charge as a regulator, is my query under the second expected outcome. Hence, I have calculated their respective shares in the market from 2007-2014 to see whether there was any gradual change.

Outcome-3: Sustainability and efficiency

Financial sustainability is an important indicator of the institutional viability of any organisation (Waterfield & Ramsing, 1998) in an 'institutionist' approach. Operational self-sufficiency (OSS) is considered a very useful tool for measuring financial sustainability, though it is not a perfect measure as it does not take subsidies from soft loan or grant into consideration in the calculation. OSS of NGO-MFIs has been examined in this research to evaluate the trend of their sustainability condition. Moreover, since OSS does not take subsidies into account, I have used a scale to measure an organisation's level of dependence on subsidies.

Operational expense ratio (OER) is the most commonly used efficiency indicator of any organisation (CGAP, 1998). OER is the ratio of operating expense to average loan outstanding. Cost per client is another ratio, which shows efficiency of serving a client in monetary terms. These two cost factors have been taken into account in this paper to measure the efficiency of organisations.

Output-4: Standardisation of interest rate

Before the MRA issued the interest rate policy⁴⁹, there were different rates, mostly around 15 per cent by the flat method, which would be close to 30 per cent if calculated by the standard declining balance method. The MRA has been trying to standardise the method while it has imposed an upper limit of 27 per cent. The current method of interest calculation has been analysed and verified at the field level to check whether this new rule has improved the pricing transparency of microloans and whether it has any impact on sector's interest income.

⁴⁹ Circular no. 05 dated 10 November 2010, MRA

Expected outcome at client level

Laws and regulation can play a significant role in protecting the interest of clients [EAYM, 2015]. Though the major focus of MRA law is on ensuring transparency and accountability in the operation of NGO-MFIs, section 52 (2)(da) of the law has given the MRA power to formulate additional rules on client rights and responsibilities. Hence, sections 16 and 17 have been added to the Regulation⁵⁰ to address these issues. It desires that clients should make informed decisions and the responsibility of disseminating knowledge lies with the MFIs. Hence, the general assumption is that proper implementation of the law would help clients take informed decisions, thereby improving client circumstances in protecting their own interests better than before enactment of the rules.

2.6 DATA COLLECTION

In conducting this research I planned to collect data from three layers of participants involved in the process: clients at the bottom, MFIs in the middle as service providers, and the state or regulators as state agencies at the top. I am privileged by my association over a decade with the government, central bank, NGOs, donors, network agencies, wholesale agencies, and academic players in Bangladesh, as part of my duties. Initially I was a supporting hand to the National Steering Committee formed by the government to formulate policy guidelines for the sector, and later, one of the key personnel in establishing the MRA as an organisation, as well as in formulating rules for the sector. Therefore, I could build up an essential knowledge base of the process that helped me form the foundation of my thesis. My easy access to many policy makers and the microfinance community, helped me collect valuable data in the form of interviews and discussions. I also have easy access to Bangladesh Bank's files and records as a central banker, and have access to the MRA data system and policy files as one of the key planners of the organisational structure.

I have used secondary published materials as well as unpublished documents of two state regulatory bodies such as the Bangladesh Bank and the MRA to analyse the role of the state in the evolution of microfinance institutions (MFIs) in Bangladesh. While these exercises with secondary sources of data are immensely beneficial to reach conclusions about past effects, the recent information had to be collected from direct interaction with clients at the field level, with policy makers who

⁵⁰ Microcredit Regulatory Authority Regulation, 2010

were directly involved in the process, and with the practitioners and other stakeholders who were considered important for this research. I went to Bangladesh for data collection first in October 2013, but could not physically move around much to collect data, due to political unrest in the country; therefore, I had to go back again for the same purpose in February 2014, when the situation improved after elections in January 2014. In the first phase, I mostly collected documents from Bangladesh Bank and the MRA. In the second phase, I went to the field for client surveys, conducted interviews and focus group discussions. I have collected financial and operational data of NGO-MFIs from the MRA in two phases, first in 2013 and again in 2014, to get updated data and verify previously collected data. Both quantitative and qualitative data have been collected for the purpose of this thesis. The sources of data and collection procedures are described here:

Document collection

I have collected official policy documents regarding the background papers of policy formulation from Bangladesh Bank and the MRA (Appendix-A1 presents the list of documents). Documents related to some experiments of the Bangladesh Bank, the establishment of Grameen Bank, recent debates around Grameen Bank issues, the Bangladesh Bank's views on NGO-MFIs and so forth, were collected in two phases from October-November 2013, and February 2014. Documents related to the formation of rules and regulations for NGO-MFIs, and the establishment of the MRA, were collected from the MRA in December 2013 and March-May 2014, in two phases. Since there were an enormous number of files from back in 1972, and some of them were missing, breaking continuity, I had to go back and forth to check whether there was any information gap in my reconstruction of old history.

Financial and operational data of NGO-MFIs

Reliable and proper data sets are always a problem for any research and even more problematic in the case of the microfinance sector, considering the history of the emergence of microfinance. Some operational data are available from some sources but they were neither complete nor reliable and getting financial data on the sector is even more difficult. As an emerging sector, microfinance institutions are not yet as structured as other formal sectors like banks, hence data reliability is a big concern in this case. Generally, larger and older institutions have relatively better quality data,

especially those who have working experience with outside donors and lenders. Localised, small NGO-MFIs are not fully aware of and lack experience in the maintenance of books of accounts properly; it is costly for them too. External auditing and regulatory supervision always help in improving data reliability, which has only just started for NGO-MFIs in Bangladesh since the emergence of the MRA. The MRA has started bringing all the NGO-MFIs under a uniform accounting policy, which was absent previously. Measuring sustainability and collecting financial data on expenses, cost, income, and different sources of funds, mostly need thorough accounting data, which demands professionalism and proper disclosure as well.

There are two sets of national data warehouses for the microfinance sector in Bangladesh. One is private (CDF Microfinance Statistics), and the other one is public (MRA Database). Data reliability of the private source is a concern as it contains duplication of data, especially in counting client outreach and measuring the loan portfolio. The MRA has been publishing a public data set once a year since 2004-- both as MRRU and MRA-- as part of its disclosure and monitoring system. Providing regular reports in a prescribed format to the MRA is mandatory for all NGO-MFIs under its jurisdiction. The MRA has an automated data migration and integration system in place since 2008, which claims to take care of data verification and data loss. Another data set is available on the web (MixMarket, <http://www.mixmarket.org>) from an international web-based portal, which maintains a global collection of data for the microfinance. Mix-Market's data is also self-reporting based supplied data, and it contains data from a few selected organisations of Bangladesh which do not offer any consistent information on the sector as a whole (not all of the institutions follow a single year as a basis). Considering all these three sets of data, data set from the MRA seemed the most reliable, consistent, and complete, at least for 2007 and onwards till 2014. Statistical publications of the MRA before 2011 do not provide complete information on all the licensed NGO-MFIs. Therefore, operational and financial data on 654 MFIs, those licensed before 21 August 2013, for the period 2007-2014, have been collected from the MRA database directly. The MRA database does not preserve financial data on the sector before 2007, hence collecting financial data before 2007 was not possible. The data could have been collected directly from individual MFIs, but that process was beyond the scope of this research.

Interviews

Altogether there are 15 interviews. Most of the interviewees were directly involved in the rule formulation process. Table 2.1 contains the summarised list of interviewees and Appendix-A2 provides a detailed list, along with short profiles of each of them. A few of them had indirect but significant contributions to different phases of the rule formulation process. All four policy makers were from the Bangladesh Bank (three Governors and one Executive Director) and they were directly involved at different stages in the making of rules, either in rule formulation or at a later phase in the implementation process. One of these four policymakers was also involved with MRA management. Participants from the PKSF and international donor organisations were considered a financing agency group. Participants from PKSF were selected on the basis of their role in policy formulation, and participants from donor agencies were chosen based on their degree of involvement with the sector. All four researchers were directly or indirectly involved with the industry and/or with the MRA, one of them was the Chief Executive of a large NGO, and another person was a Board Member of the MRA. Two top level officials from the MRA were chosen according to their involvement with the operations of the MRA, but one of them was found not well conversant on the issue. Personal interviews of any top level MFI leader were purposely not done to avoid any biases, and group discussions with sector representatives were arranged instead. However, a personal interview of Professor Muhammad Yunus, the former MD of Grameen Bank, has been taken into account, considering his crucial involvement in the sector, as well as in the rule formulation process⁵¹.

I started my first interview in February 2014 and completed all of them in June 2014. All of the interviews were recorded and transcribed. I have undertaken one telephone interview with a high ex-official of the central bank, who lives outside Bangladesh, considering his importance in the research. One of the policy makers was found shy/hesitant in a formal interview, so I could not collect as much information as I expected from that person, considering his crucial role in the process of rule formation and implementation. Therefore, I have tried to cover that gap by taking follow-up interviews of other officials in power. I was well accepted by all of the

⁵¹ He was one of the members of the National Steering Committee formed by the government in 2000 for the purpose of preparing policies for the sector

responders due to my previous personal and professional relationships with them. However, I felt a little bit of hostility in one case, but finally it worked well.

Table-2.1: Summarised list of participants in interviews

Participants and selection criteria	Type of inquiry
<ul style="list-style-type: none"> -Four policy makers from the Bangladesh Bank -Four high officials from financing organisations such as PKSF, the World Bank, and the British DFID (UK-Aid) -Four independent researchers who were involved with the sector -Two MRA high officials -One high official from the Grameen Bank 	<p>In-depth personal interviews broadly on their experiences and perceptions regarding:</p> <ul style="list-style-type: none"> -Experience during rule formulation, -current rules, its compatibility with the existing practices and their expectations, -competency of the MRA, and expectation from the MRA, -Recent changes in the market.

Focus group discussion (FGD)

Altogether there were five focus group discussions, two with the NGO-MFI sector and three with key staff of the MRA (see Appendix-A3 for detail). The first FGD with the NGOs was held in Rangpur to get branch level views of NGO staff, and the other one took place in Dhaka, where the participants were from the respective head offices. I chose Rangpur for branch level discussion for the convenience of arranging the meeting, and also considering the high concentration of NGO-MFIs in that part of the country. These FGDs with the sector helped me understand their perspectives towards rules and regulations, both at the head office and branch levels. They were the people who were directly involved in practicing the rules in the field.

RDRS, an old Rangpur based NGO, helped me in conducting the meeting in Rangpur on its office premises, while CDF, the network organisation of the NGO-MFIs, was approached to arrange the meeting in Dhaka. RDRS and CDF both had the freedom to choose sector representatives. These representatives who participated in the focus group discussions were self-chosen with the coordination of RDRS or CDF to avoid any controversy regarding my biases due to my previous direct involvement with various players in the sector. They were equally eager to be included in my

sample as well. There were 19 participants from 13 NGOs in Rangpur, and 20 participants from 20 NGOs in Dhaka. Also, three observers attended the meeting held in Dhaka on a request from the sector, with prior approval of the researcher. In the focus group discussions, I requested the participants to express their responses to the rules and their perception of different clauses of the legal rules, and also the regulatory authority.

Discussions with entry and mid-level officials of the MRA were arranged in the MRA office with the prior approval of the Authority. Three discussions with MRA officials covered three different dimensions of MRA operations, namely its human resource capacity, the process of policy implementation, and techniques of supervision and monitoring. These discussions have been recorded electronically. Hard copy summaries of these group discussions have also been collected.

Field survey (Client survey)

Bangladesh is divided into seven divisions, and 64 districts. These Districts are again subdivided into Upazilas (sub-districts, previously known as Thanas) and then again into Unions⁵². I have chosen one Upazila from each of the three selected districts, except Dhaka. Clients from Dhaka district were chosen from Dhaka City Corporation as urban clients.

Field surveys were conducted in the following four areas of Bangladesh:

- a. Kurigram district (Ulipur Upazila),
- b. Patuakhali district (Bauphal Upazila),
- c. Tangail district (Kalihathi Upazila), and
- d. Dhaka district (Dhaka City Corporation)

The above four districts were chosen to minimise regional biases in the sample. Geographical and economic diversity, along with the concentration of MFIs' in the areas was considered in selecting districts from different parts of the country. My accessibility to the areas and acceptability to clients were also a consideration to gather reliable and authentic data from clients. Kurigram was chosen as one of the poorest districts of Bangladesh (Appendix-A4 contains a district poverty map). Tangail was chosen for its high concentration of NGO-MFIs due to its advantageous physical location, and Patuakhali was considered due to its remote location in the

⁵² Smallest administrative rural geographic unit

southern coastal belt. Dhaka City Corporation was the urban area where many of the big MFIs had head offices, and many of them have microfinance operations within the city as well.

Sample selection

Table 2.2 presents the number of clients from each sample area. I have not used MFI channels to get access to clients to avoid organisational influence or coaching; I tried to reach them via my own private channels instead. Now it is not at all difficult to find microfinance clients in any corner of Bangladesh due to the rapid expansion of MFI operations in a very short period of time. Clients were selected by their availability at the centres⁵³ during data collection, and they were informed earlier by local assistants. I personally collected all the data, where I had one local assistant in each area to organise them. No uniform numbers in selecting clients from these Upazilas was maintained; I have given importance to their interest in participating in this survey. Some of them expected financial benefits, but many of them willingly provided information due to a good rapport with them.

Table-2.2: Number of clients from different Upazilas and Dhaka City Corporation

District	Upazila/Thana	Union	Number of clients
Kurigram	Ulipur	Dharanibari	14
		Bazra	12
		Hatia	17
Tangail	Kalihati	Kokdahara	18
		Sahadebpur	12
Patuakhali	Bauphal	Surjyamani (3 villages)	30
Dhaka City Corporation	Mirpur Thana		11
	Mohammadpur Thana		9
Total			120

My basic questions to the clients were whether they were directly or indirectly, partially or fully, informed about the rules at any stage in the process of the formulation of rules, or even since then to date. This was basically to measure the degree of awareness of clients. There were three modules in the survey questionnaire: the first addressed their basic demographic information, the second dealt with

⁵³ Where they meet on regular basis with the MFIs

information on their involvement with the MFIs, and the third focused on their degree of awareness about legal statements related to their rights and responsibilities (Appendix-A5 contains sample questionnaire). The questionnaire was developed on the basis of my previous field experience during my involvement with the pre and post establishment of the MRA. I took spontaneous field notes on the spot and recorded formal and informal discussions with clients when and where possible. In Tangail and Patuakhali I stayed with the client families, so I had the chance to hear their informal stories that helped me to further understand various formal and informal dimensions of microfinance. Patuakhali being my home district I was better able to get involved with the lives of clients, but remaining ever cautious against any personal biases creeping in.

Other documents

In addition, I have the copies of many official and unofficial correspondences within the community, many drafts of rules and laws, some media reports, and features, which have also been used as data when and where necessary to support my arguments.

Furthermore, I have also used my memory and experience of my physical presence and involvement with the whole process of formulating rules and its implementation procedures from 2000 to 2010 as one of the central bank's representatives associated with the establishment of the MRA. I am witness to many important events related to this research topic; however, I have tried my best to avoid my biases as clearly as possible.

Referencing data sources

In the follow-up presentation, participants interviewed and FGD, were labelled 'PM' (policymakers), 'FA' (financing agency), 'RES' (researchers), 'MRA' (officials of the MRA), and 'PRAC' (practitioners from NGO-MFIs and Grameen Bank). I have assigned numbers for each of them, such as 'PM-1' or 'RES-2', mentioning them individually or as a group (in the case of FGD). A complete verbatim written transcript of each of the discussions has been maintained in a separate written master document. This document is used as a reference when I mention certain quotations or content related to a particular respondent. For example, MRA-1/Intvw/P-24 refers to the MRA official-1 in an interview cited from page number 24 of the written master

document. Again, MRA-1/FGD/P-5 refers to group-1 of MRA in focus group discussion, located on page number 5 of the master document, and so on. Clients were marked according to their Upazilas and villages to identify them individually. For example, a client marked “Kuri_UL_A_07” means client number 07 in Anantapur village of Ulipur Upazila in Kurigram district.

I have translated all the quotations, from original language, that were used in this thesis from interviews and other discussions. Official documents and other sources are mentioned in the footnotes with related texts.

2.7 DATA ANALYSIS PROCEDURE

Data from multiple sources have been analysed with the help of various traditional procedures like financial analysis, content analysis of policies, case studies, historical process analysis, and SWOT analysis. Text analyses of interviews and focus group discussions (FGDs) have also been a part of these procedures. It is a multi-disciplinary exercise involving economics, finance, law, history, and statistics. A brief discussion of data analysis procedures is presented below:

- a. Central Bank (BB)’s policies related to RFM (including Grameen Bank) have been analysed to understand its role in changing the overall market situation, especially in the context of microfinance institutions. Background notes, meeting minutes, and formal/informal discussions related to any policy have been followed and analysed to look at the process and to understand the political economy behind the final choice of a particular decision.
- b. Documents related to Grameen Bank Ordinance, 1983, and subsequent amendments have been analysed to understand the background, the content of the law, the rationale for amendments, and to figure out the regulator’s role in the evolution of Grameen Bank after 1983.
- c. Documents, laws, rules and regulations related to formation of the new law (Microfinance Regulatory Authority Act, 2006), and other subsequent rules (Microcredit Regulatory Authority Rules, 2010 and important Circulars of MRA), have been reviewed and analysed to understand how the need arose for the law, what are the boundaries of the MRA, implementation procedures of the rules, incentive and disincentive systems embedded in the rules, and also to get a clear idea of the hierarchal linkage of the MRA with other institutions.

- d. Content analysis of the interviews with key personnel has provided better views on how these new institutions have evolved and taken their present shape. The interviews were helpful to understand new problems of the sector and its future direction.
- e. The views of FGDs with network organisations and regulators provided insight into understanding the MRA's ability to influence the sector, the predictability of rules, and the MRA's overall market significance. These discussions were helpful to comprehend the communication gap between the regulator and the MFIs.
- f. SWOT analysis of the MRA has been done to evaluate its capacity as an important participant in the system.
- g. Simple mathematical and statistical methods like average or mean, percentage, frequency, and so on have been used in analysing data from the field.
- h. At a micro level, financial and non-financial information of a number of licensed MFIs has been analysed to understand their performance trends, changes in cost structure, sustainability, outreach, and other facts. Especially, I have examined whether there was any significant correlation between the degree of rule compliance and the outcomes.

2.8 LIMITATIONS OF THIS THESIS

This paper takes a multidisciplinary approach to analysing the evolutionary process of the microfinance sector in Bangladesh. Therefore, it may not do justice to the necessary rigor of each discipline whose help was taken to construct the analysis. It is neither a pure policy analysis nor a purely political analysis, nor is it a purely economic analysis of the law. So, there remains the possibility of ambiguity in understanding the complex, multidimensional treatment of the subject matter. It has used the well-known IAD framework developed by a group of political scientists, mainly to analyse social issues like managing common pool resources. This framework has inherent complexities in identifying variables correctly because it recognises that there are difficulties in separating variables fully, something that may be reflected in the analytical web of this paper. Moreover, it has also taken an institutional (in the sense of social norms, values, rules, laws, and others.) approach to viewing the process of microfinance institutionalisation within the greater picture of global and local political economy. All the well-known criticisms of this approach apply to this thesis.

2.9 CONCLUSION

This thesis has taken an institutional approach to analysing the historical role of the state in the development of microfinance institutions in Bangladesh. Hence, the basic idea of an institutional analysis framework (IAD framework) has been used for the purpose of this thesis, which is based on the concept of game theory.

The ‘microfinance market’ is an institution that has evolved in Bangladesh under various conditions of political-economy and a legal environment of the country where the state is an important participant both as a rule-maker and as a player in the game. The MFI sector, on the other hand, is another player that is not just an object of the rule but an active player that participates in the game on the basis of its strategic position, which ultimately decides the path of institutional evolution over time. There is another relatively silent player in the game, the clients, who are the ultimate beneficiaries of the evolving institution, but their voice remains unheard from outside. So, the state or state agencies (the Bangladesh Bank and the MRA) play the game with the MFIs by their respective strategies and counter strategies to reach an equilibrium outcome. The expected outcomes have been assessed to compare them with the final outcomes reached so far, to verify whether there is any gap between expectation and reality, as well as to understand the future direction of this complex process.

In doing so, I have collected both primary and secondary data from various sources. Primary data has been collected in interview form from stakeholders including policy makers, financing organisations, MFIs, and others. Data in the form of FGD with the sector as well as state agencies, has been collected as a part of primary sources. Client surveys have been conducted at the field level to get client views on the rules and regulations of the government. Published and unpublished official documents of state agencies like the Bangladesh Bank and the MRA have been collected to reconstruct a historical path. Financial and operational data on the sector were collected from the MRA to analyse outcomes of the game. Also, I have used many other official and unofficial documents like meeting minutes, correspondence between stakeholders, my own experience and so on, in favour of my argument when and where necessary.

Both qualitative and quantitative data are part of my data set. Hence, I have used all kinds of traditional data analysis methods, depending on the characteristics of data. It is mostly content or text analysis and document analysis that I have applied to

analyse interviews, FGD, and other textual documents. Simple statistical and mathematical tools like mean or average, frequency, percentage, ratios, and others have been used to analyse quantitative data like financial and operational information, and information from the field.

CHAPTER 3

Rural Financial Market:

Conceptual Evolution and Changing Role of the State

3.1 INTRODUCTION

Microfinance market mainly belongs to the rural financial market (RFM) though it has been spreading in the urban market as well. Hence, the focus in this thesis is mainly on the RFM. The attitude towards this market has changed fundamentally since the 70s from a centralised policy to a decentralised system. Understanding the rural financial market from the perspective of shifting worldviews, from ‘state-planned’ to a ‘market-based economy’ (Meyer & Nararajan, 2000) seems essential for this research. In this chapter, I shall trace the evolution of the RFM under different policy regimes from Neo-classical to Neo-liberal model. Though the central focus of all these views is to foster development, especially economic development, by reducing poverty, generating employment, and growth, the basic premise of the old Neo-classical model of ‘financial repression’ differs greatly from the same of the Neo-liberal model of ‘liberalisation’. The Neo-liberal model has also been going through some changes from the original model developed by McKinnon and Shaw in 1973 towards building ‘appropriate institutions’ (World Bank, 2012).

This chapter has been broadly divided into six sections including an introduction. Before proceeding, an adequate understanding of the market is important, so the next section provides an overview of the characteristics of the RFM as pointed out in literature. Transformation of the market from directed credit approach to market-based approach is the central issue in the third section. This section also discusses the changing role of the state under different policy regimes. Worldwide countries have gone through numerous experiences in addressing the issue from various approaches. The fourth section presents an analysis of four notable institutional arrangements from four different Asian countries. Defining the role of the state for the emerging institutions is part of section five, and the final section concludes the whole arguments.

3.2 CHARACTERISTICS OF THE MARKET

There are diverse natures of views (Bardhan, 1980; Stiglitz & Weiss, 1981; Basu, 1983; Bhaduri, 1983; Greenwald & Stiglitz, 1986; Lim, 1993; Ganzlez-Vega, 2003; Conning & Udry, 2005) in analysing the characteristics of rural financial markets. According to these views the distinguishing features of the market are:

- a. Interlinking of credit to the factor and product markets,
- b. High transaction costs due to imperfect markets,
- c. Personalised nature of fragmented market,
- d. Information asymmetry and problem of adverse selection in a segmented market, and
- e. Absence of right kind of institution to address various needs of the market.

These views can be summarised as: the interlinking nature of the fragmented rural financial market is vulnerable to the high level of information asymmetry, which makes the transaction cost high in operating in this market and makes legal enforcement difficult for the operators.

Interlinked markets

The RFM is connected with the rural economic structure, which is complex in nature, This is particularly true for developing countries. It is the 'rich peasants' not 'capitalist farmers', who are the dominant actors in the rural economy in the developing countries. The characteristics of 'rich peasants' differ from the 'capitalist farmers' in many ways. The capitalist farmers prefer wage relationship with free wage labour, whereas, the rich peasants prefer traditional form of relationship that is based on interlocking labour with other markets (Byres, 2003). Land plays the crucial role in the rural economy; the amount of land holding is critical to the political economy of this market.

Agriculture and agricultural based non-farm activities comprise rural livelihood. As mentioned in Bhaduri (1983), the market involvement of rich peasants is guided by their free choice, but small producers or poor peasants are forced to enter the market because they are locked into a given production relation. So, poor peasants may not be in a position to respond to the market forces, they either respond because of their 'involuntary market involvement through debt' (P.33) or because of other numerous forms of interlocked obligations. Marginal farmers and the landless poor

lack capital to invest, and do not have enough assets to offer as collateral to get access to credit either from the formal or informal market. 'Labour' is the only factor of production that they own, they either can sell labour for a wage in the labour market or can enter into tenancy relationship with the landowner. The landowners act like the 'lender of last resort' for them, they supply credit at various flexible terms and conditions. A landowner and a tenant enters into several transactions at the same time such as in land renting, in wage labour hiring, in production and consumption credit, in cost sharing of purchased inputs and in marketing of output, all as part of a comprehensive and interlinked contract encompassing several markets (Bhaduri, 1973; Bardhan, & Rudra 1978; Bardhan, 1980; Baroop, 1980; Basu, 1983). Landowners also have control over the product market as advanced buyers.

Sometimes landowners dominate a credit market as moneylenders. Moneylenders in the informal market operate in a small local market where they have full social control over the clients and on their businesses. There are many different types of collateral substitutes, from bonded labour to advance sale of the harvest that they accept to secure 'lender's risk' (Basu, 1984: lender risk hypothesis). In a monopoly market moneylenders charge a very high rate of interest for credit, and some researchers view the market as exploitative in nature, especially when credit market is interlocked with other markets (Sarap, 1987) like land and labour. The major cause of inter-linkage has been identified as the diversity and dependence of relations among the various agents of informal market in an under-developed economy, which has been termed 'asymmetry of economic power' by Byres (2003; p.24). This interlinking form of exploitation has been identified as the cause of backwardness by some economists, which intensify the poverty that prevails in the 'backward agriculture' (Basu, 1984). Contrary to this view some argue that interlinking is rather an efficient mechanism in reducing transaction cost and risk costs, so it can be used either in support of informal lenders or to attack them (Lim, 1993).

Issue of transaction costs and information asymmetry

Transaction costs are the costs of running the economic system (Arrow, 1971). In each transaction, there involved various types of costs (Furubotn and Richter, 1997; P. 47-63) such as;

- a. Search and information costs;

- b. Negotiation or bargaining costs;
- c. Policing or monitoring costs;
- d. Enforcement costs; and
- e. Costs of setting up and maintaining the standard institutional framework under which all these transactions are taking place.

The problem of information asymmetry is acute in the segmented rural market; it creates lending risks because borrowers have more information about their projects and intentions than the lenders (Stiglitz and Weiss, 1981). In the real world, information is not perfect and enforcement is not easy, so only effective monitoring can ensure timely repayment. However, monitoring needs expertise, time, and efficiency. Therefore, it is usually costly too. In the credit market, the problem related to enforcement cost and imperfect information may become important factors in attaining Pareto efficiency (Besley, 1994). Lenders try to reduce risk by transferring it to the third party like insurance companies or by improving their expertise in selecting a viable project and monitoring the project. In the absence of any third party insurer, these problems could be resolved if borrowers could offer collateral to secure their loans, but that solution is almost absent in the case of poor landless and marginal borrowers as they lack possession of land and other physical assets.

This particular problem of collateral has been amplified again with the legal and regulatory barriers related to the property rights (Goldstein & Udry, 2008). The legal constraint in establishing right on the property discourage formal sector to enter into this market (Conning & Udry, 2005). The process of creating a mortgage and establishing a claim on immovable properties is lengthy, costly and uncertain. Untitled land, high registration cost, and high search cost make the enforcement of claim very expensive in the developing countries. Establishing rights to land and other assets sometimes are not straightforward there.

Repayment of credit is an issue which makes the credit market different from other markets. An individual fails to repay credit for several reasons such as bad investment decision, unwillingness to pay or a sudden shock from external environment that causes loss. The lender simply may not be interested in investing because he or she lacks information about the potential borrower. The lender may not know whether the borrower is wise enough to take a right decision about an investment, how much hard work that person will be trying to make the project

successful, whether that person will misuse the money, or whether she/he has capacity and knowledge to run a business. All these issues discourage the lender not to serve to a particular borrower. The formal sector suffers (susceptible to inefficiency and default problem) more from imperfect information than local moneylenders, who live in close proximity in a similar cultural environment and are connected socially with the borrowers (Besley, 1994; Bhaduri, 1983). Hence, enforcement of legal issues, which arise from loan default, becomes a serious problem in the credit market, and that is very costly if the legal framework is not developed enough. The lender may not be interested to invest on account of the high cost of enforcement. This is quite common in developing countries with a weak legal structure.

Transaction cost for lenders in this market is high due to the problems related to collateral security, enforcement of legal action, and monitoring. Operating in this market is also perilous because agricultural production is an outcome of biological activity which is highly sensitive to changes in weather and natural climate. In the absence of any effective insurance scheme, and in the condition of poor rural infrastructure (such as road, electricity, communication, etc.), it becomes riskier for a lender to operate in the rural financial market. Therefore, the formal sector like banks is not interested in serving the market unless the government or a third party takes the responsibility of risk and shares, at least in part, the transaction costs.

New views to address traditional problems of RFM

Conning and Udry (2005) have developed a generalized framework under which the rural economy might grow; Figure-3.1 shows the process and relationship of that framework. According to them within the background of imperfect information (particular attention was given to ‘moral hazard’) and enforcement problem, successful contractual forms can come into existence by new entrants when they have greater insider information, and favourable legal environment. Thus, it can develop new markets or can expand an existing market further, which later can create more opportunities for trade and specialisation. Like a continuous spiral process, this again generates a new set of information and enforcement problems. The solution to this problem and development will depend on the:

- a) Nature of underlying information and enforcement problem and
- b) Quality of society’s law and institutions.

It is mentioned in this paper that the state has a role in this regard in creating these institutions like credit bureaus that facilitate the dissemination of information regarding growing conditions of the market and its outcomes. A broad set of issues like development of institutions related to property rights, legal environment for enforcing contract and diffusion of public goods like information (Stiglitz, 1994) are unlikely to emerge without state intervention.

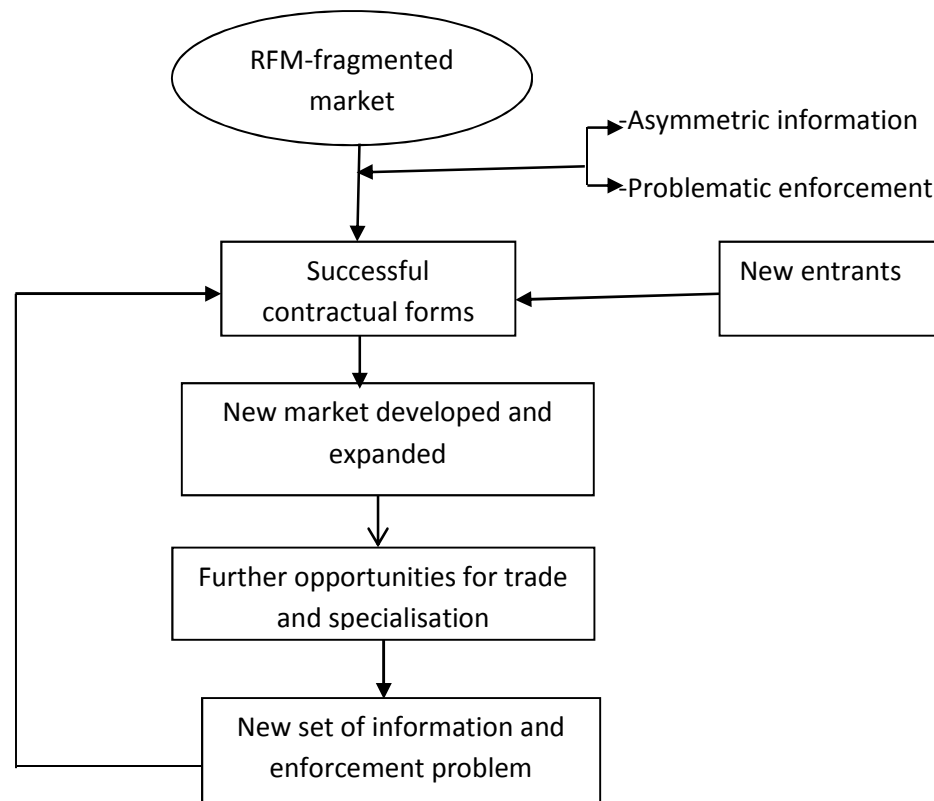


Figure-3.1 Framework of Development-RFM⁵⁴

In this context, Greenwald and Stiglitz (1986) mention that externalities may result from other markets as well. It can generate from land titling, commercialisation of goods markets and government expenditure on rural infrastructure that are likely to reduce information asymmetries, improve the level of competition and hence lessen the distortion in the rural credit market (Stiglitz, 1986). They also mention that externality in institutional innovation, such as peer-monitoring and joint liability can facilitate in overcoming the informational problem in the rural credit market.

⁵⁴ Adapted from Conning & Udry, 2005

As seen, there are many issues underlying the development of the structure of rural financial markets in developing countries. It is assumed that commercialisation of agriculture and agricultural related markets, technological advancement, and new opportunities for trade do have important role in its development. In addition, the emergence of new institutions that are capable of reducing the problem of information asymmetry and enforcement problem related to legal contract and property rights can change the structure of RFM significantly. It is an ever-evolving process of development which requires alternative policy support and intervention from the government (Holf and Stiglitz, 1990; Stiglitz, 1994; Conning and Udry, 2005), it may not be the same traditional role of direct intervention in the market.

3.3 POLICY APPROACH: CHANGING ROLE OF THE STATE

Traditional views of the Neo-classical school

Traditionally, credit for the rural financial market has been viewed as a development tool (Pischke et al. 1983). Therefore, the whole approach towards this market is different from the approach that exists in the case of the urban market. Yaron and Benjamin (1997) express their concern that the agricultural sector in developing countries is being viewed as the input supplier for industrialisation not as a separate growth sector. Therefore, it remains neglected, and it is being treated differently by the states. Policies are biased in favour of industrialisation and the urban sector. In this context, Ray's statement (Ray J., 1983) is relevant:

Policies that discriminate against the rural sector in favor of import-substitution industries or other activities in which a developing country has no competitive advantage, are likely to repress agricultural production and rural incomes, encourage rural-to-urban migration, and lead to inflation and balance of payments problems. Such policies hinder the development of rural financial markets capable of equitable and efficient resource allocation. (abstract)

The traditional approach views the RFM as:

- Poor cannot save;
- Government provides cheap credit to drive out moneylenders and compensate for low prices of agricultural goods;
- Performance of institutions is assessed by the volume of credit disbursement and the impact of loan on production;
- Government policies address the symptoms rather than the causes of insufficient FIs;

- Neglect rural non-farm sector.

It is believed that supply of cheap credit to the rural market will boost agricultural production and hence will help poor people in bringing them into the mainstream of development. This model of development was supported by Keynesian economic doctrine after the crisis of the World War II. Neo-classical economics focuses attention on investment to increase employment and uses interest rate to stimulate investment so that capital can be employed at its full scale. It pays little attention to the capital formation through savings, an important part of the financial market. As a result, large numbers of Development Financial Institutions (DFIs) were created with the support of national government and international donors. In many developing countries banks were brought under government ownership to supply 'directed credit' facilities to the rural market to boost agricultural production and hence the economic development of the country. It was hoped, the moneylenders would be replaced by the government initiative, either directly via DFIs or indirectly via decree. However, very little of this subsidy could reach to the actual beneficiaries and genuine borrowers mostly due to the political influence of the big farmers that finally ended up with the collapse of DFIs because of the rise of massive non-performing assets (Khalily & Meyer, 1993). As mentioned by Gonzalez-Vega (1994), the iron law of interest rate restriction benefits richer and powerful farmers. Adams and Vogel (1986) also mention that the greater the credit subsidy, the lesser are the chances of the same being availed by the poor farmers.

Approach of the Neo-liberal school

On the other hand, Neo-liberal school believes in 'prior individual savings' for economic growth. According to this approach, high-interest rate encourages savings which can be allocated to the productive sector that demands it most, and that agrees to pay high price for a return to productive investment. McKinnon-Shaw theories of financial repression have challenged previous Neo-classical theories of Keynesian, which has been supported by academic institutions like Ohio State University and policy making agencies like the World Bank (Lim, 1993). They recommended charging 'positive real rates' as a preferred strategy for overcoming 'repression'. Financial repression has generally been characterized as the interest rate restriction, priority sector lending, undervaluing savings, and protectionist policy of the state.

Thus ‘financial repression’, as mentioned by McKinnon (1973), is the result of fixing interest rate of credit below the rate that would prevail in a competitive financial system, subsidizing loans for specific sectors, and regulating the (heavily) banking sector. Berthelemy and Varoudekis (1996) define all these policies and regulations, which prevent financial intermediaries from operating in accordance with their full technological potential, as forms of financial repressions. Financial market rigidity (Yaron & Benjamin, 1997) arises from excessive intervention by the government in the form of the reserve requirement, subsidised fund channelizing through state-owned banks and restrictive interest rate, which hinders efficient allocation of resources and intensifies problems arising from imperfect information. Financial repression is associated with a restriction on interest rates and, in a strict sense, controls deposits due to inflation (Kitchen, 1986). These are very common practices in developing countries that are imposed by the governments (Ahmed & Islam 2010). In this connection, the comment by McKinnon (1973) in the context of mid-1960s’ Brazil is relevant:

Total bank credit still is very small in relation to total real output, in view of the dependence of farmers on informal credit markets. The lack of interest-rate rationing makes it difficult to tell whether the loans really were used for high-priority purposes. Indeed, the banks were given incentives not to lend to small farmers because of the fixed interest charge and because of allowances for administrative expenses, which, perversely, were actually higher for large loans benefiting established farmers and agricultural intermediaries. The net effect of the credit switch was probably to benefit agriculture slightly.(P.83)

By the early 1980s, the Ohio School’s model of ‘counter-revolution’ came into place as an alternative solution, and dominated the policy debate around serving rural financial market of developing countries throughout the 1980s. The suggestions of the Ohio School were as follows⁵⁵:

- a. Financial services should not be supplied in advance of demand but to meet existing needs;
- b. Informal sector provides credit at cheaper rate considering its quick response to the request and the flexibility. Working practices of informal lenders in developing countries are more flexible than DFIs, which can be set up to replace them;

⁵⁵ Summarised from Hulme, D. & Mosley, P. (1996).

- c. Sectoral targeting, interest rate capping, and subsidy for DFIs should be abolished to ensure competition in the market and to handle economic rationing originating from excessive demand;
- d. Savings mobilisation has been given importance as a necessary condition for financial discipline (means of knowing market better) for lending institutions;
- e. State intervention is to be replaced by the market mechanism.

The view of this school towards informal lenders varies from the Neo-classical school. It claims that informal sources generally do not charge excessively high-interest rates. They need to cover opportunity cost of money, and high transaction costs associated to credit monitoring and supervision. They also have to cover the risk related to credit. According to them, the informal sector is actually more efficient than DFIs in allocating capital and they are much more flexible regarding trade. So, this school assess informal sector rather positively (Hulme & Mosley, 1996 and Lim, 1993). Table 3.1 shows major differences between these two views.

Table-3.1: Differences between Neo-classical and Neo-liberal views towards financial market⁵⁶

Component	Neo-classical	Neo-liberal
1. Priority	Investment	Savings
2. Role of financial market	Subsidised and supervised credit, help poor, stimulate production	Operate without intervention and interest rate ceiling
3. Users	Most farms	Bankable and viable farms
4. Sources of fund	Government and donors	Mainly depositors
5. Interest rate structure	Artificially low-interest rate for small farmers	Can be high to cover opportunity costs, transaction costs, and risk premiums
6. Role of government	Direct intervention	Indirect promotional
7. Attitude towards informal lenders	Monopolist, exploiters, usurers	Efficient and generally positive
8. Evaluation	Focus on credit impacts	Focus on performance of financial intermediary and systems

⁵⁶Summarized from Lim, 1993 and Bose, 2004

McKinnon's suggestions of interest rate liberalisation, Ohio School's views of the market mechanism, and the Neo-liberal approach to narrowing down the state's role are being echoed in the broader outline of policy suggestions under financial liberalisation programmes for developing countries. It has especially been promoted by the change in global politics in favour of market economy after 1990.

Some promising financial innovations had taken place in the rural non-farm sector under the Neo-liberal approach. However, the response of the private financial intermediaries to these liberalising policies was not as expected or as was envisaged by many of its supporters (Conning and Udry, 2005). Credit flow to the rural sector of many developing countries declined due to the closure of many insolvent DFIs and bank branches under financial liberalisation programme (Gonzalez-Vega, 1995, 2003; Rice 1993; Gosh, 2005; Chavan, 2004; Bose 2004, Bhusal, 2012).

Changing role of the state

Deregulation, privatisation, and withdrawal of the state from the market have been identified as three major components to ensure a Neo-liberal policy that has become hegemonic as a model of discourse in development since the 1990s (Harvey, 2005). But, liberalisation policy that moved from 'over regulated' to 'under-regulated' systems has faced some difficulties because it has neglected the importance of institutions in economic development (Nayyar, 2007) and failed to identify the specific role of the government (Stiglitz, 1994) in the market mechanism. The issue of institutional development or 'governance reform' (Chang, 2007b) and the debate on the 'evolving role of the state' (World Bank, 2012) in the financial sector have come to prominence after a couple of financial crises in 1997 and afterward. Chang (2007a) mentions that:

the institution-free technocratic reform programmes promoted by the IMF and the World Bank and by many donor governments since the 1980s have almost universally failed. Many of these reform programmes blatantly ignored institutional differences across countries,..(P.1)

The Neo-liberal school of economics supports the arguments of Goldsmith-Mckinnon and Shaw that emphasize on the minimum role or involvement of the government in the financial market to ensure productive and profitable allocation of resources for long-term economic development. This school states that when a particular market functions badly, the authorities feel the need to 'do something', which is generally the

reason for a government to intervene in the market. According to them, this pressure for public intervention creates severe fragmentation in the market of the underdeveloped economy because the state does not have (cannot possess) enough information on market signals such as price and it distorts the market by its powerful one-sided intervention (Harvey, 2005).

Under this new paradigm, 'market' is the main force, which has been seen as the 'hidden-hand' of Adam Smith. Therefore, the market should be kept free from any intervention, as mentioned by the supporters of Neo-liberal school. In this argument, two institutions such as 'market' and 'government' or 'state' are standing face to face to set the rules of the game, which ignores diverse role and evolutionary process of setting an institution.

A more nuanced and balanced counter argument is placed in the context of this long-standing debate by Structuralist and Neo-structuralists school of economics, who say that financial institutions may not allocate funds to those projects where social returns are highest without intervention (Stiglitz, 1994, Ahmed & Islam, 2010). Their argument in favour of so-called 'financial repression' is that firm's equity is actually increased with financial repression that ensures lower cost of capital, and hence, firms are more likely to engage in projects with higher expected returns. They further argue that financial repression actually can be used with other incentive schemes to reward a specific sector that contributes more towards economic growth such as high technology industries, and in innovation that demands more access to capital for experiment and research. According to them, issues like financial crises, economic recessions, financial innovation, technological advancement, emergence of new institutions, development of more sophisticated financial tools, and other similar factors demand the specific role of the government in the financial market. Stiglitz (1994), in his famous paper on 'The Role of the State in Financial Markets', identifies seven major market failures as rationale for government interventions, as follows:

- a. Monitoring of public goods
- b. Externalities of monitoring, selection, and lending
- c. Externalities of financial disruption
- d. Missing and incomplete markets
- e. Imperfect competition
- f. Pareto inefficiencies of competitive markets
- g. Uninformed investors

According to him, in the above cases of market failure the government has enough rationale to intervene in the market as it has power through indirect control mechanism, incentive, and through regulations. He mentions that the credit market is prone to market failures and hence a government intervention in the area of prudential regulation and supervision is justified. He concludes the paper by saying that ‘some amount of financial repression may actually be beneficial’, but as a caution adds that interventions should be well designed because the success of government interventions has mixed results. There is growing literature that now supports the argument in favour of government intervention. One argument (Besley, 1994) says that since externalities of a particular type are common in the credit market and the market functions inefficiently, government policy can play important role in eliminating this problems impartially.

In the view of the structuralist school, the de facto role of government is seen as an insurer of the financial system (Fry, 1995). They warn by saying that without careful management, liberal attitudes to finance and the financial market may disrupt economic activity seriously. Protecting depositors, protecting the market from monopolist behaviour of moneylenders, and dealing with externalities (Greenwald and Stiglitz, 1986) are other arguments for government intervention. According to them, moneylenders should be replaced by an institutional structure that is equally efficient in collecting information and enforcing repayment (Besely, 1994), and that initiative can be taken by the government. Arguments are also given for state intervention from the views of social returns that say that there are some sectors which have high social returns but may not deliver the highest profits for the investors. Therefore, this could be one of the reasons why the government needs to intervene to protect social sectors (Gosh, 2005). According to this view, government’s intervention is also necessary during a period of crisis which has a cascading effect that creates difficulties in the society, adversely affects the poor, farmers and workers.

The behaviouralist school⁵⁷ has another interesting view, it says that in the world of ‘risk’ and ‘uncertainty’ people behave on the basis of ‘bounded rationality’. Therefore, society creates rules that deliberately restrict people’s freedom of choice in order to reduce the complexity of the problems of the real world. According to this argument, the government need not know better to intervene; it simply intervenes into

⁵⁷ Herbert Simon, the winner of the 1978 Nobel Prize in economics.

the market with regulation just because of limiting the complexity of the activities, which enables the regulated to take a better decision (Chang, 2010). The occurrence of the financial crisis of 2008 has been pointed out in this literature as an example of this behavioural problem of bounded rationality. It mentioned that financial crisis is the outcome of a kind of 'speed gap' (bubbles of derivatives) created between finance and the real economy that needed external intervention to reduce the gap where the state has a role to play.

Among all these diverse views regarding the role of state and creation of institutions in the financial market, the latest dominant views are reflected in the World Bank's current report (World Bank, 2012). It reassured that the financial crisis in the USA in 2008 and recent Euro crisis had reopened important policy debates on the role of the state and governance in finance. It is mentioned in this report that the financial crisis has led regulators, policymakers, and academics to review the whole issue for further reforms. According to this current view, there is no dispute regarding the state's role in intervening in the areas of financial sector regulation and supervision. However, the debate is about 'how to ensure that the role is carried out well, and how well it is performing', hence, the issues related to the development of institutions and governance come to the forefront. As pointed out in this report, direct intervention can work when policies are practiced on the basis of sound operating principles and it could be justified when it addresses the specific problem of market failure and when it brings a positive outcome and reduces poverty. Intervention could be in the form of supporting pilot project, information dissemination, training and dissemination of best practices, others. They suggest that support can be channelized through other organisations such as banks, cooperatives, and NGOs instead of direct intervention by the government.

Surprisingly, this report of the World Bank expresses positive views regarding ownership of banks by the state as a short term remedy during the crisis while it mentions that states' direct involvement for a longer period may have an adverse effect on the market. Based on updated data from both developed and developing countries, research, and experiences from around the world, it concludes the report by saying that active involvement of the state in the financial market can help in maintaining economic stability, improving growth and in creating jobs. However, the state's role should be adjusted from time to time to improve distorted competition, improve the flow of information and to strengthen the contractual environment rather

than restricting competition, it adds further. This current analysis of the World Bank regarding the role of the state in the financial market is slightly different from its previous position of complete reliance on the market. It recognises the existence of the various institutions in the market and therefore, it analyses the role of the state from a more nuanced approach on the basis of new data, research and experiences (World Bank, 2012) instead of previous simplistic ideological views.

On the basis of above debates around the issue of the role of state and importance of institutional development in the financial market, it can be concluded that the views have been changing over the period. It changes from ‘getting the policy right’ to ‘getting the institutions right’, which means that ‘solid and transparent institutional frameworks to promote financial stability’ (World Bank, 2012) are essential, and therefore, the state has a role to play here.

3.4 A FEW NOTABLE INSTITUTIONAL ARRANGEMENTS IN ASIA

Many countries have taken many approaches in addressing this particular problem of RFM; some were successful while some were not. The following four institutional models to serve rural poor or marginal farmers from four Asian countries have attracted attention all over the world:

- a. Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand,
- b. Grameen Bank in Bangladesh,
- c. Bank Rakyat Indonesia (BRI Unit desa), and
- d. SHG-Bank Linkage Programme (SHG-BLP) in India.

As a full government owned (over 99 per cent) bank, established in 1966, BAAC has tremendous positive impact on the rural farms and non-farm sectors (Sathakarn, 2004; Kitano, 2001) in Thailand. Before the 70s, it had replaced collateral requirement by introducing joint liability programme for the poor people, who did not have any physical collateral to offer. It has proved itself as a sustainable institutional intervention by readjusting programmes time to time depending on market requirements. It has been getting priority treatment from the Thai government. Decentralisation of power, performance-based incentive mechanism, and strong financial management systems are considered its sources of strength (BAAC & GTZ, 1998; Fitchett, 1999).

Grameen Bank in Bangladesh, established in 1983, mostly owned by the poor people (members of the organisation)⁵⁸, has become a hallmark organisation in addressing issues of poverty in the development arena. According to Hossain (1984, 1988) and Khandker et al. (1994), under the dedicated leadership of Professor Muhammad Yunus, it has successfully created a niche market targeting the women among the poor. A group of committed staff is also considered the organisational strength of Grameen. Its unique nature of ownership structure has attracted many and enabled it to get support from all over the world.

The Unit Desa (village units) under the Bank Rakyat Indonesia (BRI) is another sustainable banking for the poor aimed at addressing financial problems of the rural market (Charitonenko et al., 1998). As an old state-owned bank dedicated to serving rural areas, it has been permitted to run commercial banking since 1970. It was converted to a public company in 2003 with the provision of 40.50 per cent share for the public and 59.50 per cent by the government. In the early 80s, BRI introduced Unit Desa programme under a separate agenda of the government that has finally turned into a commercially viable model after some restructuring. It has a clear mandate of operating on a commercial basis without subsidy. Therefore, it has been focusing on deposit collection from the rural sector to reduce costs and on charging commercial rates on credits to make it viable (Maurer & Seibel, 2001).

SHG-BLP model in India had launched by NABARD in 1992 that combines the banks with the self-help groups (SHGs) of the poor. In this system, groups pool their savings to get access to formal credit as matching funds under the normal lending business of the banks. Sometimes, NGOs are involved as mediators in organising SHGs and in collaborating with the banks (NABARD, 2003). Currently, the NGO/MFIs have more prominence in the market (under MFI-Bank linkage) in channelizing funds from the banks. This has become a cause of concern for the policy makers because sometimes NGO/MFIs were observed involving in unethical practices (NABARD, 2011-12) and in charging high rate of interest on loans (Mohanty, 2011).

There are some other local levels new types of financial institutions that also are playing significant role in the rural markets of respective countries. A few examples are BKK system in Indonesia, SANASA (credit cooperatives) in Sri Lanka, microcredit programmes of NGOs in Bangladesh and in other countries (Hulme &

⁵⁸ 75 per cent by the members and 25 per cent by the government

Mosley, 1996). The major objective of all these institutions lies in the responses in dealing poverty, one of the main challenges of development, through the institutional mechanism. NGOs have been playing an important role in serving RFM in many countries including Bangladesh where NGOs as ‘drivers of policy change’ have been positioned in between policy autonomy and external influence (BRAC University, 2012). In Bangladesh as well as in many other developing countries NGOs, an emerging institutional setup, are now the most active and dominant financial intermediaries or catalysts in the rural financial market having the status of development partners of the respective governments and in India, they have been playing an important role in linking SHGs and Banks.

The basic operation and techniques of these institutions differ fundamentally from those of the traditional commercial banks. They have minimized the risk of information asymmetry either with the help of group guarantee and joint liability or by intensive monitoring or by both mechanisms. Many of them have advantages of:

- Minimizing information gathering and processing cost via group formation,
- Transferring part of the monitoring cost to the borrowers via joint liability programme,
- Transferring credit risk on the clients via group guarantee,
- Fixing high-interest rates to cover operational costs⁵⁹,
- Focusing on non-farm small business to reduce risks associated with the investment.

In Bangladesh and some other countries, the NGOs have received start-up fund and subsidy from national and international donors. They also have enjoyed facilities of no regulatory barrier, at least at initial stages. Some of them such as BAAC, NGOs, and Grameen Bank also have been rewarded by tax rebate by their respective governments as well.

3.5 REGULATION AND SUPERVISION: REDEFINING ROLE OF THE STATE

In all these organisations, ‘saving’ is an important integral part that helps them in capital formation. Among these four prominent institutional arrangements, Grameen

⁵⁹ Except BAAC and SHG-BLP. BAAC charges lower rate to the farmers and the banks charge regular rates to the SHGs, whereas MFIs’ rate is much higher in India. Grameen’s rate is 20 per cent on its regular loan, BRI used to charge as high as 30 per cent, and the interest rate cap on NGO-MFIs’ loan in Bangladesh is currently 27 per cent.

Bank of Bangladesh and BRI of Indonesia got considerable attention from the international community and these two organisations symbolise two prominent sub-models (Robinson, 2001) of financing the poor. Initially, Grameen Bank was considered the most successful model in addressing poverty, however, criticism regarding Grameen's dependency on subsidised or donor funds have raised questions about its long-term viability⁶⁰. Robinson (1992, 1994, 1997, and 2001) is one of the pioneers who popularises BRI as a sustainable model and addresses the issue of 'financial system approach' instead of 'poverty alleviation approach'. Focusing on savings and charging commercial rates on credit are two important features of this approach. In response to this change, NGO-MFIs have shifted their focus towards financial system approach. In this connection, Bateman and Chang (2012) have mentioned that it became apparent to Neo-liberal policymakers by the early 1990s that most of these MFIs were actually dependent upon a continuous flow of subsidised capital, so they (the policy makers) began to feel 'awkward about using subsidies to keep the supposedly non-state, market-driven microfinance sector going'. As a result, 'new commercialised model' (formally known as 'financial system approach') has been introduced (replaced) as the 'best practice' for the original subsidised model.

This new approach goes hand in hand with the views of the Neo-liberal school. Hence, savings collection as sources of fund gets priority under this model. However, NGOs and some other non-banking models of emerging institutions are not supposed to have legal permission to collect savings or deposits from the market. The issue of savings collection by the MFIs has been getting increasing focus in many discussions in different platforms⁶¹ both from the perspective of sustainability of MFIs as well as from the perspective of demand of the market (Robinson, 1995). To overcome this problem at one stage, in some countries, they were allowed to collect savings selectively from their clients or public in general. However, as soon as they were given permission to collect savings from the public, regulation of these new institutions became one of the very important issues for many countries, where again

⁶⁰ Thereafter, Grameen has brought some changes in its operations and currently it has been running sustainably without subsidy.

⁶¹ Consultation on Regulation & Supervision of Microfinance held in Washington DC on May 17, 1999, arranged by USAID sponsored Microenterprise Best Practices; High level policy meeting on Microfinance and Rural finance in Asia, Yogyakarta, Indonesia, 26-28 February 2004; Microfinance Regulation: Who Benefits?, Conference arranged by the MRA in Dhaka, Bangladesh, 15-17 March 2010.

the role of state comes into the discussion in order to safeguard the interest of the depositors or savers.

Under the hegemony of Neo-liberal policy and financial liberalisation, the international community was in a dilemma for a long time on the issue of 'regulation'. Initially, most of the discussions were focused on 'no regulation' or 'self-regulation' and 'non-prudential regulation', at the later stage however discussion has moved toward 'regulate deposit collecting institutions' only (Christen et al., 2003). As more and more new institutions started operating in the rural financial market with deposit services, countries and their respective governments started facing difficulties in protecting depositors and as a result, the issue of 'prudential regulation' has been gaining more importance. There were many workshops, seminars, conferences around the world (both at the national and international levels), especially after 2000, on the issue of right mode of regulation of 'microfinance institutions'. Central banks of many countries were divided on the question whether banking sector rules and regulations are appropriate for these institutions, and how much central banks should be involved in regulating this new sector. In this context while discussing global experiences in regulating MFIs, Rahman and Rashid (2011)⁶² point out:

In some countries central banks are not willing to participate at all, while in others they have participated rather strongly. However, none of the central banks has imposed banking sector rules and regulation directly Some have customized banking regulations, others starting from a clean slate have created wholly new regulations. A number of countries are still in the preliminary stages of considering microfinance regulation. (P.xxvii)

However, the discussion on microfinance regulation has still remained limited and unfolded at least from the perspective of the overall historical evolution of RFM under different policy regimes and also in respect of the re-defining role of the state.

3.6 CONCLUSION

The rural financial market has always been the focus of discussion among the policy makers, especially in the context of developing countries. It is an important issue in the field of research as well. Researchers for long have tried to understand and analyse the market. Some view it as an interlocked market where credit is linked with other factor and product markets. Some view it from the perspective

⁶² For detail see Background and overview in Rahman & Rashid (2011)

of transaction cost while others explain it as a problem of information asymmetry and adverse selection in a segmented market. Again, it has been identified as a market which suffers from the absence of the right kind of institutional arrangement.

The market has gone through the evolutionary process of a policy shift from centralised directed credit to market-based credit delivery approach. The traditional supply-led approach that was highly dependent on government or donor subsidy, neglected rural non-farm sector and paid little attention on institutional sustainability. It has changed its direction since the 70s. New view of Neo-liberal approach emphasises on savings collection from the market to accumulate capital, and prefers market-based interest rate to cover the cost of delivering service. Under this approach, the state's direct role in market intervention has been modified to indirect promotional and developmental role. Initial views of narrowing down of state's role have further been reviewed after a few financial crises in the late 90s and thereafter. Redefined role of the state under Neo-liberal approach considers the state's role in managing situations like financial crisis, economic recession, financial innovation, technological promotion, reduction of externalities from the market, and in disseminating information. It lays emphasis on building an appropriate institutional framework instead of direct intervention in the market.

Many Asian countries have gradually adopted and implemented a new market-led approach under financial liberalisation programme. A number of rural branches of commercial banks which were expanded under the directed credit have been shut down on the grounds of sustainability. Hence, the gap has further been enhanced by demand and supply of financial services in the rural market. Various kinds of institutional setups to reduce this persistent gap in the market have existed for long in many countries.

Grameen Bank of Bangladesh and BRI system of Indonesia, specialist banks for the poor, are two important institutional innovations among many. NGO modality of delivering credit is another non-public, and non-private type of semi-formal organisational arrangement has also emerged in the market in many countries. Initially, Grameen Bank was considered as the most successful model in addressing poverty; however, over time the BRI model has received significant attention on account of its sustainability approach. Therefore, those NGOs

following the Grameen model have re-oriented their strategy towards a market approach in keeping with the changing views of the market.

As NGOs and other semi-formal type of emerging organisations have started paying attention towards savings collection from the market under the new approach, the issue of regulation and supervision has come to the forefront. However, supporters of this model were not for restricting this new model in the name of regulation. Hence, policy makers were divided on the question of mode of regulation and nature of state intervention in the microfinance market. Discussions on regulation and supervision of this new type of institutional arrangement in the context of the evolving role of state under policy shift are still waiting to unfold fully.

CHAPTER 4

Rural Finance in Bangladesh in the Context of Changing State Policy

4.1 INTRODUCTION

Bangladesh, officially known as the People's Republic of Bangladesh, emerged as an independent country in South Asia in December 1971 following a nine-month bloody war with the then West Pakistan. Because of its past linkage with India and Pakistan, it shares a similar historical background of the financial system of those countries. Since independence, the country has undergone a long journey in its efforts in poverty alleviation and economic development. There have been some achievements, with poverty declining, GDP rising and some Millennium Development Goal targets being met. National poverty, which stood at 72 per cent of 75 million people in 1970, fell to 59 per cent in 1980, dropping further to 49.8 per cent in 1990 and finally to 24.30 per cent in 2014. In this period the population doubled from its 1970 level. The main contributory factor in this achievement was robust and stable growth. GDP has been growing steadily at an average rate of 6 per cent for last ten years since 2004/05, and per capita income stood at US\$1,314 in 2015⁶³ as against only \$212 in 1987.

The focus of this thesis is to trace the emergence and evolution of microfinance institution operating mostly in the RFM⁶⁴ of Bangladesh in connection with the changing policy atmosphere at the state level. In doing so, it is essential to understand the historical context that has created the space for the MFIs to evolve as financial institutions with the political changes in the country. This thesis, therefore, refers to the necessity of looking at the historical context before addressing the issue of NGOification⁶⁵ of rural finance. This chapter contains five sections including the introduction. The second section describes the brief political history of Bangladesh along with changes in broader policies of the state from 'nationalisation' to 'privatisation' along with major economic indicators. The third section discusses the evolution of the financial sector, its reform and thereafter the effect of reform on the

⁶³ The Daily Star, May 20, 2015

⁶⁴ Nearly 90 per cent of microfinance operations are in the rural sector (CDF, 2014)

⁶⁵ The term has been borrowed from Feldman (2000)

rural market. Section four presents an analysis on NGOification of rural credit, and the final section concludes the chapter.

4.2 BRIEF POLITICAL HISTORY AND MACROECONOMIC SCENARIO

Bangladesh emerged with the promises⁶⁶ of ‘nationalism’, ‘democracy’, ‘socialism’, and ‘secularism’ as the four pillars of the state. Parliamentary form of government under multi-party system was ensured immediately after liberation war by the new government formed by the Awami League (AL) as the largest majority party in Parliament (Hasan, 2010). Sheik Mujibur Rahman became the first elected Prime Minister of the new country. During the first three years under this government, the base growth was very low due to the sudden fall in GDP. Even after drastic economic condition after the liberation war, the average growth rate during this period was 6.5 per cent. In 1974, there was a severe famine and the inflation rate rose to as high as 80.57 per cent due to many reasons including export of consumer items to meet the deficit of food production and rapid expansion of money supply to boost the economy from its low initial base after the war⁶⁷. The government adopted policies favouring public sector and nationalised many industries including banks⁶⁸ (Sobhan, 1991). This invited criticism from western developmental agencies who were pressurizing the government to increase the role of private sector.

Ironically, the country’s political system turned in the opposite direction, towards promoting the private sector, immediately after the assassination of Sheik Mujibur Rahman on 15 August 1975⁶⁹ in the middle of the economic turmoil faced mainly due to the devastating aftershock of the war followed by famine in 1974. Thereafter, the country remained under military dictatorship for fifteen years (1975-1990). For most of the period of military dictatorship, it was ruled by two military dictators- Major General Ziaur Rahman (1976-1981) and Lieutenant General Hussain Mohammad Ershad (1982-1990). There were coups and counter-coups in the period following the political change in 1975 (Rono, 2005; Roy, 2014). Ziaur Rahman was assassinated in May 1981 by another group of military forces and Hussain Mohammad Ershad had to resign from power in December 1990 in the face of public

⁶⁶ As per its original constitution adopted in 1972

⁶⁷ Bangladesh Bank Annual Report 1973-74

⁶⁸ The Bangladesh Banks (Nationalization) Order enacted in 1972

⁶⁹ Jahan (2000) has referred to Lifschultz, Lowrence (1979) in the allegation of CIA involvement in the August 1975 coup.

protest against his regime. Bangladesh has since resumed its journey towards democracy, though controversies remain⁷⁰.

The country shifted its policies from 'nationalisation' to 'privatisation' and sought foreign assistance with the aim of rapid economic development after 1975. The process was initiated by Ziaur Rahman and gained momentum under the Ershad regime. Zia shifted from the previous political commitment to 'socialism' into broader 'capitalism', and extended cooperation towards the West and the Middle East. Ershad ruled the country on the foundation of the same political ideology that had begun under Zia, with more emphasis on policies of liberalisation. Many donor-prescribed policies were implemented during the Ershad regime. The privatisation programme of the government initiated during the Zia period, and the Structural Adjustment Programme (SAP) supported by the World Bank were boosted by Ershad's push. However, the average growth rate during this period was just 3.81 per cent; so the entire decade of the 80s can be termed as the 'decade of stagnation' (Sobhan, 1991) and the country became excessively dependent on foreign aid⁷¹.

Though a democratic government came into power again after the downfall of Ershad in the 1990s, both the political parties⁷², in power since 1991, have been following the same path of free market economy, privatisation, and liberalisation that was started in 1975. Jahan (2000) argues that global changes during this period had a positive influence on the changing dimension of the political-economy in Bangladesh. In the first half of the 90s, during Khaleda regime under BNP (1990/91-1994/95), the government tightly controlled expenditure and increased its revenue collection and, as a result, both budget deficit and inflation remained under control. Though, both the trade deficit and dependence on foreign agencies decreased significantly during this period, but, as a consequence, the growth rate declined simultaneously. However, the stability of the economy improved and hence, this period is termed by economists as 'stability at the cost of growth'⁷³.

⁷⁰ For detail see Jahan (2000).

⁷¹ 108 per cent foreign aid of development budget in the worst year, usually it was 80 per cent (Sobhan, 1991b)

⁷² Awami League (AL) under the leadership of Sheik Hasina, the daughter of Sheik Mujibur Rahman and Bangladesh Nationalist Party (BNP) under the leadership of Khaleda Zia, the widow of Ziaur Rahman.

⁷³ CPD. (different issues from 1995 to 2001). "Independent Review of Bangladesh Development, (IRBD)". Dhaka: University Press Limited.

In the second half of the 90s, during the Hasina regime under AL (1995/96-2000/01), the government started spending more liberally, especially in the case of agriculture, thus, growth picked up and for the first time crossed the 5 per cent rate after a prolonged period of stagnation. However, budget deficit, loan from the banks by the state, inflation, and related other factors were also rising slowly. After that, BNP and then AL came into power one after another. Since then the average growth rate remained steady at over 6 per cent, GDP at current US\$ and GDP per capital are also showing increasing trends as population growth rate was in between 1.5 to 2 per cent.

Though the country has not grown as per its potential (Khan, 2000; P.266), Bangladesh is one of the earliest countries in South Asia that has initiated economic reform programme with the support of international development agencies. The privatisation programme was undertaken here in the early eighties and gained momentum in the late eighties under the Structural Adjustment Program (SAP). The first reform programme in the financial sector was initiated in 1982; the then government had decided to allow the operation of private banks and decentralised three Nationalised Commercial Banks (NCBs) during 1984-1986. The formal Financial Sector Reform Program (FSRP) under a credit agreement with the IDA was introduced in the early 90s. This reform programme was “part of the process of liberalisation programme that began with the change of regime in 1975 and resulted in the abandonment of ‘socialism’ as a state principle” (Chowdhury, 2000; P.5). As a consequence, the flow of credit to the priority sectors like agriculture, small and cottage industries declined during 1990-1999, and the relative share of rural banking declined after the adoption of reforms measures with the shutting down of many poorly performing rural branches of NCBs (FSRP, 2000).

The agro-based economy of the country has been transforming rapidly into a mixed one. The service sector now dominates the economy with the lion’s share in GDP. In 2013⁷⁴, out of the total GDP, the service sector accounts for 49.30 per cent, the industrial sector 31.99 per cent and agriculture 18.70 per cent. Though the contribution of agriculture in GDP has gradually been declining from 60 per cent in the 70s to 18 per cent in 2013, the sector still provides employment to 40 per cent of the total working age population. The majority of the working-age population of

⁷⁴ Economic Consensus 2013, Government of Bangladesh

Bangladesh still resides in rural areas and depends on agriculture or agriculture-related economic activities, but this growing labour force can no longer be fully absorbed by the agricultural sector. Income from the agricultural sector now constitutes only one-fifth of household income on average as against one third two decades ago. Therefore, self-employment based rural non-farm activities have gained importance over time and are seen as a crucial sector for employment generation as well as reducing poverty in rural areas.

A recent study (Hossain and Bayes, 2010) mentioned that most capital invested in rural non-farm business was financed by own savings, and the role of the formal financial institutions was found relatively small. Hence, lack of access to credit was identified as a major constraint to the expansion of rural non-farm enterprises. Khalily et al. (2011) have mentioned that in 2010 at the national level, only about 7.99 per cent people have access to credit facility from formal financial services, 36.63 per cent have access to quasi-financial credit that includes MFIs and cooperatives while 45.88 per cent do not have access to any credit facility. According to Hossain and Bayes (2010), microfinance institutions do play a crucial role here to loosen this financial constraint in the rural economy.

In this section, I have tried to present a brief summary of the major political changes along with significant economic indicators and policy shifts under different regimes. It gives us a general view of the political context under which the RFM of Bangladesh has been operating since independence. These historical trends will be mentioned again in the following sections and in the other chapters of this paper to relate it to the state's regulatory role in the evolution of microfinance institutions in Bangladesh.

4.3 FINANCIAL SECTOR AND ITS REFORM⁷⁵

This section discusses banking reform in Bangladesh under the broader financial sector and its reform for the period from December 1971 to FY 2012-2013. Instead of discussing the entire financial market, I am focusing the discussion only on the RFM, the subject matter of this thesis. Here, I am trying to trace how the RFM of Bangladesh has been used and abused over the years to serve the political purposes of

⁷⁵ Information of this particular section is largely drawn from the Annual Reports and Schedule Bank Statistics of the Bangladesh Bank from 1973 (the first report) to FY 2012/13. However, I also consulted other secondary sources as and when necessary to cross check the information.

the state and in the later phase, how there has been created a liberalised space for the NGOs to become a new ‘private’ player in the market.

1972-1975: Directed credit supply without viability concern

After the independence, the Bangladesh Bank, the new central bank of the country⁷⁶, inherited a total 1191 branches of 22 banks. These banks were nationalised (except foreign banks and two development banks) and restructured⁷⁷ into six commercial banks by the new government to make them attuned to the state policy which was along the line of socialism. So, the financial sector of Bangladesh started its journey with six nationalised commercial banks (NCBs); two government-owned development banks, the Bangladesh Shilpa Bank⁷⁸ (Industrial Development Bank) and Bangladesh Krishi Bank⁷⁹ (Agricultural Development Bank), and eight foreign banks. Being an agricultural based country, the rural financial market of Bangladesh always received special attention from the policy makers. Bangladesh Krishi Bank (BKB), rural branches of Nationalised Commercial Banks (NCBs), and cooperatives⁸⁰ were the major sources of institutional finance to the rural sector in the early years of the banking sector. All these banks accounted for only 15 per cent of the credit requirement of the sector in the early 70s (Soliman & Huq, 1972). Banks had a dual mandate of social and economic development, so government policies encouraged banks to establish rural branches and to set up special credit programmes targeted towards the rural financial market without considering their financial viability. A few important policy initiatives targeted towards rural market during the period under Sheik Mujibur Rahman, from 1972 to 1975, were as follows:

- Mandatory opening of rural branches by the NCBs after maintaining certain ratios;
- New scheme to inspire commercial banks to provide loans to the agricultural sector with the help of thana cooperatives;

⁷⁶ As per Bangladesh Bank Order 1972 (President Order no. 127 of 1972).

⁷⁷ On 26 March 1972

⁷⁸ Bangladesh Shilpa Bank Order, 1972 (President Ordinance no. 129 of 1972)

⁷⁹ Bangladesh Krishi Bank Order, 1973 (President Ordinance no. 27 of 1973)

⁸⁰ The traditional cooperatives under the Registrar of Cooperative Societies those are financed by BSBL (Bangladesh Shamabay Bank Ltd, an apex cooperative bank founded in 1948). And the two-tire Comilla model of Cooperatives under IRDP/BRDB those are financed by Sonali Bank, a nationalized commercial bank. Both types of cooperatives have been getting refinance facilities from the Bangladesh Bank.

- Ensure sufficient flow of credit to the priority sectors like jute, food, small business and agricultural sector even though the government had taken credit contraction policies by raising interest rates to control excessive money supply and inflation;
- BKB was given refinance facility at the rate of 2 per cent while bank rate was 8 per cent,
- Special loan facility to BKB and cooperatives;
- Introduced targeted agricultural loan for all the banks and cooperatives.

By the end of June 1975, the total branch network of all these banks stood at 1626 while credit advance and deposit rose into Taka 781.66 crores and Taka 994.38 crores respectively from Taka 388.31 crores and Taka 339.42 crores in December 1971. However, loan default increased in BKB and cooperatives.

1976-1981: Promoting private sector and searching alternative viable solution for rural financial market (RFM)

During this period under Ziaur Rahman, a similar emphasis on the rural sector continued with special attention to the private sector. Monetary and credit policy had been liberalised and relaxed on a selective basis during 1975-76. Therefore, a sharp expansion in credit to the private sector and a substantial rise in deposit resources were observed during this phase. To enhance the availability of institutional credit for the agricultural sector, Bangladesh Bank continued its policy of providing counter-finance facility to the agricultural credit agencies at the concessional interest rate of 2 per cent below the Bank rate (8%). The idea of lead bank system, leading bank in coordinating agricultural credit in a particular area, was introduced for better coordination of rural credit. At the same time, the government reopened the capital market and established a financial relationship with the oil-rich countries, especially with the Middle East. Opening the financial market to outside countries and increasing financial assistance by foreign countries were two important initiatives of this government. On the one side, the government launched own funded Special Credit Programme in February 1977 to boost up agricultural production; and, on the other side, the government introduced several other projects financed by bilateral and multilateral development agencies especially targeted at the rural market. Rural

Finance Experimental Project (RFEP)⁸¹ funded by the USAID and RD-1 financed by the IDA are some notable projects among them. At the same period, the government invited foreign experts with the hope of developing a viable credit programme especially for the small and marginal farmers, sharecroppers, landless labourers and other occupational groups. Bangladesh Bank hosted an international workshop on providing financial services to the rural poor in 1978 in collaboration with Ohio State University and the United States Agency for International Development to improve and expand financial services to the rural poor (Bangladesh Bank, 1979). The remarkable Grameen Bank Project (GBP) and programme under Swanirvar Bangladesh⁸² were also initiated under Zia regime with direct support from the government.

At the end of June 1981, rural branches of scheduled banks comprised over 65 per cent (2851) of total bank branches although yearly credit disbursement remained only about 9-10 per cent of total credit and advance of the banks. It is worth noting that rural deposit at the same time stood at 16.29 per cent of total deposit collected by the banks. The NCBs played a marginal role in the agricultural area even though the decision to induct them in the field was taken as early as 1973 and despite their having branches in the rural areas down to the thana⁸³ level. It was mainly BKB that provided over 60 per cent of the total rural credit under continuous financial support from the Bangladesh Bank at a concessional rate.

1982-1990: Period of rapid privatisation under liberalised market

Financial liberalisation or reform programme and rapid privatisation with financial support from the World Bank and the IDA actually gained momentum after H M Ershad came into power in May 1982. One notable development in the banking field

⁸¹ This was to experiment different models to reach rural poor through viable institutional setup. Experimenting with differentiated interest rates (12%-36%) was one of the common factors in each model.

⁸² It means Self-reliant Bangladesh. It was an organisational setup to promote rural upliftment and community development through self-reliance. Pioneered by a high public official and social worker Mahbub Alam Chashi, the movement was formally launched on 24 September 1975 under the patronage of the Bangladesh government in power. This had notable success in the late 70s in mobilizing communities. The main thrust of its activities was geared towards increasing food production and income generation. It helped landless, marginal farmers and women to get loans from commercial banks without collateral, and encouraged them to save for the purpose of their own investment needs. The idea of Swanirvar Gram Sarkar or self-reliant village government was conceptualized from this movement and was later propagated and politicized by Ziaur Rahman [Maloney & Ahmed, 1988, P.131].

⁸³ The lowest administrative level of local government.

was the opening up of the first private sector joint-venture bank named the ‘Arab-Bangladesh Bank Limited’ in 1982. This period can be specially singled out for privatisation and other reforms aimed at liberalisation of the financial market. Some of the major reform programmes or decisions taken for financial market during this period were as follows:

- Reduced subsidies for food and fertilisers;
- Enable the private sector to play a more active role in agricultural development;
- The private sector was given opportunity to compete with the public sector;
- The new Industrial Policy announced in June 1982, revised in 1986, provided for substantial incentives and opportunities for private investment. As cited in Feldman (2000), this policy promoted the development of the private sector in a shift away from rural cooperatives and village development programmes to a new form of individual credit;
- Opened eight private banks including the first Islami Bank (Bangladesh Islami Bank in March 1983 under joint venture with Islami Development Bank and other foreign private shareholders) and Al-Baraka Bank, another joint venture with Saudi Al-Baraka;
- Transformed two NCBs (Pubali Bank and Uttara Bank) into public limited banks;
- Transformed Grameen Bank Project into a Grameen Bank in September 1983 where the government held the lion’s share;
- Introduced pass book system for farmers;
- Decision taken regarding transforming another NCB (Rupali Bank) into public limited company;
- Constituted a National Commission on Money, Banking and Credit in 1984 for recommendations regarding restructuring financial sector;
- BKB was divided into BKB and Rajshahi Krishi Unnayan Bank (RAKUB);
- Islami banking system started getting especial importance at policy level;
- Bangladesh Bank arranged two seminars in the FY 1986-87 on ‘Deposit mobilization’ and ‘Recovery of rural credit’ with Ohio State University;
- Official Structural Adjustment Facility started in 1986-87 for a period of three years;
- Enabling environment to attract foreign investors created;

- License to five Non-Bank Financial Institutions (NBFI), 3 were under joint venture provided;
- Another private bank (Bank of Small Industries and Commerce Bank Ltd) especially targeted to small and cottage industries opened;
- Bangladesh Rin Shalish Ordinance, 1988⁸⁴ to reduce the amount of non-performing loans promulgated.
- Significant reforms on the liberalisation of interest rates were undertaken in November 1989;
- Refinancing windows of Bangladesh Bank were closed completely except for the credit operations by BKB and RAKUB;
- Wide-ranging reform programmes were undertaken on the basis of recommendations of a World Bank Consultative mission and the Financial Sector Reform Program (FSRP) under a Financial Sector Adjustment Credit (FSAC) programme with the World Bank was finally launched at the beginning of 1990.

The rural financial market had shrunk remarkably during this period as rural credit disbursement had been drastically reduced, both in absolute amount and percentage especially after 1984, though the expansion of branch networks in rural areas was on the rise. However, the contribution of rural deposits in total deposit had increased up to as high as 23.38 per cent in FY 1987-88 and hence the gap between rural deposits and rural credit expanded with the increasing amount of deposit collection and decrease in the amount of credit delivery as shown in figure-4.1. So, it is assumed that rural branches of the banks were mostly involved in siphoning funds from rural sector to urban during this period.

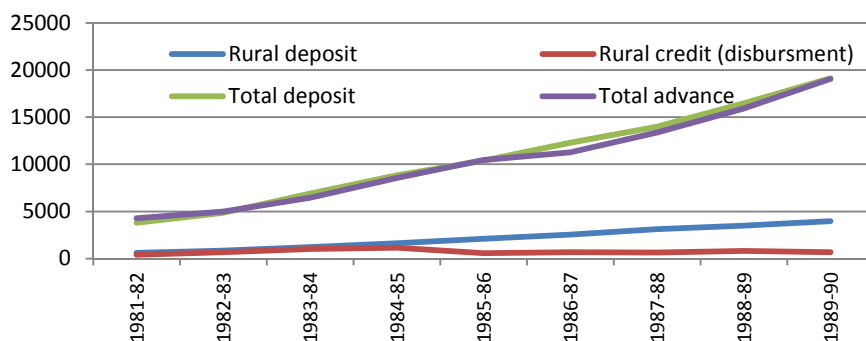


Figure-4.1: Trends of Rural Deposit and Credit during the period 1982-1990 (in crore Taka)

⁸⁴ Financial Loan Court Act, banks can obtain decrees against defaulters under this Act.

1991-2013: Reform continued

The basic economic policy favouring market economy and liberalisation, and promoting the private sector remained unchanged during this time. So, the ‘first round’⁸⁵ reform programme of promoting a market-oriented financial sector remained undisturbed under the democratic government after 1990. Bank Companies Act, 1991 was passed, which empowered the Bangladesh Bank to get more control of the banking sector, especially private banks which were brought under the full monitoring and supervision system of the central bank with defined rules. Though officially public sector banks were supposed to be under the Bangladesh Bank, in reality, they were broadly under the control of the government.

In the early 90s, over 60 per cent of deposit and 50 per cent of credit (advance) portfolios were under the control of NCBs, private sector banks had controlled only over 25 per cent of deposit and a little over 20 per cent of the credit. Lion share of the rest portfolios was maintained by the specialized banks (also owned and managed by the government), and an insignificant amount of the credit and deposit portfolios were under the control of the foreign commercial banks. So in a true sense, the Bangladesh Bank did not have much control over the banking sector until the beginning of new millennium when PCBs acquired more control over the industry’s assets and deposits (figure 4.2). By June 2013 PCBs hold 62.2 per cent of industry assets and 63.6 per cent of deposits⁸⁶.

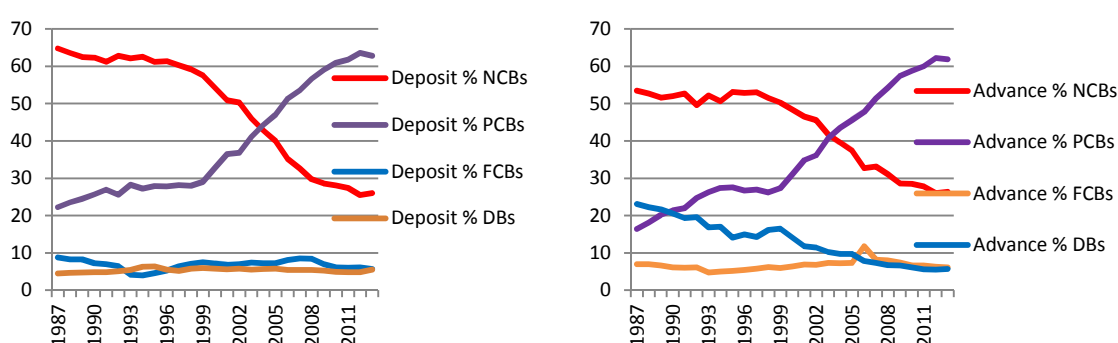


Figure-4.2: Changing trend of market share of SCBs, PCBs, DBs and FCBs, 1987-2013

⁸⁵ The term ‘first round’ was used by Bhattacharya & Chowdhury (2003) in the context of the financial sector reform programme which was started in the early 80s.

⁸⁶ Bangladesh Bank Annual Report, 2012-2013

Under the reform programme, the government removed refinance facility against the rural credit of commercial banks and liberalised interest rates further by eliminating the interest rate bands on lending, except for some priority sectors including the agricultural sector. Despite introducing different measures like credit norms, loan classification guidelines, CAMEL rating, early warning system, strengthening commercial bank management, bank loan defaults emerged as one of the most serious issues for the financial sector after the mid-nineties. Classified loan stood at 29 per cent of outstanding credit in 1989 and rose to over 39 per cent in 1998. About 72 per cent of classified loans were categorised as bad loans by June 1997 (Chowdhury, 2000). Moreover, the market observed the unexpected rise in the interest rate spread (the difference between lending and deposit rate) even after complete deregulation of the interest rate as per policy prescriptions under the reform programme.

Interest rate deregulation could not bring about the expected competition in the market as commented by Bhattacharya & Chowdhury (2003). Bangladesh Bank expressed its concern (Annual Report, 1995-96) regarding achieving its goals of structural development and poverty alleviation with the help of this reform programme (FSRP). The project was terminated in 1996 when a Banking Reform Committee (BRC) was formed by the then elected government. Meanwhile, some new PCBs were licensed in the 1990s, and by the end of the 90s, the total number of PCBs stood at 30 when there were 49 banks in total.

Both the government Task Force Report on financial sector reforms (under the chairmanship of Professor Wahid Uddin Mahmud, in 2000) and CPD Task Force Report (2001) expressed apprehension regarding the adverse effect of reforms on the rural financial market as follows:

- i. The relative share of rural banking has declined after the adoption of banking reform measures. The share of the branches in the rural areas has gradually been declining. A substantial number of loss making rural branches of NCBs have been transferred to Bangladesh Krishi Bank (BKB). The provision of credit by the rural bank branches is low as compared to their deposit mobilization. Moreover, closure of only rural branches in the name of branch rationalization, has adversely affected the overall rural banking environment. (Government Task Force Report, 2000; Section 12, P.3)
- ii.the proportionate share of rural banking has declined after the adoption of banking reform measures. The share of rural banking is expected to further decline because of closure of 500 loss incurring branches, as most

of these are expected to belong to rural areas. (CPD Task Force Report, 2001⁸⁷)

Figure 4.3 shows the share of rural credit, deposit and branches in total during the period 1982-2013, which further explains the apprehensive comments made by the task forces mentioned above. Salehuddin Ahmed, former governor of the Bangladesh Bank, (Ahmed, S., 2014) criticised the policy of shutting down of rural bank branches during the 90s. According to him, these branches could have been utilised in channelizing funds to the rural sector via NGOs and that would have helped Bangladesh Bank in building inclusive finance much earlier in the late 90s.

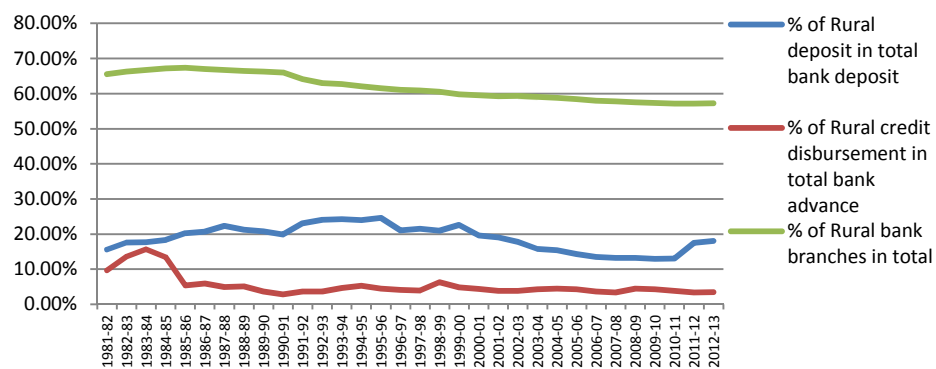


Figure-4.3: Percentage of rural credit, deposit, and branches during 1982-2013

In 1995-96, the government undertook another reform programme for commercial banks with financial assistance of the IDA and the ADB, while NPL (non-performing loan) was on the rise, especially in SCBs (state-owned commercial banks) and development banks. At the same time, the obligation of schedule banks to open rural branches was withdrawn and they were advised instead to establish linkage with the NGOs in delivering rural credit⁸⁸. Since then, the policy of encouraging banks to work with NGOs has been continuing that has gained momentum in recent years, especially after the introduction of the following three policies of Bangladesh Bank for the rural financial market:

- a) Mandatory participation of all banks, including PCBs and foreign commercial banks (FBs)⁸⁹, in delivering agricultural/rural credit⁹⁰;

⁸⁷ As mentioned in Bhattacharya & Chowdhury, 2003 [P.7]

⁸⁸ Bangladesh Bank Annual Report, 1994-95

⁸⁹ Previously PCBs' participation in rural credit was insignificant and FBs' participation was nil.

⁹⁰ ACD Circular no. 10, 29 September 2008, Bangladesh Bank

- b) Separate and concrete policy guidelines to the banks for establishing linkage with the NGOs⁹¹;
- c) The pre-fixed minimum target of rural credit for PCBs and FCBs (2.5%⁹² of total credit disbursed) and the introduction of a punishment clause in case of failure⁹³.

As a result, the share of PCBs and FCBs in agricultural credit has been increasing gradually and rose to 43.28 per cent in total credit in June 2013, where the BKB, as a single supplier, has 31.26 per cent, and state-owned commercial banks (SCBs) have 16.36 per cent share in the total.

4.4 NGOification OF RURAL CREDIT

If NGOs are defined as the foreign donor driven organisations that are not part of the government, then the existence of at least international NGOs in Bangladesh could be found even before independence⁹⁴. Generally and originally, they had emerged in Bangladesh as some relief and service delivery agency for a targeted section of the population. Bangladesh experienced the existence of many local and foreign NGOs immediately after its independence in 1971 when these organisations played the role of ‘care and welfare’ like agencies for distributing relief, participation in nation building efforts and recovery from the devastation of the war. With changes in the political economy of the country and with the increasing trend of privatisation under structural adjustment programmes, roles of the NGOs have also been evolving gradually from their previous ‘welfare’ role to an ‘agent of development’ to work for pro-market structural changes in the society. Eventually, they have become the partner for development with the country’s government to fill the gap (Khan, Ahmed, & Quddus, 2009). As Feldman (2000) mentioned, the market principle based NGOs fitted well with the increasingly liberalised economy of the country. During 1982, Bangladesh was already considered as “the aid capital of the world”. The process of liberalisation in Bangladesh got speed after the end of cold war in 1989. Donors were pushing these NGOs to be sustainable after the 1990s (Khan, et. al.2009) to be

⁹¹ ACD Circular no. 13, 09 June 2010, Bangladesh Bank

⁹² Later it reduced to 2 per cent

⁹³ ACD Circular no. 01, 16 May 2011, Bangladesh Bank. It makes mandatory deposit of undisbursed amount to the Bangladesh Bank at Bank rate for a year.

⁹⁴ International NGOs such as CARE and CARITAS had operations in Bangladesh (the then East Pakistan) during 50s and 60s (Khan, Ahmad & Quddus, 2009)

compatible with the liberalised policy of the country, as stated in Wood and Sharif (2001):

..the continuing endorsement of NGO as MCI (*Micro-credit Institution*⁹⁵) by the World Bank, the Clinton Administration (with the support of the South Shore Bank in Chicago), and neo-liberal academics.....These neo-liberal academics are increasingly restricting the function and purpose of any group formation in poverty-focused development to the policing of micro-credit loans in order to reduce transactions and information costs.....The policy pressure from key donors polarised the debate.....Since the donors were in direct contractual relationships with NGOs holding large microcredit portfolios (e.g. BRAC and Proshika in Bangladesh), their primary concern for the sustainability of these lending institutions was understandable...[Introduction, P.36]

Hence, the entrance of NGOs into the financial market is understandable both from the views of the supply and the demand sides. They responded to the long-standing demand of the rural financial market and at the same time have fulfilled their own urge of gaining gradual financial independence from donors as well.

Reflecting Bangladesh Bank in the context of entrance of MFIs in the RFM

Bangladesh Bank is generally responsible for monetary policy as well as prudential regulation and supervision of the financial sector, especially the banking sector. Like many other central banks in the developing countries, it performs both the developmental activities and promotional activities, though over time with the gradual changes in the political sphere, its direct developmental role has been shrinking. The global paradigm shift in favour of market economy also promotes the promotional role of a central bank instead of developmental role (Chandavarkar, 1996). Thereafter, the country observed Bangladesh Bank's gradual withdrawal from quasi-fiscal activities such as refinancing and credit guarantee scheme for commercial banks with increasing importance on inflation targeting and other monetary policies⁹⁶.

The Bank provided direct support to Grameen Bank during its early stage before it was transformed into a bank. It also supported Grameen Bank with lines of credit during the 90s as well. After that, Bangladesh Bank has not been seen providing direct support to any MFI till 2009⁹⁷. Like other credit cooperatives, MFIs always remain outside the regulatory regime of the Bangladesh Bank. Grameen Bank too

⁹⁵ Italics inserted by the researcher

⁹⁶ Various volumes of Monetary Policy Statements of the Bangladesh Bank

⁹⁷ On 16 September 2009, Bangladesh Bank and BRAC signed an agreement on disbursement of agricultural credit to sharecroppers.

does not belong to the regulatory system of the Bangladesh Bank, but its progress and activities since inception have always been reflected in the Annual Reports of Bangladesh Bank, since GB has to seek prior permission from the Bangladesh Bank before opening a new branch⁹⁸. Though the microcredit activities of the NGOs have gained momentum since the 1990s, it did not come into official observation of the Bangladesh Bank before 1994⁹⁹. The credit activities of the NGOs in the rural financial market were first reported in the Annual Report in 1994-95; it reported that currency outside the bank had increased due to credit activities of Grameen Bank and NGOs. No other facts had however been presented in that report on the credit programme of the NGOs. During this period, the Bank was seen in the encouraging the banking sector to establish linkage with the NGOs in providing credit to self-help groups for income generating activities¹⁰⁰.

However, Bangladesh Bank was found silent about savings collection by the NGOs during the 90s. In the absence of any workable policy guideline that might clarify the legal situation about mobilising savings by the MFIs, NGOs like ASA and BURO Tangail were found collecting different natures of voluntary savings from the market since the mid-90s, which was a clear violation of banking legislation. In May 1998, there was a discussion under the Chairmanship of the Governor¹⁰¹ at Bangladesh Bank on “Evolving an appropriate new Institution or Improving the capabilities of the existing institutions for poverty eradications purposes”, where the issue of emerging new institutions was brought for discussion. But, that meeting also did not raise the issue of illegal savings collection by some NGOs, it only had endorsed the fact that NGOs as new type of evolving institutions were helping the government in implementing some social development agendas like poverty alleviation. Analysis of various documents and facts indicates that the Bangladesh Bank viewed the MFIs as a kind of trivial organisation around mainstream financial institutions to address social development agenda like poverty alleviation. Bangladesh Bank did not view MFIs as financial intermediaries as such. So, it did not pay any significant attention to the sector until it was desired either by outside agencies or by the government itself.

⁹⁸ As per requirement of the law

⁹⁹ It conducted a seminar in 1994 (McGuire, 2000)

¹⁰⁰ Bangladesh Bank Annual Report, 1995-96

¹⁰¹ Where representatives of banks and MFIs as well as PKSF were present

With the establishment by the government of a unit (MRRU) in the Bangladesh Bank, at the beginning of this millennium, to provide regulatory suggestions on credit operation of the NGOs, the Bank has gradually become more involved with the matter. After that, it began presenting statistics on credit operation of a few NGOs¹⁰² along with the same facts on the Grameen Bank in its Annual Reports where it compared good performance of the NGOs in loan recovery and monitoring system with the bad performance of the banking sector. As part of its promotional function, Bangladesh Bank Training Academy (BBTA) launched training programmes for its staff on microcredit operation of the MFIs at the same time. Gradually the Bangladesh Bank was seen more engaged in the matter. It raised the question about sustainability of the NGOs in the absence of donor funds and commented that if NGOs were allowed to collect deposit with an appropriate regulatory measure that would help them to be self-sustainable¹⁰³. After a while, with increased experience and maturity, the Bank was seen raising concerns about NGO modality of credit operations. It pointed out some critical issues like:

- a. Absence of accountability in the operation of NGOs;
- b. Lack of coordination among the service providers;
- c. Absence of a regulatory framework;
- d. High interest rate charged by the NGOs on loans, and others¹⁰⁴.

At one stage, it was found commenting about mainstreaming of microfinance operation of NGOs and integrating them with the macro-economic policies¹⁰⁵.

After the establishment of the MRA (Microcredit Regulatory Authority) in August 2006, the Bangladesh Bank has come forward in promoting the banking sector to deliver rural credit via the NGO network. Hence, we see three important circulars of the Bank, mentioned earlier, that have a notable effect on the loanable funds of the NGOs from the banking sector. Figure-4.4 shows rising trend of banking funds to the NGOs since June 2011, immediately after issuance of a circular by Bangladesh Bank to the banks (ACD Circular no. 01, 16 May 2011). After issuing these circulars, private and foreign banks were found more obligated in lending to the RFM via NGO-network in the absence of their own branch network in the market.

¹⁰² Initially BRAC and Proshika, and lately some more like TMSS, BURO etc.

¹⁰³ Bangladesh Bank Annual Report, 2002-03

¹⁰⁴ Bangladesh Bank Annual Report, 2003-04

¹⁰⁵ Bangladesh Bank Annual Report, 2007-08



Figure-4.4: Flow of funds to the NGOs from the banking sector (2008-2013)

Growth of NGOs in the financial market

It has been mentioned in the introductory first chapter that MFIs are now the main supplier of institutional credit to the rural market. Some empirical data on the gradual entrance of NGO-MFIs in the financial market would help in understanding the NGOification of the RFM in Bangladesh. Since no permission was needed from any agency by an NGO to start microcredit operations before the enactment of the new law¹⁰⁶, the exact number of these organisations in each year was not recorded and, therefore, is not known to any agency¹⁰⁷ till now. However recent data from the newly established regulatory authority (MRA) enables us to identify 4241 organisations according to their reported date in initiating microcredit operations. If their reported dates are correct, then it confirms the quick jump of NGOs into the financial market immediately after the 1990s.

The year 1991 indicates the highest growth rate (61.54%) if it is calculated on the basis of previous year's base. Available data indicates that the number of organisations grew on an average at the rate of 25 per cent from the 1980s till 2005. In the period from 2001-2005, after the establishment of MRRU and immediately before the enactment of the new law, we observe many new organisations in entering the market, which seems understandable. Organisations took quick advantage of the time to enter the market before the enactment of the law on the assumption that the new

¹⁰⁶ Microcredit Regulatory Authority Act, 2006

¹⁰⁷ CDF, a network organisation of NGO-MFIs has reported highest on 745 organisations (CDF Statistics, 2010). PKSF received applications from 6000 organisations in early 90s (Kader, 2014). Bangladesh Bank (MRRU of BB) published its first report on 633 organisations (MFI Statistics, 2004). MRA database has detailed information on 4241 applicants for license; many of them were cooperatives though.

law might restrict the freedom and the scope of easy entrance in the market. This phenomenon is noticeably manifested in Figure 4.5 below.

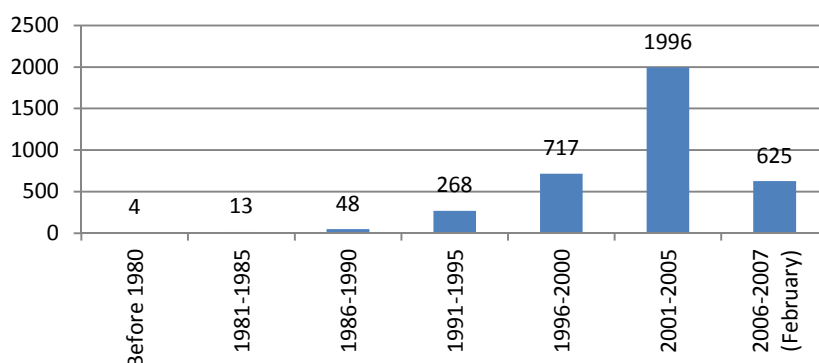


Figure-4.5: Number of NGOs that entered the credit market from 1980 to 2006

This figure includes all types of NGOs working in the field of microfinance, but officially, there are only around 700 licensed NGO-MFIs as of December 2014. The new law, Microcredit Regulatory Authority Act of 2006, had provided the opportunity of legalising their activities to the existing NGOs who had microcredit operations before the enactment of the law. The new authority had called for applications from the existing NGOs within the six months of the enactment of the law and restricted the free entrance of new players in the market. After that, the official entrance of NGOs into the market slowed down¹⁰⁸.

So, it is clear from the above discussions that Bangladesh Bank has changed its policies from direct development role to promotional role which promotes NGOs in channelizing credits to the RFM, especially to reach poor people those remained outside the banking services. Different sources¹⁰⁹ indicate that currently MFIs occupy 8-10 per cent of the total domestic credit, and hold 60-70 per cent of the total rural credit. Table-4.1 below further qualifies the argument that the broader scenario of RFM in Bangladesh has changed dramatically over a period of only three decades

¹⁰⁸ However, many new organisations were found in the field under the title ‘insurance company’ or ‘cooperative’ who were also providing credit and/ or saving services while visiting field during February-May 2014. Field discussions with local people revealed that many NGOs who failed to get license from the new regulatory authority had later registered under some other laws of the government either as cooperatives or as insurance companies and some of them are still operating without any legal registration. So, it is expected that there is a gap between the official count and the unofficial existence of microfinance organisations in the field. Discussion with DFID consultant (Dr Riazul Islam on 16 April 2014) confirms the facts.

¹⁰⁹ 1) Rural Credit Survey 2014, Bangladesh Bureau of Statistics, 2) Bangladesh Bank Annual Report 2012-2013 & 2013-2014, 3) NGO-MFIs in Bangladesh (MRA), June 2013, and 3) Bangladesh Microfinance Statistics (CDF), 2013.

with direct policy support from the state in favour of MFIs. It mostly captures market share from moneylenders and other informal sources. Apparently it did not capture market share from the banking sector in that way since banks mostly serve the big farmers and businesses who reside outside the target group of the microfinance organisations.

Table-4.1: Share of rural credit by disbursing sources

Sources	1987 (%)*	1988 (%)**	2008 (%)**	2013 (%)*
Banks	17.30	20.70	21.00	16.99
MFIs	3.82	6.70	37.00	67.55
Moneylenders	29.21	39.00	14.80	5.83
Friends	38.81	33.60	26.80	3.99
Cooperatives	5.33	NA	NA	2.95
Total ¹¹⁰	94.47	100	99.60	97.31

*Rural Credit Survey 2014, Bangladesh Bureau of Statistics, Bangladesh Government

** Hossain, & Bayes (2010)

Presently, there are two clearly different types of institutional arrangements for serving the RFM as under:

- a. Formal banking arrangement for rich farmers or businesses who get credit at a relatively lower price¹¹¹, and
- b. Formal MFI credit arrangement for small farmers, micro-enterprises and landless people of rural areas.

The latter provides credit at the relatively higher interest rates¹¹² compared to the banking sector, but at lower rates than the moneylenders.

4.5 CONCLUSION

Bangladesh emerged as an independent country in 1971 with the promise of equitable redistribution of resources among the various groups of population to ensure socio-economic development of the country. However, with the changes in the political regimes, it has changed its policy direction from ‘socialism’, ‘nationalisation’ to ‘privatisation’ and ‘liberalised market’ under the Structural Adjustment Policy (SAP),

¹¹⁰ Rural Credit Survey of the Government has divided the sources of rural credit under nine categories whereas Hossain & Bayes (2010) has divided it under broader four categories.

¹¹¹ Usually ranges from 8-12 per cent

¹¹² Usually ranges from 20-27 per cent

and other follow-up policies. Most of the industries, including the banking sector, were brought under the nationalisation programme initially. So, the banking sector was mainly dominated by the state-owned banks till the mid-90s.

The government initiated Financial Sector Reform Program (FSRP), financed by the World Bank and the IDA, in the 1990s. Privatisation of banks, their sustainability, financial management, and interest rate liberalisation got focused under the FSRP. With the gradual implementation of liberalisation programme, the Bangladesh Bank shifted its policy from its previous direct developmental role to a promotional role. It deregulated interest rates, emphasized on sustainability of bank branches, and promoted private investment in the market. A few hundred of rural bank branches were shut down by the mid-90s on the consideration of unsustainability. As a result, credit delivery to the rural sector declined significantly. The rural branches of commercial banks were mainly engaged in syphoning money from rural to urban sector for better investment.

In the mid-90s, Bangladesh Bank withheld one of its instructions to the banking sector regarding mandatory opening of the rural branch. Instead, it prescribed banks to establish linkage with the NGOs in delivering rural credit since it perceived this mechanism as one of the efficient ways to serve the rural poor to alleviate their poverty. Documented evidence of that period indicates that the Bangladesh Bank was not quite aware of the legal status and operational procedures of the NGO-MFIs during the early 90s. It did not perceive this sector as financial intermediaries as such. Instead, NGO's microfinance operation was considered by Bangladesh Bank as a kind of development tool to address poverty issues. Hence, it had not taken any attempt to regulate or clarify matters related to saving mobilisations activities of the NGOs, which was a clear violation of the banking legislation of that time.

NGOs have been present in Bangladesh since long; but they were not as involved in the financial market as they were after 1990. With the shifting national policy from nationalisation to privatisation and implementation of liberalisation programme, Bangladesh fitted well with the 'NGOification' model of rural finance. It was neither public, nor private. It promoted private business, charged market based interest rate on credit, and its major focus was on sustainability.

In the later phase, Bangladesh Bank became involved in formulating policy for the NGO-MFI sector on a demand from the government. It came closer to the sector, but its approach to the sector remained unchanged. In the recent years it was seen

hugely promoting NGO-MFIs via its direct influence on the banks. But, it was mostly to help NGOs in getting finance from the banks. Its recent policy direction to the banks for investing more in rural market was indirectly promoting NGO's microfinance operations rather than developing other alternative institutional arrangement for the rural poor.

CHAPTER 5

In Search of a New Viable Model of Microcredit

5.1 INTRODUCTION

Over the years, Bangladesh has inherited many kinds of enriching experience in rural development. Some notable initiatives being¹¹³:

- a. The control of rural indebtedness through Moneylenders Act and Debt Settlement Boards;
- b. Tenancy reform;
- c. Reorganized cooperatives and agricultural credit;
- d. Community development (V-AID) and Agricultural extension program; and
- e. Integrated rural development program (IRDP)¹¹⁴.

As a part of the socio-economic objective of the nation, there was a seminar on cooperative organisations held at BARD, Comilla in 1972 where a few recommendations on an adaptation of cooperative system were accepted for future experiments (Husain, 1979). Accordingly, a few attempts were undertaken at different places of the newly born country; ‘The Shimla Cooperative Farming Project’ of Bangladesh Agricultural University (BAU) was one among those early initiatives. Mutual savings and credit to the cooperative members were some of the key components of these projects (Husain¹¹⁵, 2014). Adopting IRDP/BRDB¹¹⁶ as a national program was another early attempt of the government.

¹¹³ Summarized from Khan, A. Hameed (1978)

¹¹⁴ An integrated approach in rural development which is based on experiments in Comilla Kotwali Thana (Upazilla) in late sixties by Akhter Hameed Khan. It consists of four components such as: a) Thana Training and Development Center (TTDC), b) Rural Works Program (RWP), c) Thana Irrigation Programme (TIP), and d) Two-tier Cooperative system.

¹¹⁵ Dr. A. M. Muazzam Husain, former Professor at Bangladesh Agricultural University, was involved with a few early experiments on rural development programme during 70s.

¹¹⁶ IRDP (Integrated Rural Development Project) started operation in late 1960s under the financial and technical assistance of US-AID. After independence, this programme was undertaken by the government as a national programme and extended throughout the country. IRDP was renamed as BRDB (Bangladesh Rural Development Board) in 1982 (Ordinance no. LIII of 1982). But instead of implementing four interrelated components within a common framework, the Bangladesh government implemented only one component, the two tier cooperative (Momin, 1987). Akhter Hameed Khan, the pioneer of this model, has described this distortion as ‘suicidal’ (Khan, 1978; Vol.III; P.208).

In 1979, Gangopadhyay¹¹⁷, a renowned Deputy Governor of Bangladesh Bank, mentioned in a paper (Bangladesh Bank, 1979) that providing sufficient institutional credit for agriculture and other rural economic activities was a difficult and complex task for the Bank. It is not because of the lack of determination and goodwill on the part of the policymakers but because of the inherent difficulties in reaching the rural poor and making them economically viable, he added.

During the 70s, the Bank undertook many efforts to expand credit flow to the rural market. As a result, the size of the rural credit increased, but it could not fulfil the expectation of finding out a viable institutional model. Some local level initiatives and support from foreign agencies like FAO, UNDP, USAID, also played a substantial role in searching for some solutions to this problem. Finally, a viable solution emerged from the experience gained over the decade from 1972 to 1983, and a new institution dedicated exclusively to the poor people was established in 1983 by an Order of the government namely 'The Grameen Bank Ordinance, 1983'. A separate Bank was created under this Order to serve the poor, which creatively conceived most of the salient features of all the previous experiments done by the cooperative approach and banking sector with the policy and financial support from the government, international donors as well as the Bangladesh Bank.

This chapter critically analyses some important experiments of the government and the Bangladesh Bank to observe how some solutions finally emerged from these efforts. In doing so, the IAD framework shown in figure 5.1 has been used, which is part of the broader IAD framework mentioned in Chapter Two. This has been considered as the first phase of 'concept' development from the multi-dimensional efforts of multiple agencies applied to multiple organisations as participants. It has created a special type of policy environment under which participating organisations interacted and finally gave birth to the new idea of 'microfinance', the 'overwhelming' and well discussed perceived solution of the long pending problems of the rural financial market.

¹¹⁷ A. K. Gangopadhyay [spelling of his name varies widely, this paper follows Bangladesh Bank 1979 for spelling] joined State Bank of Pakistan in 1950 as Officer Class-1. After liberation, he was appointed in Bangladesh Bank as Executive Director in 1973 and later as Deputy Governor in 1976. As an outstanding officer he had played significant role in the central bank with competence and proficiency (Bangladesh Bank, 2013). He was involved with many important activities of the Bank including RFEP and GBP and had special interest in rural banking. As an influential Deputy Governor, he had a good reputation in the banking community (BIBM 2011). He left Bangladesh Bank in 1981.

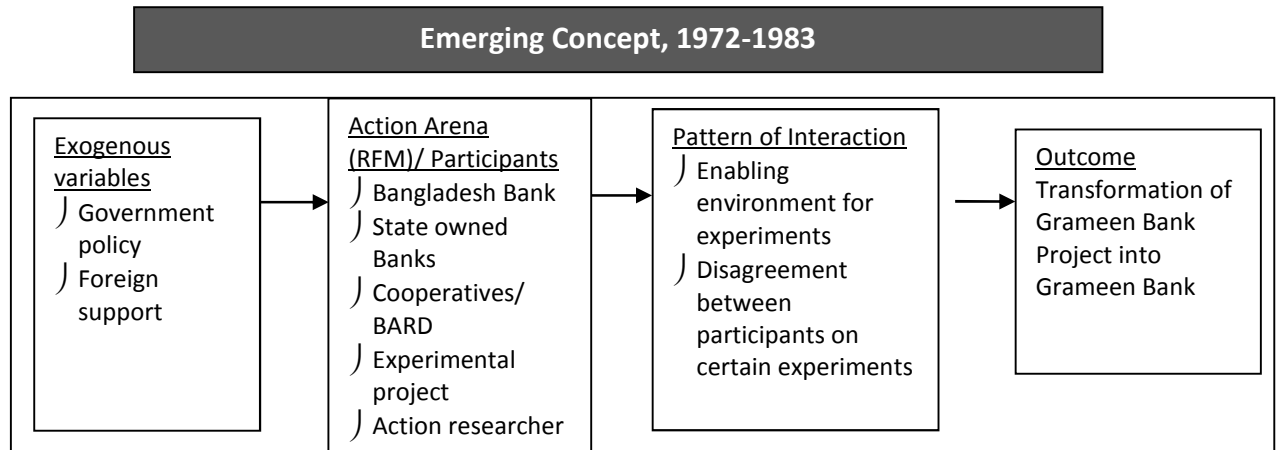


Figure-5.1: IAD framework for analysing emergence of new concept of microfinance in Bangladesh

There are four sections in this chapter including the Introduction. The next section discusses four major experimental projects or efforts of the government and the Bangladesh Bank. They are titled;

- a) ‘Small Farmers and Landless Laborers Development Project’ initiated by FAO/UNDP under ‘Asian Survey of Agrarian Reform and Rural Development (ASARRD)’,
- b) ‘100 Crore Special Agricultural Credit Programme (SACP)’ of the government,
- c) ‘Rural Finance and Experimental Project (RFEP)’ initiated by USAID, and finally
- d) ‘Grameen Bank Project (GBP)’ of the Bangladesh Bank.

Section three highlights important features of these projects to examine whether there is any convergence of ideas, and it also focuses the discussion on the final choice of Grameen Bank (GB) experiment. The last section concludes with the emerging concept of GB and treats it not as “individual efforts” but as the outcome of the comprehensive effort of many agents, especially Bangladesh Bank and the Government.

5.2 THE EXPERIMENTS

5.2.1: Small farmers and landless labourers development project, an experience in group lending under broader ASARRD project

Background and objective

According to the decision of FAO in 1972, a team under the FAO/UNDP project had organised problem identification, solution-seeking Field Workshops in 1974 in eight

Asian countries under the broad 'Asian Survey of Agrarian Reform and Rural Development (ASARRD)' project. The purpose of this survey was to search for ways and means for the improvement of rural institutions with particular emphasis on 'marginalized groups', the small farmers and the peasants. Malek (1978) mentions that 'the Action Research Project on Small Farmers and Landless Labourers, sponsored by the FAO, was born out of the failure of the sixties as a decade of development'. Bangladesh was one of these eight countries that received special attention in consideration of its prominent poverty scenario during that time. The field workshop was conducted in Bangladesh in March-April 1974, and on the basis of the findings, recommended initiation of Field Action-cum-Research Projects.

Accordingly, the Government of Bangladesh (Ministry of Local Government, Rural Development, and Cooperatives) introduced ASARRD project in the country in March 1976, initially for a period of three years¹¹⁸. It experimented over eight villages in three areas of the country, namely, Comilla, Mymensingh, and Bogra. It was the first experimental project of its type, and was specially designed for the disadvantaged low-income farming people, small owner cultivators, tenants, sharecroppers, and landless labourers¹¹⁹.

The main objective of this project was to organise small farmers and landless labourers into groups under different activities to raise their income through a process that involved active participation in planning and implementing developmental goals by the poor people themselves. These groups, therefore, had been treated as pre-cooperative informal teams that would enable them to organise themselves as an effective channel for the services and supplies of resources from government and non-government sources. The short-term goal of the project was that it would continue and expand all over the country. It was also expected that the target population would be federated into a number of self-propelling 'Associations' within two or three years of the project and they would develop the capability for group planning, group contracts, group management of productive activities and many other matters of mutual interest. When they would be self-propelling, they would then become a supporting centre for advice, guiding and training for the poorer households of the locality.

¹¹⁸ Pilot phase from 1976-1979, but the Project continued till 1998 under four phases (Kamal, et al, 2001)

¹¹⁹ In Comilla area the target groups were identified as the landless labourers and farmers possessing one acre of irrigated land or two acres of non-irrigated land (Bari, et al, 1978). In Mymensingh area they were identified as landless if they possessed two acres of irrigated and three acres of non-irrigated land (Alam, 1979)

Project features

As an action research program, this project was an experiment in real action targeted towards landless and small farmers. Major features of this project were (Alamgir, 1979; Alam, 1979; Malek, 1979; Bari et al., 1978):

- Took participatory approach in arranging workshops at different levels which involved community people including beneficiaries, and other agencies to understand local problems and to find out solutions;
- Organised small farmers and peasants into groups (usually eight persons per group) of common function and activity. Each group was managed by one secretary and one chairperson selected by the members.
- Introduced the idea of initiators of group organisation (like the concept of ‘animator’ in PAR¹²⁰) who helped small farmers and peasants to organise, they were called Action Research Fellows (ARFs) or Group Organisers (GOs).
- Promoted joint productive activities for the most efficient use of resources;
- Gave the target people the opportunity for direct participation in planning, decision-making, and management of their farming and other income raising activities.
- Arranged weekly meeting of members.
- Credit was one of the major elements of this project, but it had other complementary components like training, institution building, and social development. Under this project credit was given to the group or individual without collateral.
- Credit was given for ‘total’ need of a person in consideration of producer’s various needs instead of each separate productive activity or program.
- Sanctioned loan against an individual but repayment was ensured through group responsibility. The individual was responsible for the amount of loan that he/she received and at the same time the group was responsible for the entire amount of loan received by the group.
- It was mostly production loan, though there was a provision for consumption loan in case of urgency, particularly before harvest.

¹²⁰ According to Professor Rahman, Participatory Action Research (PAR) develops in the situational order through the dialogical interaction of the researchers and the people. In the process of interaction some ideas and pattern emerge and through mutual sharing a course of action is developed which finally leads to some action (Rahman, 1993).

- Introduced small savings activities to overcome risks of loans.
- Helped group to get access to low-cost agricultural technology.
- Linked groups with the market and storage facility to ensure fair and appropriate prices for their productions.

Participating organisations and pattern of interaction

The project was designed and partly funded by the FAO/UNDP team under ASARRD, which was finally adopted by the Ministry of Local Government, Rural Development and Cooperatives of the Bangladesh. During adaptation country specific requirements like local need, practices, socio-economic structure of the project area or the country had been taken into consideration via a series of workshops with the communities and local agencies. Formally, three institutions, the Bangladesh Academy for Rural Development (BARD), Bangladesh Agricultural University (BAU) and the Rural Development Academy, were entrusted with the responsibility of initiating and implementing the project at district level in Comilla, Mymensingh and Bogra respectively. A central coordination committee representing various government departments, autonomous bodies, and banks was in charge of the whole project. The Janata Bank (JB), a local state-owned commercial bank was involved¹²¹ in advancing necessary loans to the project areas. There were three Sub-project Implementation Committees (SPICs) as well under the Central Committee. The Action Research Fellows (ARFs) or Group Organisers (GOs) also played a crucial role in forming the groups. They were selected by the respective SPICs and were also the main mediators between the development agencies and the groups.

Figure-5.2 shows the procedure how all the above-mentioned development agencies, action research fellows, groups and individual participants were connected and communicated with each other. It was more of a participatory nature, where all the agencies had opportunities to participate in planning and decision-making except the bank. It is observed that there was no arrangement of direct funding to the groups from the Project itself. The bank branches provided credit after getting a request from ARFs/ SPICs. Though there was no clear future goal of this project especially regarding its sustainability issue (Husain, 2014), it had huge potentials considering its concept of motivating people to form their groups, and to take their decisions jointly. According to Husain (2014), it had an implicit concept of peer pressure for loan

¹²¹ The Bangladesh Krishi Bank (BKB) became involved at later stage.

monitoring but at the same time, it had a flexible loan repayment system, as well as the concept of managing the project with the involvement of all the stakeholders.

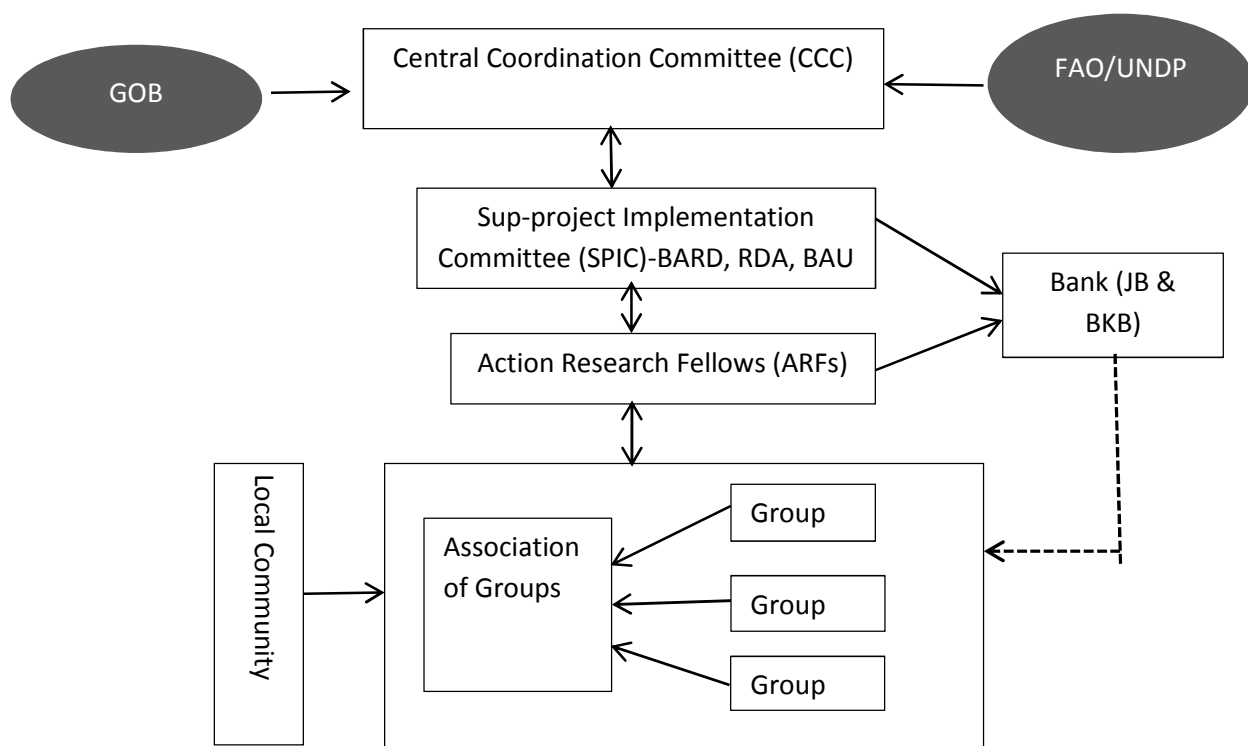


Figure-5.2: ASARRD Project in Bangladesh- Participants and pattern of interaction

Evaluation and outcomes

Initially, the project was undertaken for three years started from 1976, however it continued till 2004 under different phases and was finally transformed into an Organisation called ‘Small Farmers Development Foundation (SFDF)’ in 2005. In 1980 Rural Development and Cooperatives Division took the responsibility of implementing the project and continued till 1985. In 1986 BARD, Comilla was again entrusted with the responsibility to implement the project. The project was gradually expanded to 30 Upazilas of 8 districts. However, the final outcome did not fulfil the expectation of the early experimenters¹²². According to them, in the later stage, the project suffered from bureaucratic malpractice and failed to bring the outcomes as it was expected initially.

¹²² Hussain (2014), one of the key persons involved with a SPIC and Hakim (Dr Hakim, Ex-General Manager, PKSf), who was one of the ARFs of the Project have mentioned (telephonic conversation with Dr Hakim in September 2014) about their dissatisfaction regarding this Project. Both of them were involved in the process of establishing the SFDF at later stage in 2005.

However, the first phase of the project, as the experimental phase, is important for this research. Therefore, the outcomes of this stage have been reviewed here for the purpose of building emerging concept of 'microfinance' in Bangladesh. A study was conducted in May 1979 by the Bangladesh Institute of Development Studies (BIDS) which along with other workshop proceedings are being analysed here to understand explicit and implicit outcomes of the project. A few positive outcomes were:

- a. High repayment rate of credit due to close supervision by the ARFs,
- b. Improvements in participants' income at least at a certain level, and
- c. Opportunities for sharing experiences among the group leaders.

At the same time, it also pointed out some critical issues as follows:

- a. Dependence of villagers on the ARFs for arranging loans,
- b. Crucial role of ARFs' in assuring securities of loans because of inadequate rapport building between the banks and the villagers,
- c. Complex loan sanctioning procedures of the banks, and
- d. Requirement of insurance system for the participants especially to protect crop loss and health hazard.

It identified the education factor of the group members as one of the main constraints for their high dependence on the ARFs. Therefore, greatest emphasis was laid in these reports on the mass literacy programme for villagers. A workshop proceeding on this project revealed that there were suggestions regarding changing the banking system, while also recommending setting up a separate institutional or banking arrangement for providing credit to small farmers and landless people¹²³. It had mentioned bringing the bank service to the doorstep of the villagers instead of bringing the villagers to the bank.

Summary of learning from the first project

The very nature of the project was 'cooperative' still considered a very popular vehicle to organize and develop the condition of farmers and the poor in Bangladesh. Therefore, it had all the positive and negative features associated with the cooperative system of Bangladesh. In Bangladesh, main weakness of a cooperative system lies in

¹²³ Suggestion made by Dr Eunos (Yunus) of Chittagong University in the 2nd Annual Evaluation Workshop held in BARD in May 1978 (Bari, et al., 1978; P.19)

the lack of unity of the group members within the group as well as in the inter-group conflicts, both of which had been reflected in the workshop proceedings. The added feature of this project was the introduction of the so-called initiators of group organisations (ARFs). They were the key facilitators in between the project itself and the villagers. Loan appraisal, loan repayment, proper utilisation of loan, and other important issues were mainly looked after by them. The group members were dependent on ARFs' roles. Therefore, their presence in organising these groups was a crucial issue for the project. Questions like, whom they (ARFs) are accountable to (to the coordination committee, or the group/ Association, or the bank), how much their involvement was expected, how costly they would be, what would be their level of education, and other issues were raised in different forums and meetings.

This experiment was one of the significant efforts, among many others during the 70s¹²⁴. It had an important role in taking a systematic approach in practicing the early concept of 'microfinance', at least, in suggesting a few features. These features consist of 'formation of group', 'joint liability', 'extensive monitoring of loan', 'weekly meeting' 'flexible repayment system', 'credit for all purposes', 'decision from the bottom', 'restructuring of banking system', 'women's participation in income generating activities, and few others. All these features were unfolded and discussed in the related workshops and were brought into the public sphere of knowledge.

5.2.2: '100 Crore Special Agricultural Credit Programme (SACP)' – Credit to serve political purpose

Background and objective

'100 Crore Special Agricultural Credit Programme' or SACP was initiated by the government of Bangladesh during calendar year 1977 to 'enlarge its flow of institutional credit to the agricultural sector' to be disbursed by the specialised agricultural bank (BKB) and six NCBs. This was one of the main and the largest agricultural credit program of the government that had been announced after the major political change in 1975, and just before the presidential election that was scheduled to be held in February 1977¹²⁵.

¹²⁴ There were many other local level small initiatives as well

¹²⁵ Political power was expected to be handed over soon by the Marshal Law Administrator/ non-elected President to the elected government after this election which actually was held in June 1978.

The army-backed government that was in power at that time wished to be in power with proper legitimacy via election. Therefore, this government aimed to concentrate on the local power system and to get sympathy from the people, especially from the rural people. It was a very crucial time for Major General Ziaur Rahman, the President in power. He wished to get connected¹²⁶ with the key sources of power to handle the political turmoil including a series of army coups which were happening immediately after the incident of August 1975. Initially, this credit program was planned for a year and was to be implemented all over the country for both landowner farmers and share-croppers. It aimed to provide short-term credit in cash or kind directly to a small farmer or a group of farmers by simplifying application procedures and easing collateral requirements; meaning credit should be easily available to them.

Project features and policy environment

As a top-down program of the government, all the characteristics of the project were formulated on the basis of discussion among the policy makers and implementing agencies. Therefore, most of the program features were of a very traditional nature with a few exceptions. The following aspects of the program give the impression of a non-traditional nature:

- a. Credit facilities for sharecroppers;
- b. Crop hypothecation deed as security;
- c. Establishment of mobile unit of the bank if no bank branch was available near to the farmers;
- d. Group loan facility and group security system;
- e. Recovery of loan with interest would be made in one instalment from the sale proceeds of the crops under cultivation giving reasonable time for processing and marketing of the crop;
- f. The idea of lead bank system was also introduced to avoid duplication and effective coordination in loan disbursement for each district. Under this concept, one bank was designated to serve for a district as lead bank.

¹²⁶ He endorsed Swarnirvar Bangladesh Andolon (movement for a self-reliant Bangladesh) and the concept of 'Gram Sarkar' (village government) to integrate the Union Parishad, by highlighting the role of Union Parishad Chairman and members, in the process of rural development based on voluntary mobilization of rural resources (Huque, 1984)

Under the arrangement of SACP, borrowers were selected by the Union Credit Committee (UCC) which was formed by the Chairman of the Union, and ward members. The total amount of loan for a particular Union was fixed by the District level committee and higher committee on the basis of crop production target of the government. The interest rate on the loan was fixed at 12 per cent. The fund had been supplied by the banks from their own source under refinance scheme of the government.

Participating organisations and interaction pattern

The banks' role was reduced under this program; they had no role in selecting borrowers, reviewing loan request, determining project feasibility and borrowers' creditworthiness. Farmers also had no active part in any decision making. Table-5.1 presents a list of different participating organisations and agencies involved in this program along with their role at different levels. The Bangladesh Bank was in a position to make necessary policy arrangement in collaboration with the government for smooth delivery of credit, to coordinate with the banks, and to keep watch on the performance of the program. Ministry of Agriculture of the government was the leading agency in designing the basic framework of the program that desired the involvement of local administration in selecting borrowers and assisting banks to deliver credit, as well as in fixing targets of the credit.

Table-5.1: Participants and their roles-SACP

Participants	Role
Ministry of Agriculture	Fixed loan targets for districts
Bangladesh Bank	Make plan and implementing policies
District Coordination Committee headed by the District Commissioner	Fixed Union level target, monitor loan disbursement for the district and coordinate and supervise credit
Participating banks/ Lead banks	Disburse loan and collect repayment
Union Coordination Committee (UCC)/ Local Administration	Select borrowers, assist banks in disbursing loans
Farmers	Use loan for production and repay it in time
BADC	Supplier of other inputs like seeds, fertiliser, etc.

Evaluation and outcomes

This credit program had a tremendous effect on the rural credit scenario of Bangladesh, especially in term of volume of credit and branch network regardless of its performance. Within a very short time, rural bank branches had increased from 900 in 1976 to 3200 in 1984 since it was a program to push banking sector for rural development. However, the performance of this project became a serious concern for the policy makers and bankers within a year as most of the loan disbursed remained unrecovered and that also mostly from the large farmers. In this situation, the President (Major General Ziaur Rahman) issued an amendment to the Public Demand Recovery Act, 1913¹²⁷ in September 1978 to bring agricultural credit under this law to ensure loan recovery. However, all these efforts failed to recover loan from the farmers, especially from the rich farmers who received favour from the local administration¹²⁸. Hence, banks faced a problem for further expansion of credit due to a shortage of liquidity. Bangladesh Bank attempted to find the way out to improve recovery situation¹²⁹. The problems, in the very mechanism of the program, identified by the District commissioners and bank representatives were as follows:

- a. Recovery of loan was affected by the situation before and after the general election on account of the influence of the political process in the country;
- b. In absence of any firm decision and strong political will of the government, it was difficult for the local administration to apply any coercive action to recover loan;
- c. The bank officials were afraid of taking any action against influential people in a given area;
- d. All the government officials involved in the monitoring and supervision process of the loan were not equally responsible for carrying their duties;
- e. Most of the difficulties faced in recovering loan were from the rich peasants and powerful individuals (UP Chairman/ member and their relatives);
- f. Bank officials appointed from the local areas to disburse and collect loans were not effective because of their personal connection with the borrowers.
- g. The program failed to reach target groups as per its objective because disbursement was made on the basis of list of borrowers prepared by the

¹²⁷ Ordinance number XXXV of 1978 of the Government of Bangladesh

¹²⁸ Circular letter no. ACD.1203/79-103(7) dated 19 July 1979, Bangladesh Bank, Agricultural Credit Department

¹²⁹ Endt. No. ACD.911/2662(79) dated October 20, 1979

Union Parishad Chairman/Ward members/ UAAs where bank managers' involvement in verifying real borrowers and their repaying capacity were neglected;

- h. Message was given by the influential people that this credit was a kind of charity relief, so there was no need to repay;
- i. Certain areas were declared as 'distress areas' by the government without consulting with the local administration, which actually was not entirely true.

Finally, the government had to go for law suit (filed certificate cases) against these borrowers to recover the loan. The Establishment Ministry had sent written instruction¹³⁰ to all District Commissioners to provide necessary help to the local court to handle a few thousands certificate cases against borrowers to recover this loan. This situation continued for quite a long time.

A field study conducted on this project in Tangail district in the 1980s by McGregor (1994) revealed that actually bankers did not relax collateral requirements or guarantee requirements from landowners. Resultantly, small farmers were unable to get a loan in the absence of minimum land; which prevented the program to achieve its goal of reaching small farmers and landless sharecroppers with easy credit delivery. During the interview with senior bank officials, McGregor also found that bankers were resentful of conducting such a politically motivated credit program, because, this type of programme contradicted business principles, internationally accepted prudential norms and general practices of a bank. Banks did not want to be directly involved with people whom they were not familiar with and wished to avoid conflict with the local powerful people by handing over the duties of borrowers' selection to the locally elected politicians such as UNION Parishad members. Therefore, this subsidised development credit program of the government faced serious implementation problems.

Summary of learning from the second project

It was a typical program undertaken by the government to fulfil a political purpose. There were inherent problems in the program structure as it did not consider loan disbursement from a business perspective, but rather as a kind of cash or kind incentive to the people who supported the existing power structure. The banks' role in assessing project viability, selecting borrowers, etc. had been undermined by the

¹³⁰ D.O. Letter no. JAIV./56/82/-186, dated Dacca 18th February 1982, Establishment Ministry, GoB

policy makers. The top management of the banks who participated in policy decisions had to remain silent for understandable reasons. It was possible that they were not interested in operating business in the rural market as they did not have the administrative capacity to handle the rural situation and the risk associated, but they had to abide by the government decision. It is also seen that this program was managed and monitored by dual authorities, on the one hand, it was the Bangladesh Bank that was working with the banks and, on the other hand, it was the government administration that was working with the Union Parishad and banks. So, there was the possibility of confusion in following instructions by the bank employees, who were afraid of taking any action against influential defaulters. So, SACP not only allowed large farmers to get more access to resources but also reinforced the existing exploitative nature of the economic and political power in rural Bangladesh.

However, it was a great lesson both for the participating banks and the government itself. The main learning of this program was that a proper institutional set up was a vital necessity in serving a rural financial market which was not as simple as it appeared. Moreover, there was a significant gap between policy statements and implementation of policies. It was also clear from the experience that only a legal setup was not enough in handling an issue like this, there were other factors like the rural power system and the social and political structure that played a significant role in credit supply and credit recovery in this market. An important internal problem that the banking sector faced was the dichotomy between dual objectives, the objective of development and upliftment of the rural poor versus the objective of performing as professional banks. The experience of SACP therefore, raised two important questions:

- a. Whether banking sector would be interested at all to operate as development institutions for the RFM in future, and
- b. What mechanism could ensure credit as an effective, sustainable development intervention?

5.2.3: Rural Finance and Experiment Project (RFEP) - an experiment based on market economy approach.

Background and objective

USAID had expressed its interest in 'Small Farmer Credit Pilot Project' sometimes in July 1976 to the new government of Bangladesh. The government sought comments

from the Bangladesh Bank, and the Bank responded, "*Considering the imperative need to evolve a viable model to meet the credit needs of the small and marginal farmers, it was tentatively agreed that the scheme offered by USAID deserved a fair trial on experimental basis.*"¹³¹

After getting a green signal from its headquarters in Washington, USAID Dacca (Dhaka) office sent a fresh proposal to the government on 15th February 1977 stating its intention to complement the efforts of the government's Taka 100 Crore special credit program (SACP), mentioned earlier, which just had been launched a few days ago. In the proposal they mentioned, "*AID project will complement and build upon this very substantial effort. Many of problems which become apparent in the initial operation of the Taka 100 core program can be addressed in the final design of the AID project*"¹³².

However, the government was not interested in mixing up these two projects because SACP was the project to fulfil a political motive of the then government and was designed to be practiced throughout the country initially for one year, whereas the proposed project of USAID was an experimental pilot project to test some hypothesis for three years in a few selected regions. Despite these, the Bangladesh Bank had shown its interest in an experiment some models to address the complex problem of the rural financial market, especially in reaching small farmers and landless people in a sustainable manner. This was more so because the other alternative of the cooperative model (traditional and IRDP) was yet to show any appreciable improvement as such (Hossain & Jones 1983). There were series of discussions and meetings between the USAID and government representative along with representatives from the Bangladesh Bank and the participating banks regarding project design and models that would be tested in the selected fields. In this backdrop, a grant agreement was signed in August 1977 between the governments of USA and Bangladesh and after taking adequate measures of caution to handle the controversial¹³³ experiments, RFEP the Rural Finance Experimental Project (RFEP) was finally launched in November 1978.

As mentioned in the title it was an 'experimental' project, under which USAID wished to experiment eight different models that included 'savings' as an

¹³¹ ACD (PROJ)515/76-1079 dated 30th March 1977 [ACD(RES/AID)407A/77;S4]

¹³² USAID letter no. 211 dated February 15, 1977

¹³³ The major controversy had arisen due to its proposed experiment with high interest rates.

integral part of the project to serve as the major sources of funds. Additionally, it wanted to charge higher interest rate to some credit to cover all costs, including inflation, to make the lending institutions viable. The stated objective of this project was to find a way to identify at least one credit model which would be successful at extending credit to, and receiving it back from, the target group¹³⁴. The USAID supplied the fund as a grant, so the participating banks had minimum financial risk attached to the credit operations. The Grant Agreement¹³⁵ desired to get a waiver on certain existing rules of the Central Bank. It stipulated:

The Bangladesh Bank and Government will lift the standard banking regulations governing interest rates and loan security in order to permit broad experimentation in these critical areas (*project areas*).¹³⁶

Accordingly, the Bangladesh Bank issued circulars¹³⁷ to the banks to allow an exception in charging various interest rates and in conducting experiments, initially for 36 months in the selected regions. Not only did Bangladesh Bank agree with the initial ideas of the USAID, it even participated in formulating different treatment variables for the experiment and actively supported the conduct of this experiment in parallel to SACP. The Bank withdrew the SACP project from some areas to conduct RFEP experiments¹³⁸, though the basic frameworks of these two projects were fundamentally different.

Project features and policy environment

A basic hypothesis that was tested via this project was ‘flexible interest rate¹³⁹, efficient administration and organisational innovations which can perhaps overcome major constraints to the delivery of credit and savings services to the target group’ (Church & Adams, 1979). Primarily, twelve variables were identified (table-1 in Appendix-B) to test nine different models¹⁴⁰ that would be undertaken by the six commercial banks, the BKB, the Jatiya Samabaya (Cooperative) Bank and the IRDP

¹³⁴ The target group was defined in the project document (Grant Agreement no. 388-0025 dated August 31, 1977) as rural dwellers over age 18, male or female earning less than Tk 3,000 per year from all sources, having a net worth (excluding the value of land) of less than Tk 5,000 and cultivating six bighas of land (two acres) or less, irrespective of whether such land is owned, rented or sharecropped.

¹³⁵ Agreement no. 388-0025 dated August 31, 1977

¹³⁶ Section 4.1(c) of the Article 4 of Agreement no. 388-0025. Italics inserted by the research

¹³⁷ BCD circular no. 10 of April 20, 1977 and amendments thereafter.

¹³⁸ Bangladesh Bank’s letter to the ERD, GoB; Letter no. ACD (PROJ)515/76-1079 dated 30th March 1977, (S4)

¹³⁹ From 12% to 36%

¹⁴⁰ Last two models were actually similar in nature which were based on cooperative approach

under the direction of the Bangladesh Bank, the implementing agency. Banks were allowed to prepare their models by these variables which were to be finally approved by the USAID. Incentives to banks were provided for one-third of loan amounts upon disbursement and one-third upon repayment of loans. Finally, eight models were developed by nine institutions (table-2 in Appendix-B), among them, the cooperative model was tested by the IRDP and Jatiya Samabaya (cooperative) Bank (BSBL) which also adopted the same market-based features.

Among all these features, the most important, most critical, and overly criticized (Akash, 1985) feature was the interest rate on loan. It was incorporated to cover the full cost of credit and to earn a reasonable profit to make the program viable. Accepting and promoting this kind of project in a credit market that used to prefer directed credit at subsidised interest rate indicated the changed attitude of the policy makers towards credit market and banking system. In many respect, this was the project which introduced a significant policy shift of the Bangladesh Bank and the government from its previous position of a market interventionist policy.

A publication of Bangladesh Bank (1979) reconfirmed the fact of its policy shifting towards 'market approach' from directed credit for the rural financial market in Bangladesh. This policy shift went hand to hand with the changes of political-economic condition of the country during that period. It echoed the work of Spring Review of USAID¹⁴¹, as well as the policy suggestions by the agricultural economists of Ohio State University¹⁴² for the rural financial market of developing countries. This shifting nature of policy is reflected in many internationally published literature of that time (Donald, G., 1976; Von Pischke et al., 1983; Adam et al., 1984). Reviewing Bangladesh's experience with adjustment policies (Syeduzzaman, 1991; Islam, 1991) indicates no surprise. Raising bank rate and other interest rates was one of the measures which the government had already agreed, after much bargaining, in July 1975 with the IMF. The government also promised to undertake adjustment policies associated with support from IDA and the IMF.

¹⁴¹USAID's *Spring Review of Agricultural Credit* in 1973 suggested policy shift for RFM, argued about cost-effective interest rate (Donald, 1976)

¹⁴²Popularly known as 'Ohio School' in honour of a group of economists. This was mainly based on platform of the World Bank, 'a crucial conduit for the transmission of the School's ideas into the Bank's operational practice'. (Hulme & Mosley, 1996)

Participating organisations and interaction pattern

In addition to the participating banks and the Bangladesh Bank, there was an inter-ministerial coordination committee with representatives from the various related ministries and the banks for the purpose of administering the fund and take policy decisions. As per design of the project, it was a top-down type target oriented programme, none of the participants had much freedom to exercise once the designed framework was finally developed and accepted and approved predominantly by the USAID in consultation with the participating agencies. Different meeting minutes and letters¹⁴³ regarding this project pointed out that the project was signed ‘hurriedly’ by the government and therefore, many concerns from the government’s side could not be incorporated into the final agreement, which it did later. The minutes also indicate that there was ‘disagreement’ amongst the officials on the issue of ‘high-interest rate’ charged under this project. One of the Managing Directors of a participating bank even raised serious questions against the Bangladesh Bank regarding its involvement with the USAID in accepting that kind of project which went against the vital interests of the country. All these discussions indicated that interaction among the participants was not quite smooth and was not beyond question in accepting these experimental models as test cases. After taking lots of precautionary measures, the project was finally launched in some selected areas where it did not come into significant conflict with other programs, especially with SACP of the government.

Outcome and evaluation

Two consulting firms, one local and one foreign¹⁴⁴, were involved in preparing the final evaluation report of the RFEP. A joint report was submitted in January 1982, but with differing opinions regarding the interpretation of data. Hence, the foreign agency submitted another report in August 1982¹⁴⁵. The ‘Major Evaluation Report’ jointly submitted by both the agencies in January 1982 (Bangladesh Bank & USAID,

¹⁴³ Minutes of the meetings held on 27/8/77 and 28/11/77 in the Planning Commission on Bangladesh Rural Finance Experimental Project, D.O. No. BKB/MD/77/2173 dated October 5, 1977 and letter no. ACD (Proj)/515-5028 dated 29th November 1977 of the Bangladesh Bank.

¹⁴⁴ Public Administration Service of USA and S.F Ahmed & Company of Bangladesh

¹⁴⁵ As per this report (Terminal Evaluation Report, August 1982):

“This letter is to transmit this Terminal Evaluation Report for the RFEP. The two consulting firms are not in full accord with all the findings, opinions and recommendations set forth in this report. As the differences could not be fully resolved, this report reflects the views of the Public Administration Service (Virginia, USA). The S.F Ahmed & Company (Bangladesh) may wish to submit additional, differing or qualifying opinions. In this case the Bangladesh Bank can determine where there are differences which best serves the government needs. (Foreward)”

However, the local firm did not submit any rejoinder due to lack of funds (Akash, 1985).

1982) highlighted following outcomes of the project, which was prepared on the basis of twelve months statements started from October 1980 to September 1981:

- a. No single model or no single institution could be considered to have satisfied the criteria that would justify its replication nationwide. The combination of rural bank outlets, village agent and budget line of credit for borrowers was the best system for replication.
- b. There were some rural activities especially non-agricultural activities such as transport and pottery where the internal rate of return was high enough to attract borrowing at 36%. However, Agriculture might not be a good candidate for such high-interest rate especially in those circumstances where the family was dependent entirely on the crop income.
- c. Profitability at borrower level depends on a lot of factors such as the size of the activity, the region in which it was carried out, the topography of the region, soil condition, demand for goods and services produced, availability of raw materials, skilled labour and marketing facilities for such products, size and contribution of the family including the contributory labour from the family and its capital structure.
- d. The performance of group lending in the experiment had not been very satisfactory in general. Groups were formed primarily to obtain loans. There was little identity outside the function of weekly meeting for some specified purposes. Borrowers generally were not in favour of group lending; some other broader needs of the borrowers such as combining credit with other services were required to make group lending effective.
- e. Group formation and maintenance of group solidarity are a specialized, time consuming and costly job which did not fit with the usual scope of banking and credit.
- f. Cooperatives considered as a good attempt to organize conservative and disadvantaged groups such as women, landless and wage labourers who, as individuals, were less likely to borrow and who would benefit most from the cohesion of the group.
- g. The rate of interest paid on deposits was not a significant determinant of savings balances for target groups, but it was significant for non-target rural savers.

Some interesting inside information of the individual participating organisations of the RFEP is presented in table-3 in Appendix-B, which provides valuable facts regarding cost structure and lending mechanism in the rural sector. The facts argue that determining the reasonable rate of interest on a loan to cover the full cost of operation is not a straightforward matter. It is observed from the table-3 in Appendix-B that mainly two things matter in making a lending operation viable; a) administrative costs, and b) overdue loan or reserve for bad debt. All these features provide valuable insights for the credit institutions to find out an appropriate strategy or model to make a program viable¹⁴⁶.

However, the final outcome of this project was never widely disseminated, and it remained inconclusive (McGregor, 1994). Despite this inconclusive findings, the project had been followed up by another project namely Rural Finance Project (RFP) over three years from 1983. The USAID had prepared a concept paper for this project on the basis of another evaluation report that was conducted in March 1982¹⁴⁷. That paper highlighted several areas of significance such as RFEP's better performance in loan recovery and overdue loans, its effect on informal credit in reducing moneylenders' rate in project areas, and in stimulating economic activities and reducing under-employment. The main objective of this extended project (RFP) was 'to induce the Government of Bangladesh to make a number of key financial sector policy changes' (McGregor, 1994; P.13), that included three vital requirements such as-

- a. A revised lending and discount rate¹⁴⁸ structure to cover full cost of loan and to increase domestic resources by individual savings as opposed to government subsidies,
- b. Loan administration reform that included adaptation of policies to handle loan classification and bad debt, and introduction of incentive system for loan recovery and,

¹⁴⁶ Uttara Bank had relatively small overdue problem compare to BSBL, but it needed 51.8 per cent interest rate, the highest figure among all, to cover its very high administrative costs and costs of salaries and allowances. Again, Rupali Bank despite spending high costs for salaries and allowance because of appointing village agents, could make some profits due to its low reserve for overdue loan whereas JSB and Uttara Bank failed to do so. Among all these institutions, Sonali was the lowest cost lending institution, but needed higher interest rate compared to BKB to cover reserve for loan overdue. Four institutions out of nine were able to make profits, BKB earned the highest profit and Pubali bank incurred the highest loss due to high costs related to both administrative expense and bad debt.

¹⁴⁷ As mentioned in some documents of the Bangladesh Bank, but no such evaluation report was found.

¹⁴⁸ Proposed Interest rate for lending was at least 24% (Concept paper page-5), whereas existing rate was about 12% to 13%

c. Provision of foreign exchange required for the project.

RFP was just the continuation of RFEP, so no further discussion of this project is seen relevant here.

Summary of learning from the third project

The relevance of RFEP in the context of this research seems very important from the perspective of its approach towards 'financial viability' of the lending institutions. It was a completely new approach to the rural financial market of Bangladesh, though not unknown. This experimental project was continued for three years and implemented only in 106 outlets of the nine institutions, none of them private. The major features of the variables were in practice already under different programs, may not be in the exact form, except the concept of differential interest rates for lending and savings. Group formation, group lending, group liability, were the major characteristics of the cooperative system. Area development approach, the concept of appointing an agent, bringing the bank service near people had also been tried before under ASARRD program.

However, the uniqueness of this project was its combination of different features in the form of variables to develop some models to find out a viable solution for the market. Only one variable was common in each case; that was charging interest on credit at a rate sufficient to make the institution viable. Though the collection of savings was given the second highest priority, it did not get enough attention from the participating institutions but for a few exceptions. However, it was a great learning that there were some businesses which could generate more internal return to bear the higher cost of credit, though not all kinds.

It was also discovered that charging high-interest rate was not the only solution to build a viable institution. Other factors like efficient management of credit, loan supervision, borrower selection and an incentive system could also play important roles in this case. Though the project could not bring forth any common solution to the problem prevailing in the rural areas, it was a good learning experience for all involved. It could be considered as a step forward on the path to the market economy that the Bangladesh government had formally embraced in the later part of the 80s, true at least, for financial liberalisation (financial sector reform) programmes that the process had started by the mid-80s.

5.2.4: Grameen Bank Project (GBP)- A local initiative

Background and objective

Parallel to the RFEP, the embryo of the Grameen Bank Project (GBP) (the original name was ‘Jobra Bhumiheen Samity’, which can be translated as *Jobra Landless Society*, had become visible during the period 1977-1978. It was initiated by Professor Muhammad Yunus of Chittagong University in December 1976¹⁴⁹ in a neighbouring village (Jobra, Fatehpur Union of Chittagong district) of the University under the ‘Rural Economics Programme’ of the Department of Economics with the initial financial support from the local Janata Bank¹⁵⁰. As mentioned by the initiator in 1978¹⁵¹:

Jobra Bhumiheen Samiti launched in December, 1976, without a formal structure. Janata Bank was persuaded to participate in our experiment in Grameen Banking by extending credit to the landless without collateral and security arrangements¹⁵². Credit facilities from Janata Bank were being utilised for the members of the landless association until Bangladesh Krishi Bank, at our request, opened and (*an*) experimental grameen branch in Jobra in March 1978. Operational policies of this branch are determined by the Rural Economics Programme of the Department of Economics, Chittagong University (P.2; Sum-29).

‘Grameen Bank’ is an important development in the emergence of microfinance in Bangladesh which attracted attention in every sphere of development, both nationally and internationally, and subsequently spread all over the world. It would be relevant to discuss its origin in greater detail from the perspective of political economy.

From the very beginning it was evident that Professor Yunus was not happy about the then existing socio-political structure of Bangladesh. He expressed his concern about centralized urban biased policy¹⁵³ and proposed a framework for ‘Self-

¹⁴⁹ Formally launched on 22 December 1976 (Asaduzzaman, 1977)

¹⁵⁰ BKB and Sonali Bank had participated later (Yunus, 1978)

¹⁵¹ A paper (Bangladesh Bank file no. ACD(Proj)526/79) on “Bhumiheen Samiti (Landless Association) and Mohila Samiti (Women Association) in Jobra and other villages”, dated September 25, 1978

¹⁵² First loan was sanctioned by the Janata Bank on 3rd January, 1977 and total amount was about Taka 16,050.00 which was given to buy four Rickshaws, two cows and for processing puffed rice (Asaduzzaman, 1977)

¹⁵³ He was involved with the planning commission of Bangladesh Government (from July-September 1972 as Deputy Chief) immediately after the liberation war after finishing his PhD from USA in 1970. In one of his papers (Yunus, 1974), he criticized government’s first five year plan where he mentioned about ‘One-year Plan Rather Than Five-year Plan’, ‘Planning for Growth Versus Planning for Development’, ‘Manufacturing Production Function Versus Agricultural Production Function’, ‘Decentralized Planning’ etc.

Reliant Rural Bangladesh (*Swanirvar Bangladesh*)¹⁵⁴ in March 1976 (Yunus, 1976). In this paper, he mentioned about ‘institutional vacuum’ and ‘fragmented’ nature of existing rural institutions. Professor Yunus also criticized existing cooperative models (IRDP) for its bias towards large and medium farmers and recommended the idea of ‘integrated rural development’ and ‘Gram Sarkar’¹⁵⁵ in relation to the so-called ‘*tebhaga farming*’¹⁵⁶ operation to solve the distributional problem of agricultural production. Probably for the first time, he discussed the basic concept of ‘Grameen Bank’ publicly in a National Seminar on ‘Rural Development’ organised by the Ministry of Local Government, Rural Development and Cooperatives that was held in Dacca (Dhaka) on April 24-27, 1978 (Yunus, 1978). In this paper he proposed models for two new institutions that needed to be implemented. One of them was the idea of decentralised local government, the ‘Gram Sarkar’ and the other one was the creation of a new grassroots level bank for small farmers and landless people, the idea of ‘Grameen Bank’. He described the experiment on GB:

Operation begins with the formation of Landless Association in each para or cluster of paras. Weekly meeting of each association is held at fixed place and time without fail. Credit requirements of individual members is discussed in the meeting. Members are classified into groups according to the purpose for which loan is sought. Each group has its own chairman and secretary. Each group is asked to select two or three candidates to begin the loan procedure. It is made clear to the group members that remaining members will receive loans only if the repayment records of the first loanees remain clean. Repayment is made in weekly installments. Members also deposit one taka in their personal account on every meeting day. No collateral is required for any loan. [Yunus, 1978; P.10]

¹⁵⁴ The idea of Swanirvar Bangladesh (self-reliant Bangladesh) was conceived and developed by Mahbub Alam Chashi, a senior officer of the former Pakistan foreign service, during 1967 as a response towards villagers’ distress due to flood (in Rangunia Thana of Chittagong district). The basic principle was to organize people to solve their own problems through self-help and through mobilising local resources instead of depending on outside help. The idea again came into surface after liberation war in 1971 to deal with various national problems like famine and other natural disasters. The efforts were combined with national programs gradually and the first National Swanirvar conference was held in 1975. This movement continued and got attention from the government, and finally Mr Chashi was appointed as Special Secretary (Swanirvar), Agriculture by the government (Huque, 1984).

¹⁵⁵ The idea of “Gram Sarkar” (village government) evolved with the idea of Swanirvar movement (self-reliant movement) in Bangladesh during late 70s which captured attention from the then president Ziaur Rahman who had given it recognition by passing a legislation (in June 1980 an Act of parliament formally established a nationwide system of ‘Swanirvar Gram Sarkar’) as part of his government’s interest in decentralizing power at local level (Huque, 1984).

¹⁵⁶ Professor Yunus was the initiator of ‘Nabajug tebhaga khamar’ which was established in October 23, 1975 and he was in charge of management for the first year and took a loan from Janata Bank in favour of it under his personal guarantee (Barua, 1980). The same concept he applied here, where all land would be at the disposal of ‘Gram Sarkar’ without disturbing land ownership pattern (‘Gram Sarkar’ would be responsible for supplying all inputs except labour), and the harvested crop would be divided into three equal parts and distributed among ‘Gram Sarkar’, the cultivator and the landowner.

As a follow up to the above-mentioned seminar, the Bangladesh Bank was given a D. O. letter¹⁵⁷ by Mahbub Alam Chashi¹⁵⁸, the special secretary (Swanirvar) under Ministry of Agriculture, regarding “Grameen Bank Project” (along with a draft project proposal¹⁵⁹ for consideration). The Secretary requested the Bangladesh Bank to provide necessary support to this project. He asked to make it an experimental project in another district (Tangail) where the central government (under Ziaur Rahman) had already “completed the formation of ‘Gram Sarkars’ and ‘Union Sarkars’ in all of its 2014 villages and 99 unions”. The Secretary also added “Tangail offers an opportunity to the Banking system for experimentation in total area development” along with various development plans of the government. He requested the Bangladesh Bank (the then Deputy Governor A.K. Gangopadhyay) to take necessary steps to launch the Grameen Bank Project on October 01, 1978. According to Bangladesh Bank’s official documents, the Deputy Governor himself took all the personal initiatives to move it further. He visited the program at Chittagong, discussed the matter with bankers for necessary cooperation, requested USAID to consider this proposal as another model under the RFEP, placed the proposal before the Board meeting of the Bangladesh Bank, and requested the VC of the Chittagong University for Professor Yunus’s leave. Further, he attempted to get financial support for this GBP from FAO/APRACA under SCARED¹⁶⁰ programme, and made arrangements for bank staff for coordinating the project¹⁶¹. During this process budget had been cut down¹⁶², the proposal had been revised, and operational areas had been reduced from

¹⁵⁷ Letter number Shaw 247/9 dated 23rd August 1978 on his own pad with a monogram of the government of Bangladesh.

¹⁵⁸ He was a Bangladeshi from Chittagong district and as a senior officer of former Pakistan Foreign Service he had close links with the government. Later he was appointed Special Secretary Agriculture (Swanirvar) of the Bangladesh Government. After the political change in 1975 Mr Chashi was appointed as principal secretary to the President Khandakar Mushtaq Ahmed (Huque, 1984).

¹⁵⁹ Draft prepared on 20th August 1978. It is mentioned in this draft that GBP would be a project of the Bangladesh Bank where Professor Yunus might be involved as the Project Director. According to this proposal, the project would work with existing bank branches in the project area (Tangail district and Hathazari thana of Chittagong district) to build up “appropriate organisations, frame rules, procedures, norms and formats to take banking services to all people” to “compete moneylenders out” of the market. There was no plan of setting up a separate banking institution like “Grameen Bank”, rather it was mentioned there that this GBP could be converted into Grameen Bank Academy if it performed well. The Academy could “undertake the massive training programme which will be needed to introduce Grameen banking all over the country”.

¹⁶⁰ ‘Scheme for Agricultural Credit Development (SCARED) of FAO’, Rome

¹⁶¹ Gangopadhyay himself had mentioned in an interview – ‘I had to pursue the central bank board members, commercial banks and government to give it a chance. If Grameen Bank succeeded, it would be very useful so I took a calculated risk although there was considerable hesitation and scepticism all around’ (reprinted in BIBM, 2011)

¹⁶² Initial estimation was Taka 12.07 lac for the year 1979-80, that reduced to Taka 7.67 lac.

99 Unions to 5/6 Unions of Tangail district¹⁶³. Finally, after completing all procedures, the project was launched as 'Grameen Bank Project (GBP) of the Bangladesh Bank on 9th November 1979 in Tangail instead of 1st October 1978 as the Secretary (M. A Chashi) had originally desired. Professor Yunus took the responsibility of the GBP as the Project Director on 6th June 1979, initially for one year which was extended later.

Chashi's presence in many incidences and meetings related to GBP was found in the related documents¹⁶⁴ of the Bangladesh Bank, which played an instrumental role in getting favour from the top level policy makers of the government. Recently¹⁶⁵ I asked Professor Yunus about this initial phase of GBP, and asked him how he had initially approached Bangladesh Bank. He replied that he had directly communicated with the then Deputy Governor (A.K. Gangopadhyay) regarding the issue after presenting a paper at a workshop arranged by the USAID¹⁶⁶, and that the Deputy Governor himself took great interest and initiative in making it a project of the Bangladesh Bank¹⁶⁷. Professor Yunus did not pay much importance on the letter from the Secretary of Ministry of Agriculture regarding the GBP. According to him Mr Chashi was enthusiastic about the project, so he volunteered to introduce Professor Yunus to the central bank and wanted to spread it (at large scale). In this connection, a few comments made by Dr Sheik Zinath Ali of Bangladesh Agricultural University in a national daily¹⁶⁸ about Professor Yunus' connection with the power seem relevant:

Sometimes in June 1978, there was a conference in Tangail district, mostly for government officials and locally elected representative like Union Parishad Chairman and members, where the newly elected (through a referendum) president Major General Ziaur Rahman was the Chief Guest. That meeting was conducted by Mr Chashi, Professor M. Yunus was one of the speakers of that conference (seated beside the President) where he talked about the concept of Grameen Bank, the VC of Bangladesh Agricultural University was also present there among other speakers.

¹⁶³ Minutes of the 18th Board meeting of the Bangladesh Bank, held on 22nd February 1979.

¹⁶⁴ In the meeting with bankers, in the discussion with lawyer etc.

¹⁶⁵ In a formal interview on 31 March 2014 at the Grameen Bank

¹⁶⁶ This workshop was held on October 23-25, 1978 where Professor Yunus had presented a paper on 'BHUIHEEN SAMITI (LANDLESS ASSOCIATION) IN JOBRA AND OTHER VILLAGES' and finished the paper by saying that 'These Samities together can make the concept of Gram Sarkar meaningful by putting strong organisational muscles to the constituent associations' (Bangladesh Bank, 1979).

¹⁶⁷ A. K. Gangopadhyay had also mentioned in an interview that he came to know about Grameen and met Professor Yunus in a seminar where Professor Yunus was a keynote speaker (BIBM, 2011).

¹⁶⁸ Sub-editorial, Daily 'Sangbad' dated November 30, 2014 [translated by the researcher]

Thus, the initial action research project of Professor Yunus in the Jobra gram (Jobra village) near the University of Chittagong was finally transformed into 'Grameen Bank Project (GBP)' of the Bangladesh Bank. It received active support from many individuals and institutions, especially from the government with the direct support from the existing political power.

Project features and policy environment

Initially, the aim of the project was to organize landless people into groups to enable them to get access to financial services from the banking system, not only for agricultural production but also for any other productive activities as well. It aimed to find out an alternative banking model for the poor, in contrast to the existing banking system that denied credit facility for this group of people in the name of collateral security in a physical form, and did not take any interest in the economic activities of the poor people. In doing so, it blended many features from the then experiments and practices with some new ideas. Some of the important features are:

- a. Dedicated banking service for the poor where bank staffs should go to the door steps of the people instead of people coming to the banks' door for services;
- b. Considers all kinds of credit needs of the people, not solely the credit requirements for agriculture;
- c. Form group of 5-10 people to strengthen their solidarity, these groups then could form an association of landless people;
- d. Groups should meet every week where a dedicated bank staff would be present to discuss various issues such as business activities, loan processing along with savings collection and loan repayment;
- e. Provide credit without any physical collateral, joint liability of the groups can be considered as guarantee to minimize risk of credit;
- f. Weekly savings collection by the poor people should be given importance to build up their capital base;
- g. Weekly repayment system should be introduced, if borrowers were not able to make full payment of the amount they had taken on loan, then they should pay a token amount to maintain discipline;

- h. Not all the group members (a group of 5-10 people) would get loan at a time, full repayment by the first phase borrowers would ensure the scope of credit line by the second phase borrowers and so on;
- i. Simplified version of loan documentation procedure would be introduced;
- j. Uniform interest rate of 11 per cent compounded annually could be charged on loan;
- k. Loan disbursed would be intensively monitored and supervised.

It was an experiment that involved local level commercial bank branches, but banks were not very much enthusiastic about this kind of project after considering its non-traditional nature, and costs incurred due to intensive monitoring and supervision¹⁶⁹. Moreover, banks were already overburdened with different types of projects for the rural financial market which demanded different requirements such as application form, lending and reporting procedure, interest rates, borrower selection, and other elements. During the same time, the government desired to promote another program, namely 'Package Input Programme (PIP)', which had launched during the boro season (September) of 1978. By 1979, the banking sector had started facing serious repayment problem mainly from SACP, which came down below 50 per cent and the entire banking system stood threatened 'for deliberately encouraging the process of polarization in the rural area through collusive credit policy'¹⁷⁰. Though Tangail was chosen as the first district outside Chittagong to promote GBP as a national program, the Bangladesh Bank and the banking sector as a whole had taken cautious steps in doing this experiment.

Participating organisations and interaction pattern

The GBP was working under the existing administrative structure of the nationalised commercial banks (NCBs) and a state-owned agricultural bank (BKB). Branches of these banks undertook project operation in the areas assigned to them by the Bangladesh Bank. Separate field staff was recruited by the project office in collaboration with these participating banks; they were trained and placed by the project office at selected branches. These staff members were considered as

¹⁶⁹The Krishi Bank Branch carrying out loan operation of this project in Chittagong had incurred loss due to high cost of supervision even after having almost 100 per cent repayment (Meeting minutes, held at Bangladesh Bank on 1st December 1978 regarding this project at Jobra Village)

¹⁷⁰ Source: Project proposal (Grameen Bank Project) submitted to the Governor for approval by the Deputy Governor on 1st December 1978.

employees of the attached banks and received their salary from respective banks' offices. However, they were under the administrative control of the project, and were managed both by their respective banks and the project office. The expectation was that this project would help bank branches to take part in the development activities of the project areas. It was thought that "*transforming the bank from a passive institution waiting for people to come ... (into) an active organisation which will be persuading people to do things and making its financing available*"¹⁷¹ for all the economic activities in the areas. Initially, Professor Yunus wished to change the mind-set of existing banks with the help of this project, so he proposed the kind of administrative arrangement that the project had with the participating banks. It is evident from the documents that the participating banks undertook GBP with their existing administrative arrangement and provided it necessary supports mainly due to the request or order of the Bangladesh Bank. A. K. Gangopadhyay's following comments (BIBM, 2011) support this claim –

....there was initially much resistance from banking circles.

(again)

I had a reputation in the banking community so when I tried to persuade the commercial bank to support Grameen. They ultimately (although not always so willingly) supported me and the Bank. (P.15)

Even then, there existed a hostile relationship between the participating commercial banks and the project since the beginning that was further worsened by the project staff and administrative arrangements under dual authority of the banks and the GBP¹⁷². On the one hand, banks wanted to control their staff since they were being paid by the banks, while on the other hand, Project Director (Professor Yunus) wished to get full control on the staff to run the project successfully. Professor Yunus wanted to get various quick logistic support when and where necessary which the banks could not always meet due to their internal policy or rules or limitations (Yunus, 2014). So, they started blaming each other as their grievances intensified over time. It was Bangladesh Bank that always remained in the middle to act as the referee to resolve the problems that had arisen between the project management and related

¹⁷¹A note written by Professor M. Yunus on June 26, 1979 regarding the experimental GBP to discuss about arrangement procedure and necessary cooperation with the CEO of the participating banks.

¹⁷² File no. ACD(Proj)526/79, Bangladesh Bank and Professor Yunus' comments during interview (Yunus, 2014)

participating banks. Bangladesh Bank instructed banks to provide necessary supports to GBP and requested them for cooperation¹⁷³. But, situation did not improve much. Professor Yunus expressed his frustration of that moment after thirty-five years by saying that:

I thought the program became standstill even though it was performing well. What would be its future? It could not run this way any longer (Yunus, 2014; P.452)

Outcomes, evaluation, and related issues

This project was evaluated by many organisations and individuals such as Bangladesh Bank, BIDS (Bangladesh Institute of Development Studies), BKB Training Institute, IFAD Consultant Dr Mohiuddin Alamgir¹⁷⁴. All these studies made positive comments about its performance and impact on poor peoples' income and quality of life. It received an interest-free loan from the IFAD since 1980 which made the project operationally profitable. More than half of the GBP units were able to make profits in 1982 after getting refinance facilities (provided by the Bangladesh Bank under the agreement with IFAD) at concessional rate of 4.5 per cent.

The project was expected to continue until December 1984 and expanded the program in four new districts with a total 100 GBP outlets. However, before the formal closing of the project, it suddenly took an unusual course and transformed itself into a bank under a special law by the government in September 1983¹⁷⁵. Available documents from the Bangladesh Bank¹⁷⁶ reveal that this quick transformation was triggered mainly by the coordination problem between the participating banks and the project office (primarily with the Project Director Professor Yunus). As mentioned by him (Yunus, 2014), the program was doing well despite bankers' resentments to continue it and expanded its operations to five more districts of five divisions. He therefore planned for separating GBP from the bank branches and restructuring it into an independent institution. He restated during interview:

¹⁷³Circular letter no. ACD(GBP)/537(6)/81-188 dated 9th May 1981 regarding Calculation of Interest rate for GBP, etc.

¹⁷⁴ As quoted by Professor Yunus in a Proposal for restructuring GBP into a full-fledged bank, submitted to the Governor in August 1982.

¹⁷⁵Government established the Grameen Bank under the Grameen Bank Ordinance, 1983 (Ordinance No. XLVI of 1983).

¹⁷⁶Professor Yunus's letter to the Governor regarding 'Proposal for Restructuring the Organisational Arrangement of Grameen Bank Project' sent on March 30, 1982.

Whether it would be an institution like cooperative, or like an NGO, or a separate bank those were the options in front of me and I wrote a paper on that to present it at an upcoming conference to be held in BARD Comilla.’ (Yunus, 2014; P. 453)

However, due to the sudden promulgation of Martial Law in March 1982, that conference, where he wished to present a paper on his future plan, was cancelled. While, he could not present the paper, he had a chance to discuss the issue (his concern) with an ex-government high official, who became the Finance Minister of the Marshal Law government later. As an influential Minister of the government, the Minister took interest in transforming the GBP into GB (Yunus, 2014). Meanwhile, on the basis of his paper, Professor Yunus sent a proposal to the Bangladesh Bank Governor¹⁷⁷ and was continuing the discussion about the matter with the government simultaneously. Finally, he was able to manage government’s support and approval in establishing a separate bank for the poor in September 1983. ‘Bangladesh Bank had no role in this process’ of transformation, he added (Yunus, 2014).

However, official documents of the Bangladesh Bank reveal that it was not actually silent in this process; it rather responded positively to progress the matter. After getting Professor Yunus’s proposal regarding restructuring GBP into a separate institution, the Bank sent its comments to the government (Finance Minister) with the approval of its Board. The Bank preferred that it would either be a separate institution under the ownership of the Bangladesh Bank or the Government, or it could become a subsidiary of the existing NCBs. However, the participating NCBs were not in favour of establishing a separate institutional body at that time on the ground that the project was yet to be closed. Bankers had serious doubt about the viability of such a bank (proposed GB) due to the high cost involved in its intense monitoring and supervision process. Hence, a new debate around the nature of organisation started. That issue will be discussed in the next chapter in detail while discussing Grameen Bank as a separate institutional model or case.

Summary of learning from the GBP

Though GBP had started through initial action research experiment conducted by the Economics Department of the Chittagong University under the leadership of Professor Muhammad Yunus, in its long course of development it has received cooperation and support from several institutions and individuals whose roles should not be neglected.

¹⁷⁷ Letter to the Governor on August 20, 1982

It is seen from the available documents retained by the Bangladesh Bank that the positive and proactive role of two important government officials¹⁷⁸ was crucial in bringing the small project of Chittagong University into the national limelight. The Bangladesh Bank was directly involved in the whole issue of project implementation including financing the project, providing logistic and other supports, coordinating with the external institutions (banks and external donors), resolving conflicts, and in other issues. All the participating banks especially the Janata Bank and Bangladesh Krishi Bank (BKB) played a crucial role in experimenting during initial phases of the project by stepping out of their ways from traditional banking practices.

It was also not unusual that the main initiator of the project, Professor Yunus, had conflicts from time to time with the others associated with the project, as the project transformed into a formal organisation that was slowly being moulded into a new concept of banking for the poor. As mentioned by many bankers on many occasions that Professor Yunus's personal leadership was an important factor in the success of this project, and he wished to have full control and full 'autonomy' in running it. It was also evident from my later interview (Yunus, 2014) that he had taken the task with a missionary zeal; he was not simply a 'Project Director' as it was in the case of other projects. The Bangladesh Bank also allowed him full freedom to frame rules, procedures, and terms & conditions of loans.

The GBP was an important experiment, originated in local soils through trial and error methods. Originally it was expected to work in cooperation with the existing bank branches as separate windows or branches dedicated to poor people. The final goal of this project was to establish an academy to train bank staffs to serve this group of the poor population, but ultimately it turned into a separate bank. The initiator had dreamt that it would help in building poor peoples' association through which they would be able to participate in the decision-making process of the local government, however that aspect of the project remained absent till the end of the project. The project indirectly contributed to various financial experiments leading to possible solutions to the long pending issue of the rural financial market in Bangladesh, though it had not yet been proven to be a fully viable or sustainable model without external financial supports.

¹⁷⁸ Mahbub Alam Chashi, the Special Secretary (Swanirvar) under Ministry of Agriculture and A.K. Gangopadhyay, the former deputy governor of the Bangladesh Bank.

5.3 CONVERGENCE OF CERTAIN DECISIONS

By 1982 it became clear to the policy makers that ASARRD had lost its focus, and SACP was a total failure. There were only two programs left, the RFEP and the GBP, that were showing some signs as possible alternative models or alternative institutional frameworks for the rural financial market. Therefore, the Bangladesh Bank had given emphasis on these two projects in reference to the then Finance Minister's budget speech in 1982 (under Martial Law Administrator) to increase institutional or bank credit for rural landless farmers and other small rural producers. The Bangladesh Bank agreed to continue the RFEP under the name RFP as proposed by the USAID except for a few disagreements on some issues such as appointing technical advisor for the project and charging an interest rate on lending at least 24 per cent. At the same time, the Bangladesh Bank recommended the government to consider the proposal of creating a separate institution, the Grameen Bank, which would highlight Government's concern about the rural poor and would reflect Government's determination to take positive steps in that direction¹⁷⁹.

Comparison between RFEP and GBP

These two prominent projects of the late 70s got much attention from every quarter concerned with the economic as well as the socio-political development of the country. The RFEP project was carried out from purely economic perspective, while the GBP was a blend of economic and socio-political perspectives. They had similarities on some issues but they also had considerable differences. An attempt has been taken here to compare these two important projects to see whether there was any convergence of ideas in the emerging concept of 'microfinance'.

It is observed that these two projects had some features in common such as both of them had a focus on poor people who remained un-served by the formal banking sector, provided credit without collateral, and gave importance to savings collection, though they did not practice the same procedures. RFEP had some group-based model, but loans were given on individual basis, whereas, GBP followed mainly group based model. Women received loans from both the projects but a higher percentage of women's participation was observed under the GBP. The GBP also disbursed more credit to the non-agricultural sector than the RFEP. The major

¹⁷⁹ The working paper prepared by the Bangladesh Bank on Follow-on-Project of RFEP and GBP in 1982

difference GBP had with the RFEP was in charging interest on credit; GBP had only one rate whereas RFEP had been experimenting with a range of interests depending on the purpose of loans and areas of operations.

Gangopadhyay (1979) mentions in a policy paper of the Bangladesh Bank that interest rate policy is a highly complex and debatable subject, because policy formulation is not only based on economic criteria, sometimes socio-political considerations outweigh economic factors. The USAID decided about fixing interest rate based on purely economic factors. So, it proposed to offer the rate on loan between 12-36 per cent under RFEP that was the principal hypothesis tested under the project. On the other hand, GBP was charging initially 11 per cent per annum which was increased into 13 per cent later (actual effective rate was about 24.5 per cent)¹⁸⁰, and it was unable to cover the full cost of credit without getting subsidized fund from outside sources. The USAID refused Bangladesh Bank's request in 1979 to consider GBP as one of the models to be tested under RFEP on the ground of interest rate mainly. It mentioned¹⁸¹:

The Grameen Bank Project is not consistent with one of the major themes of the RFEP, i.e. the underlying hypothesis that higher interest rates on loans and deposits are important in addressing several major constraints to rural finance. Under the Grameen concept, government is expected to some of the initial organisational and technical costs involved in establishing these pre-cooperative groups; the group members are not expected to bear the full development start-up costs.

Professor Yunus has recollected the memories during interview after thirty-five years and has made following comments on this issue (Yunus, 2014):

I am always in an argument with USAID and Ohio State. I never have concurrence with them. They said that it (*GBP*) could be considered (*as a project under RFEP*¹⁸²) if the interest rate was increased, or if it was done according to their wish. I said these were all false statements; there was no need for those kinds of experiments. People take the money and give it back, no need to charge 36 per cent. Their argument was that if anybody has pressing need of money, he or she would come. I said that everybody (poor landless people) has a pressing need, they could not afford it (credit) if it was 36 per cent. (P.450)

¹⁸⁰ Directly it charged 13 per cent per annum but actually the effective rate was about 24.5 per cent [Interest rate on loan (13%)+ Group tax (5%) + Emergency fund (6.5%)].

¹⁸¹ Memorandum from Gary D. Adams, RDE/RFEP on Rural Finance Experimental Project: Project Committee Meeting Regarding Grameen Bank Proposal, dated January 24, 1979

¹⁸² Italic inserted by the researcher

According to Gangopadhyay (1979), credit operations should be made viable to encourage credit agencies, and again, it should consider the ability of the borrowers to pay services from the use of credit too. Hence, he made final comments in his paper by saying that the central bank and the government should decide- a) what kind of subsidy was needed by whom, and b) the cost of subsidy should be borne by which agency; the government or the central bank. By this rationale, the central bank proposed¹⁸³ 18 per cent lending rate for RFEP and 15 per cent for the proposed Grameen Bank¹⁸⁴ to pick up a model between these two by the government. The government had finally decided¹⁸⁵ to establish a separate bank for the poor by transforming GBP. Hence, the government had requested the Bangladesh Bank to take necessary steps to prepare a draft ordinance to fulfil its desire.

5.4 CONCLUSION

This chapter tried to examine how the initial concept of microfinance emerged in Bangladesh in the late 70s from many early experiments. Immediately after independence, the government undertook some initiatives in experimenting with cooperative systems to boost economic wellbeing of the rural poor. Credit was one of the important components of those early cooperative programmes for community development. IRDP and ASARRD were two prominent efforts among them, but they failed to bring the expected outcomes.

With the changing scenario in politics and state policy towards privatisation, the government conducted three more programmes for the landless and rural poor, which had an immense effect on the market. First, SACP, a politically motivated traditional credit programme, was responsible for destroying credit discipline drastically. Second, RFEP, a donor driven experimental project tested some models mainly based on differentiated interest rates ranging from 12-36 per cent. Finally, the Grameen Bank Project, (GBP) a local programme that had many features common with the previous ASARRD, though there were some differences as well, drawing lessons from failure of pervious programmes.

¹⁸³ The working paper on Follow-on-Project or RFEP and GBP, prepared by the Bangladesh Bank in 1982.

¹⁸⁴ Professor Yunus had submitted a paper to the Governor on August 10, 1982 on profit/ loss scenario of the GBP under different interest rate: 13, 15 and 18. The Bangladesh Bank proposed 15 per cent for GBP on the basis of this paper.

¹⁸⁵ Letter sent to Bangladesh Bank from the Ministry of Finance (letter no. Acg/Awe/e'vskS-3/82-175) dated 06/04/83

The main difference lies in the focus of the GBP. GBP concentrated on the individual initiative of rural residents. It also focused solely on financing. Bangladesh Bank was directly involved in these two later projects, RFEP and GBP. It participated actively with the USAID in developing some controversial models under RFEP. It even provided all sorts of policy support to RFEP bypassing existing conventional rules. Bangladesh Bank undertook a promotional role in expanding the GBP from a small, local level project, to a national project.

Most of these experiments ultimately failed for one reason or another, but they left some important lessons behind. ASARRD successfully designed a credit mechanism appropriate for the landless, but it failed to develop the right coordination mechanism between different parts of the programme. RFEP proved that interest rate was not the only criteria to make a programme viable and sustainable. Other institutional issues need to be addressed. Compared to all these programmes, GBP performance was the best under the dedicated leadership of its founder with sufficient support from many others, including Bangladesh Bank and participating commercial banks.

Initially GBP was not a commercially viable project, nor was it an old type of 'cheap credit delivery' system. Neither did it subsidize interest rates like the government, nor did it follow high rates like the RFEP. It had some inbuilt features of cooperatives but at the same time, greatly encouraged an individual petty mode of production and competition. The favourable influence of a few high officials both from the government bureaucracy and Bangladesh Bank was instrumental in its transformation from a small project of Chittagong University, to a national programme of the government.

Hence, there is enough reason to conclude that the concept of microcredit or modern-day microfinance as symbolized by Grameen Bank, was the convergence of ideas drawn from many earlier experiments and efforts that gained momentum with favourable support from many agencies and individuals. It was a mixed type of credit programme, which neither supported earlier models of cheap credit, nor followed a purely commercial model. It followed a 'poverty approach' to developing credit programmes, instead of a pure 'sustainability approach' supported by Neo-liberal views.

CHAPTER 6

The Game Over Grameen Bank:

A Case of Principal-Agent Problem

6.1 INTRODUCTION

The analysis of the legal process of transforming Grameen Bank into a formal microfinance institution from a project, thereafter Grameen's journey from Grameen Bank Ordinance, 1983 to Grameen Bank Act, 2013, addresses the economic implications of related laws in this field. The Grameen model of microfinance eventually evolved into a typical Principal-Agent problem; a critical analysis of its evolution will explore the matter. The historical sequence of moves and counter moves behind the formulation of this ordinance and amendments thereafter, are useful not only to understand current debates revolving around Grameen Bank's governance issues, but also current governance problems of other microfinance institutions (NGO-MFIs) in Bangladesh as well.

It has been mentioned earlier that Grameen Bank evolved from a personal and localized project into a national or state supported project, which was valid till August 1983. The project was transformed hurriedly into a full-fledged legal organisation, Grameen Bank, in September 1983. It was done by the initiative of Professor Yunus with necessary support from the government in the middle of the project, without much consultation with other partner organisations like Bangladesh Bank and other financiers. The proposal was initiated by Professor Yunus, then project director of the Grameen Bank Project, or GBP. He explained the reason behind this sudden decision in a formal proposal to the Bangladesh Bank on 30th March 1982, where he wrote—

The relationship between the branches (*of participating banks*¹⁸⁶) and their respective GBP units has always been hostile. It is not improving at all. If this relationship continues, the whole project will collapse at one stage.....Under the circumstances, I propose that the present organizational structure of GBP be reorganised...¹⁸⁷

The central essence of the above statement(s) is the presence of conflict and contradiction between government institutions (the participating commercial banks)

¹⁸⁶ Italics inserted by the researcher

¹⁸⁷ Letter from Project Director, Dr Muhammad Yunus, to the Governor, Bangladesh Bank on March 30, 1983 [File no: RCPD (GBD) 537(P) 82-Vol-II; P.1]. Italics inserted by the researcher.

and a semi-autonomous project, run by a private project director. The presence of this tension was retold by Professor Yunus in his recent interview (Yunus, 2014), thirty-two years after his extended filial bondage with Grameen Bank once again contradicted and clashed with the government a few years ago in March 2011.

The emergence and development of Grameen Bank was never a smooth, contradiction free process, though it received considerable attention and support from national and other governments, as well as international agencies. At different stages, there were various kinds of hostile relations between the private interests of Grameen Bank and the Government, representing the so-called public interest. Sometimes donor interests also played a crucial role. Looking back into the history of Grameen Bank from this perspective of contradiction through a 'Game Theory' and 'Agency problem' lens, would help us to unravel the underlying political economy of an emerging economic institution of Microfinance in Bangladesh.

In this particular game, the prominent players are Grameen Bank as an agent and the state as the principal, who choose one strategy or another to counter the other, which in turn yields certain payoffs for each of them. This chapter uses the game theory framework under the broader IAD framework, and is mainly based on selected documents of Bangladesh Bank and interviews related to the emergence and development of the Grameen Model of Microfinance in Bangladesh through field level interactions. The framework in figure 6.1 provides analysis of how the Grameen Bank evolved over a thirty year period (1983-2013) to institutionalise the basic concept of microfinance which had a profound impact on other organisations entering the market, following Grameen's concept. Grameen Bank has gone through a long zigzag journey to enhance societal welfare, gaining more autonomy in operation, and improving its sustainability. Many issues like ensuring accountability in its operations for good governance, evolved from protracted battles with the government. However, issues like borrower-shareholders enjoying property or ownership rights, still remain an area of controversy.

This chapter initiates discussions around the 'Principal-Agent' problem, present from the very inception of Grameen Bank. It unfolds the issue under three broad categories: a) how different players started bargaining on certain issues while finalising the draft ordinance, b) how the agent persuaded the principal at a later stage, after enactment of the Ordinance, to gain more power over the organisation and became partially successful, and c) how other participants like Bangladesh Bank and

the borrowers or members of Grameen Bank have been left out of the game in the process, due to the particular nature of the policy environment and interaction pattern between principal and agent, the two main participants in the game.

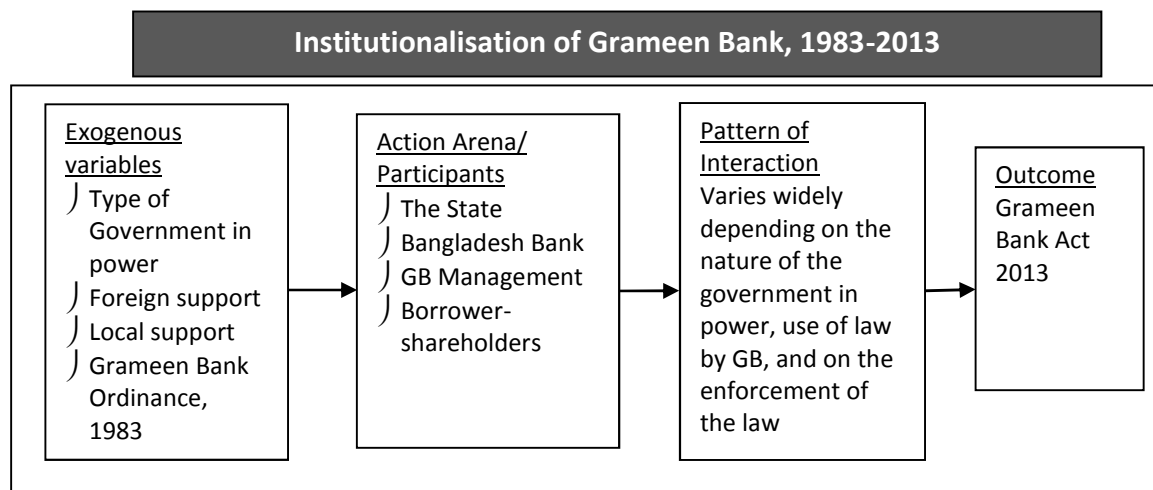


Figure-6.1: Evolution of Grameen Bank in institutionalizing microfinance in Bangladesh

This chapter contains seven sections altogether, including the introduction. The next section presents a critical analysis of the different strategies of different players that gave the Grameen Bank its initial organisational shape under the Grameen Bank Ordinance, 1983. Section three reviews the basic legal framework of the bank, where the government is the principal, and GB is the agent. It identifies some loopholes in the law, creating a principal-agent problem in this case. It also discusses subsequent amendments to the law. The fourth section discusses how the Bangladesh Bank became involved in this principal-agent problem though it was not supposed to. The next section presents an analysis of the property or ownership rights of borrower-shareholders, the grey area of the law. The final outcome of the game played by principal and agent, and the corresponding payoffs are discussed in section six. The last section presents the major conclusions of the chapter.

6.2 FINALISING THE DRAFT ORDINANCE: DEBATES AROUND STRUCTURE AND CONTROL

The following five major participants all played one or another role in the emergence of Grameen Bank (GB), its transformation from GBP under the Bangladesh Bank, to the GB under the government:

- a. The participating banks
- b. The Bangladesh Bank
- c. The Government
- d. The Project's management
- e. The borrowers

Of these five participants, the Bangladesh Bank, the government, and the project's management, mainly the project director, were the three principal actors who played very interactive and important roles in the whole process of transforming GBP into GB. Although, Bangladesh Bank had either been thrown out of the game, or distanced itself in the later phase of the process, after realising there was no chance to win or that it had no role to play¹⁸⁸. So, the final game was played between 'the government' and the 'project management/director' on the issue of whether it would be 'under full control of the government' (the Principal) or 'under full control of the proposed bank management' (the Agent). This 'control' had dual features, a) ownership control, and b) management control, which again could be extended from 'full ownership' to 'no ownership' and 'full management control' to 'no management control'. Both the government and project management had been playing with these issues to find an optimal or stable solution which could be an apparently acceptable blend of 'ownership control' and 'management control', accepted by both parties for the time being. The donors and the clients were both inactive in this part of the game.

Ownership may be viewed as a bundle of rights and obligations associated with the use and distribution of property or item. There are different forms of ownership, the most familiar and common of which is ownership by those persons, individual, or organisations that supply the firm with financial capital. The diverse pattern of ownership raised several questions from a law and economics perspective, such as underlying economic factors for variation, the influence of law on this pattern, and the extent to which that facilitated the formation of management of ownership (Newman, 1998; Volume-2; P.730-740). The ownership issue is a vital issue from the perspective of an economic transaction as well; it has a whole range of consequences related to an organisation's governance¹⁸⁹, and ultimately its future.

¹⁸⁸ 'Bangladesh Bank had no role to play' in this process, mentioned by Professor Yunus (Yunus, 2014; P. 456).

¹⁸⁹ Governance comprises the mechanisms, process, and institutions through which citizens and groups articulate interests, exercise legal rights, meet obligations, and mediate conflicts (for further reading Hyden, Court and Mease, 2005).

‘Management control’ is another area that has been gaining more and more importance especially after the recent financial crisis where management was involved in risky business for more short-term gains or the personal gains of managers. The owners of the firm must bear the cost of controlling firm managers which are commonly labelled as ‘agency costs’. Two principal components of agency costs are monitoring costs and the costs of managerial opportunism, that result from the owners’ failure to monitor the managers with perfect effectiveness. However, a firm with multiple owners or owners with diverse interests, or where ownership is not clearly defined, face many difficulties associated with governance issues such as voting rights in selecting directors, collective decisions concerning management, etc. (Newman, 1998; Volume-2; P.740). Since GB was owned by multiple owners, including the government, where ownership rights were not clearly defined in the law, the issue of ‘management control’ has become very crucial for the bank which has affected the sector as a whole¹⁹⁰. The chief executive of GB exercised single autonomous power to control the organisation¹⁹¹, that originated mostly from his long association with the organisation.

What kind of ownership structure was envisaged for this particular organisation, the GB? Initial discussions between participants reveal that it was not very clear in the minds of the actors who participated in the discussion and in drafting the legal structure. They shifted from one form to another to find a kind of ownership which would fit the original vision of ‘reducing poverty and unemployment’. The Grameen Bank was never conceived to be a profit maximizing type of private organisation by anybody, neither by the project director (PD) and founder, Professor Yunus, nor the government. Wide-ranging suggestions were offered by different stakeholders at the time, mainly by the founder, the government, and the Bangladesh Bank. A chart of the evolution of the preferred options of various stakeholders is presented in Appendix-C1.

As the chart indicates, the founder initially proposed to Bangladesh Bank in March 1982¹⁹², the idea of ‘an autonomous project participated in by all NCBs, BKB, and Bangladesh Bank’. He stated in the proposal that this new project would be run

¹⁹⁰ Concern expressed by a governor of the Bangladesh Bank (Rahman, 2014).

¹⁹¹ As mentioned in the Grameen Bank Commission Report published on 9th February 2013 ([URL:http://www.mof.gov.bd/en/budget/gb/Grameen_Bank_Interim_Report.pdf](http://www.mof.gov.bd/en/budget/gb/Grameen_Bank_Interim_Report.pdf), accessed on 22 September 2014).

¹⁹² Letter from Project Director, Dr Muhammad Yunus, to the Governor, Bangladesh Bank on March 30, 1982 [File no: RCPD(GBD)537(P)/82-Vol-II; P.2]

independently, and that it could be transformed into an independent bank if the proposed project proved successful. However, by August of the same year, he expressed interest¹⁹³ in creating a new institution with the name ‘Grameen Bank Limited (GBL)’, initially to be fully sponsored by the Bangladesh Bank with the option open for its group members to buy 60 per cent of GBL shares. In response, the Bangladesh Bank proposed the establishment of an independent company with provisions for public shares. It recommended that the new company could be owned either by the government, the Bangladesh Bank, or existing banks, taking into consideration the founder’s proposal of this proposed organisation collecting deposits from the public.

Accordingly, the founder prepared the first draft of its Memorandum of Association (MoA) proposing the creation of a bank under the Bank Companies Ordinance/ Act by keeping 60 per cent of its shares reserved for group members, the rest to be held by the Bangladesh Bank, NCBs, and BKB. However, the Bangladesh Bank initially disagreed with the proposal of establishing a full-fledged bank at the beginning; it suggested establishing a public limited company or non-bank financial institution instead. Moreover, it proposed 50 per cent shares for the public instead of 60 per cent. The participating NCBs and BKB also never agreed to the proposal of separating GBP into an independent organisation before project completion. They were apprehensive about the sustainability of this program, considering its costs and nature of operations.

The government’s first documented response was in late December 1982¹⁹⁴, when it expressed interest in building a special kind of bank by keeping it outside the purview of the Banking Companies Ordinance, i.e., outside the purview of Bangladesh Bank. In the same paper, the government further explained that creating a bank would be more attractive to potential donors in reaching target groups instead of forming it as a lending agency. The Bangladesh Bank objected to the government proposal of keeping the proposed bank outside the purview of the Bank Companies Ordinance Act. In spite of this, the government was found reinforcing its decision regarding establishing a special type of bank outside the Bank Companies Ordinance, by keeping the majority of its shares under government control. It instructed the

¹⁹³ Letter from Project Director, Dr Muhammad Yunus, to the Governor, Bangladesh Bank on August 20, 1982 [File no: ACPD(GBD)537(31)/82-Vol IX; P.2]

¹⁹⁴ Letter sent by MoF to the Governor, Bangladesh Bank about the meeting (meeting held on 26 December 1982 at the Ministry of Finance)

Bangladesh Bank to prepare a draft for a necessary legal arrangement with the help of the founder and BB complied. Curiously though, Professor Yunus offered 100 per cent share to the government initially for the first five years in the draft regulatory framework he had prepared in May 1983 as per government instruction, which contradicted the government's decision of keeping 60 per cent for itself. He also proposed, in this draft, to transfer 40 per cent of its share to the borrowers after the end of the initial phase of five years. It is worth mentioning here that the Bangladesh Bank pointed out this 'minor change' in the draft regarding share distribution, and requested Professor Yunus to revise the draft in keeping with the government's decision, which he did finally. An official note of the Bank describes it (by quoting him) as follows:-

minor change in the draft specifying a certain period for holding cent per cent shares by the Govt. taking into account the practical difficulties which may be faced in the initial stage for floating the shares among the service taking people for consideration of the Government¹⁹⁵.

Finally, the government passed the Grameen Bank Ordinance 1983 in September by keeping it outside the purview of the Bangladesh Bank and Bank Companies Ordinance. It kept the provision of 60 per cent share for the government and the rest 40 per cent for borrower-shareholders. It stated in the law that Grameen Bank would be working in the public interest. Figure 6.2 summarizes the above facts regarding how the final idea of forming Grameen Bank under a separate law evolved from discussions among three players, that is the Project Director of GBP, the Government, and the Bangladesh Bank, where the first two players played the dominant roles.

Professor Yunus' interpretation of bargaining this issue of ownership with the government, however, differs with the above facts of the official documents. Regarding this matter he mentioned in 2014 (Yunus, 2014; P. 454-455):

After getting the first draft, he (*Finance Minister*) said that "you (*Prof Yunus*) need to give something to the government, otherwise how will I promote it? (*You*) will have to give a share to the government. If (*you*) don't give anything to the government, the government may not be interested in it". Then I proposed 25% (*for government*)..but when he (*passed the law*) .. it was gone. (*He kept*) 60% for government and 40% for borrowers. I said "no (*it cannot happen like that*)", I did not agree with the decision then he (*Finance Minister*) was in trouble. Law had been passed, but I disagreed (*with the decision*).. He (*the Minister*) called me for

¹⁹⁵ Official note of the Bangladesh Bank signed by the Governor on May 8, 1983 (sum 45, P.2)

discussion...and said: “you start it as it is now, the law cannot be changed, I will eventually change it from the Ministry”. I said, “I wished to get 100%, you wanted to push government ownership, so I offered some for that reason but now...”¹⁹⁶

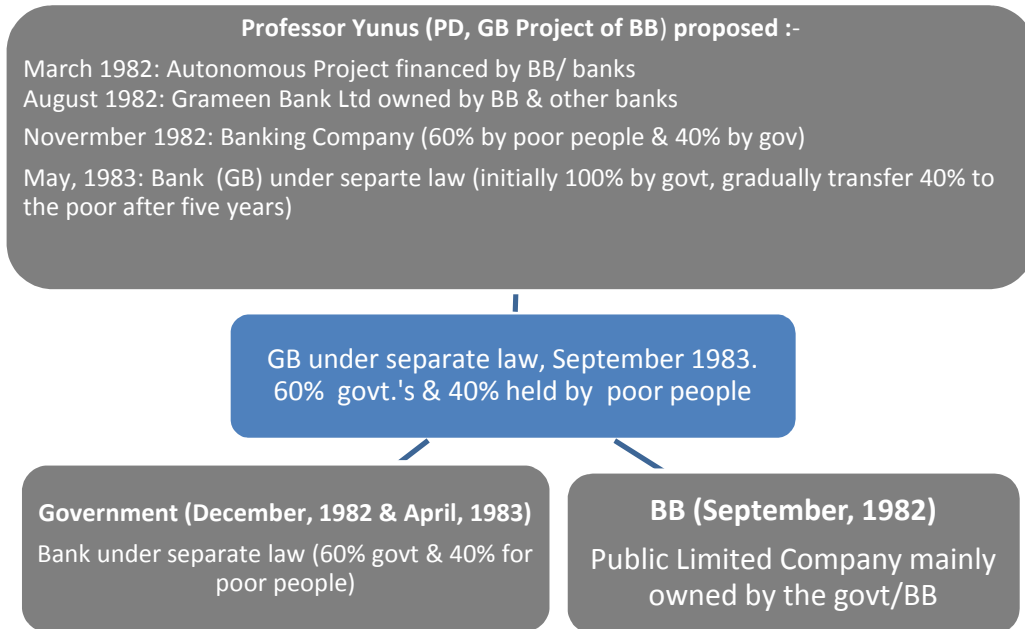


Figure-6.2: Convergence of ideas in forming Grameen Bank

He made similar comments in his autobiography as well (Yunus, 2004). All these unsettled or partially settled issues concerning shares and ownership of Grameen Bank remained an area of conflict for a long time which eventually has grown into a grave misunderstanding between many stakeholders. What kind of organisation is Grameen Bank? Is it a public organisation or private? This question finally brought the bank to Court to settle the issue 27 years after GB was established and had fully bloomed.

On the other hand, keeping Grameen’s management under the full control of the Project Director was one of the main reasons why the initiative of transforming GBP into an independent organisation was taken before completing the project period. So, this issue also prevailed during the discussion as it is reflected in the content of Appendix-C1 under the column of opinion of Professor Yunus/ project management. In his first proposal which he sent to Bangladesh Bank in March 1982, Professor Yunus proposed that the Governor of Bangladesh Bank would be the chair of the Board of the new setup. However, in the second proposal he sent in August 1982, it

¹⁹⁶ Italics inserted by the researcher.

was the Managing Director who would be the Chair instead of the Governor, and he proposed that he would be the Managing Director for the first five years. It should be noted here that the Martial Law Administrator, Lieutenant General H M Ershad, came into power on 24 May 1982, the country was in political turmoil. It can also be cited here from his interview (Yunus, 2014) that Professor Yunus had a chance to discuss the issue with an ex-high official of the government at the time, who eventually became the Finance Minister under the Martial Law government. In the interview, Professor Yunus also mentions that he met the Finance Minister for help in transforming GBP into GB and was given assurances in this regard. Therefore, it is assumed that this positive signal from the highest echelons of government gave him confidence to take charge of the organisation later, in August 1982. He prepared (at the request of the government via the Bangladesh Bank) the first draft of the law with the help of a renowned lawyer (Yunus, 2004; P. 158)¹⁹⁷ of the country, giving him full control of the proposed organisation. In the meantime, his connection with foreign donors gave him more confidence (Monwar Uddin Report, 2011¹⁹⁸) and power in a country like Bangladesh, which was very much dependent on donor funds at that time.

However, the government did not agree to his draft proposal, and the government decided to retain power in appointing the MD and Chairman, as well as most of the other Board members. The government passed the law at its discretion without further discussion with the stakeholders. This finally initiated another battle with the newly empowered bank management which continued till 2011. As a result, ‘management control’ of the GB swung like a pendulum from ‘full control in the hands of the government’ to ‘full control in the hands of GB management or Board’, depending on the nature of the government and Grameen’s ‘good will’ in the books of the particular government in power. Ultimately politics became an important factor.

Finally, despite these two unresolved issues of ownership control and management control, Grameen Bank emerged as a full-fledged specialised microfinance bank, mostly under the control of the government, where any effective role of the Bangladesh Bank could not be seen publicly.

¹⁹⁷ Dr Kamal Hossain, a renowned lawyer of the country also served as Minister of Law from 1972 to 1973 and as Minister of Foreign Affairs from 1973 to 1975.

¹⁹⁸ A committee formed by the government on 10 January 2011. This committee submitted a report to the government on 25 April 2011.

6.3 THE LAW AND RELATED AMENDMENTS

Basic legal framework and certain loopholes in the law

The Grameen Bank Ordinance, 1983 (Ordinance No. XLVI of 1983) was signed by H M Ershad, the Chief Martial Law Administrator, on 1st September 1983, that was published as a gazette notification by the government on 4th September of the same year. According to the preamble of the Ordinance, the aim of this law was “to establish a Grameen Bank to provide credit facilities and other services to landless persons in the rural areas” of Bangladesh¹⁹⁹. ‘Landless person’ is defined in the law as a person who or whose family owns less than 0.5 decimals of cultivated land, or who or whose family owns property, the value of which does not exceed the value of one acre of cultivable land based on prevailing market prices in that particular locality. Initially, of the Bank's authorised capital was Taka 10 crore which was divided into 10 lakh ordinary shares of Taka 100 each, and its paid-up share capital was Taka 3 crores which was divided between the government (60%) and borrowers (40%).

The general power of running (direction and superintendence) the bank was given to a ‘Board’ that comprised altogether 12 directors, 8 of them to be appointed by the government and the remaining 4 to be elected by borrower-shareholders²⁰⁰. The Chairman would be nominated by the Government from within the government's nominated directors, other than the Managing Director, as mentioned in the law. The Managing Director would be counted as one of the directors and be appointed by the government as well. It was specifically mentioned in the law that GB should act with due regard for the public interest and should be guided by the Government on policy matters²⁰¹. GB was given the power to collect deposits, and to provide insurance services to its borrowers. Besides this, some other functions were assigned in favour of GB with the exception of foreign exchange transactions, which can actually be considered as the broad-based sanction of activities, though some of the activities might need prior ‘approval of the Government’ as per initial statements of the law. The bank was also given income-tax, super-tax, and business profit tax exemption until the government said otherwise²⁰². The Appendix-C2 contains a summary of the basic legal framework of Grameen Bank under which it started working as a separate

¹⁹⁹ Initially it was applicable only in six districts (Dhaka, Chittagong, Tangail, Sylhet, Rangpur and Patuakhali), as mentioned in an official Notification of the government (S.R.O. 351-L/83 dated 13.9.83)

²⁰⁰ Section 9 of the Ordinance of 1983

²⁰¹ Section 8(2) of the Ordinance of 1983

²⁰² Section 33 of the Ordinance of 1983

organisation, the first microfinance organisation of Bangladesh that played a significant role in shaping microfinance institutions of the country at later phases of market development. This Ordinance gave Grameen Bank the power to work as a formal, specialised financial institution dedicated to the poor of the country. On the one hand, it received recognition and initial capital support from the government, and on the other hand it also became a statutory body, apparently under government control.

This Ordinance acts like institutional statements that describe opportunities and constraints which create expectations about an actor's behaviour and permits actions or outcomes for participants in the action arena. It is implied by the law that the government appointed Grameen Bank's Board to act on its behalf, and there should not be any conflict of interest in carrying out the act, where the government is the 'Principal' and the Board of the Bank is the 'Agent'. The Board was given the responsibility and power to run the business both in favour of the government as well as borrower-shareholders. The law talks about appointing or electing directors, but remains silent about how the 'Principal or Owner' is going to monitor Agent's activities, whether the Agent has been performing its duties as per the law and the greater benefit of shareholders, or what action(s) would be taken by the 'Principal' if the Agent does not comply with the rules. None of the statements in the Ordinance specify anything that defines the Principal's role in case of Agent non-compliance with legal bindings, which seems to be one of the crucial weaknesses of this Ordinance. The Agent is given all freedom to work without being monitored, except submitting an annual audit report, and it has also been given 'Indemnity'²⁰³ against all losses and expenses incurred by the directors of the Board, except such as are caused by any wilful act or default.

But the law keeps provisions for a penalty for borrower(s) who wilfully provide false documents to the bank and the bank is given the power to recover its dues under the 'Public Demands Recovery Act, 1913'²⁰⁴. Again, 40%²⁰⁵ of the total share capital is held by the borrower-shareholders whose rights and powers are not specified in the law other than mentioning that four out of twelve directors would be elected by them and that a borrower-shareholder is permitted to transfer his or her

²⁰³Section 30 of Grameen Bank Ordinance, 1983

²⁰⁴Section 28 Grameen Bank Ordinance, 1983

²⁰⁵It has changed into 75 per cent by an amendment

share to another borrower of the same class²⁰⁶. Also, due to vaguely defined property rights or ownership rights regarding shares, the above two rights of borrowers have functionally ceased, ultimately leaving almost nothing for them.

These two central loopholes, first the Agent's absolute power to act without being monitored or punished by the Principal, and second, the vaguely defined 'property rights' of shareholders created serious enforcement and agency problems in the later phases of development.

Amendments of the law to empower management

From this point of departure, Grameen Bank has started a new battle to set itself free from the government's control which was mostly the desire of its founder Professor Muhammad Yunus. Within two years²⁰⁷ of enactment of the law, he started pushing the government to transfer more shares in favour of borrower-shareholders, to change the composition of Board members, to assign more power to the Board in selecting the Chairman and Managing Director, and to shift controlling power from the government to the Bangladesh Bank or Board of Directors of GB. All these major issues focused on Grameen Bank's independence, to run it like a private organisation²⁰⁸, continued till 2008 with some success at different stages of the political and non-political government, mainly under H M Ershad (both as Martial Law Administrator and President) and the Caretaker Government in 2007/08.

Out of a total of 30 amendments, 26 were passed by HM Ershad; One in July 1986, 25 in 1990 just before Ershad resigned from the power, and the remaining 4 amendments were passed by the Cabinet in 2008. However, the amendments made in 2008 were not accepted by the elected government at a later stage to make them legislation as per the rules of the country²⁰⁹. The major proposals GB sent to the government and the corresponding changes the law made to empower its Board and management are presented in summary in Appendix-C3. All these amendments in the

²⁰⁶ In the draft Ordinance there was a line like 'upon the death of a borrower who holds shares, such shares shall be offered to the heirs of the deceased shareholders on terms to be determined by the Board, and if all or any of such shares are not accepted by the heirs, these shall be disposed of by the Board on such terms as it thinks fit', which had been omitted in the final Ordinance.

²⁰⁷ An unsigned letter dated 11 May 1985 addressed to the Finance Secretary

²⁰⁸ As mentioned by Professor Yunus in a letter to the Finance Secretary on 06 January 1987 (File no: ACPD(GBD)537(P)/83-Vol-III; Sum 63)

²⁰⁹ According to the law of the country, the entire Ordinance made under temporary government should be placed in the Parliament to make it legislation.

law were made in response to requests from Grameen Bank, by the Managing Director.

The first set of amendments in 1986 decreased government shares from 60 per cent to 25 per cent and increased borrower shares from 40 per cent to 75 per cent. It also brought changes in the composition of Board members accordingly; the government was given power to nominate three persons (including the MD and Chair) instead of eight as brought about by this amendment. Professor Yunus again pursued more amendments in 1987 to make GB an independent private organisation. However, no amendments were made based on these requests. Significant changes to the Grameen Bank Ordinance 1983 were made in July 1990, with a total of 25 new amendments. Most of the power the government had in making rules, in approving an auditor, or appointing the MD, were all omitted or cancelled by these amendments. The power of the MD's appointment was given to the Board upon prior approval from Bangladesh Bank. Moreover, Grameen Bank was allowed not to submit any report to the Government or Parliament, and the Board was given absolute power in shaping all the policies.

However, in August 1990, GB again continued to pursue the increasing of share capital in favour of borrowers, which was later granted in a transitional phase of democratic government in March 1991, by a gazette notification, instead of changing the law. GB was successful in bringing almost all the required and expected changes to the law to make it free from government control, except one related to the appointment of a chairperson by the government (Yunus, 2004).

So, GB made one last attempt again in 2007/08 to gain authority to appoint a chairperson. This was during the political rule of another non-elected caretaker government. In the absence of any parliament, this government backed the passage of four amendments by the Cabinet Ministry in February 2008. One of the amendments gave the bank permission to work in urban areas in addition to rural, another transferred the government's power of appointing a Chairman to the Board, and reduced the number of government-nominated directors from three to two. The remaining amendment was related to reducing the government's share from 25 per cent to 15 per cent. Finally Grameen Bank was free from outside control.

Ironically, the reverse process has started since 2011 with the removal of Professor Yunus from the position he held as MD of the bank. In 2012, an elected government cancelled all changes made in 2008, and brought a further amendment

about the MD's appointment. According to this amendment, the Board was permitted to select anybody from a panel of three, formed by a selection committee authorized by the Chairman, after clearance from the Bangladesh Bank.

After that the government passed a new law, namely Grameen Bank Act 2013, that fixed the MD's age limit, and brought back government shares once again to 25 per cent. Furthermore, it linked GB with Bangladesh Bank, giving Bangladesh Bank limited authority in maintaining accounts and reports (audits and annual reports). At the same time, it omitted the clause that allowed GB to remain outside the purview of the Bank Companies Act; indeed, it added that the government retains all rights to apply any clause of any law at any point in time. In fact, in October 1998, the Government first applied Section 44 of the Bank Companies Act, 1991, empowering Bangladesh Bank to inspect GB. Moreover, in June 2003, it again applied Section 45 of the same Act to empower Bangladesh Bank further to give directives to GB²¹⁰.

However, the Appendix-C3 reveals that most of the important amendments associated with empowering GB's management and allocating power to the Bangladesh Bank were done by the government without formal consultation with Bangladesh Bank. In 1986 and 1987, the government sought Bangladesh Bank's comments prior to the first set of amendments made to the Ordinance of 1983, but largely ignored them. In their comments, Bangladesh Bank pointed out that no financial institution should act without any regulatory oversight, of either the Central Bank, or the government. Bangladesh Bank deemed that Grameen Bank should not be allowed to function independently as it pleased, mainly due to its involvement in collecting public savings. My research did not find that any official comments were sought by the government from Bangladesh Bank after 1987, except one in August 1990 regarding increasing authorized capital for borrowers. In response to that request in 1990, the Bangladesh Bank warned the government that such action would further decrease the government's share in GB. This comment too was unheeded by the government. No other official documents were found concerning government requests or Bangladesh Bank's comments on any matter of GB.

²¹⁰ The BB had not given any power to inspect GB in the original law, so there was a requirement to legalize BB's power to inspect GB in 1997/98 for the first time and then again in 1999 to investigate clues behind allegations of financial irregularities (if any) that were raised with the government by one of the donors. The issue of financial irregularities remained vague to the BB. However, it conducted an inspection as per the request of the government, as mentioned verbally by one of the inspectors involved in the investigations who wished to remain unidentified.

Even the recent Act (Grameen Bank Act, 2013) that gives the Bangladesh Bank more supervisory tasks has not granted it any administrative authority to execute. On 06 April 2014²¹¹, the government assigned Bangladesh Bank the duty of electing nine directors from among borrower-shareholders without consulting with the Bank²¹² on the issue. However, the Bangladesh Bank refused this proposal of electing board members on the grounds that ‘there would be a conflict of interest’²¹³. Hence the government formed an Independent Election Commission (IEC) to elect Grameen Bank's board of directors. It is clear from the above discussions that BB's role in the formation of GB as it currently stands seems very insignificant, though recently it has been given certain limited duties.

6.4 ISSUES THAT BROUGHT THE BANGLADESH BANK IN THE PICTURE

On 2nd March 2011, the Bangladesh Bank issued a letter to the Chairman of Grameen Bank mentioning that Professor Yunus had been removed from the post of Managing Director. In that letter the major allegation was that his appointment as the Managing Director became invalid after he reached the age of 60 as per staff regulations of Grameen Bank, and also because the Grameen Bank did not seek prior approval from Bangladesh Bank, as required by the Ordinance (section 14 of 1990's amendment), when reappointing Professor Yunus as the MD in 2000. In fact, this irregularity in appointment was addressed by the Bangladesh Bank in one of its inspection reports in 1999 referring to an earlier reappointment of Professor Yunus as MD by Grameen Bank in 1990, without prior approval of BB. The obvious question then is why did BB not take any action immediately after the reappointment in 1990? To answer this question I went back to 1999 and looked at some internal official documents and records of the Bank for clues²¹⁴, if any.

As mentioned earlier, Grameen Bank was inspected by the Bangladesh Bank first on 22nd November 1998, and again in 1999. In the first inspection report, the Bangladesh Bank pointed out some dubious financial and management actions and involvements of GB with many other so-called subsidiaries and sister concerns. These

²¹¹Grameen Bank (Election of Director) Rules, 2014

²¹² As mentioned by a top level executive of the Bangladesh Bank in an informal discussion on 28th May 2014.

²¹³<http://www.dhakatribune.com/bangladesh/2014/sep/03/muhith-rejects-proposal-ec-conducting-grameen-election> (accessed on 22 September 2014)

²¹⁴ I tried to talk to some staffs of the BB who were involved with the issue during 1999, but they did not agree to be exposed. They have mentioned that some of them had faced some risk in their professional life at later stage due to their involvement with the issues and finally managed to escape.

were mostly established under the name ‘Grameen’ and with the guarantee or financial support of Grameen Bank. The second inspection report raised several serious concerns regarding Grameen Bank’s irregular operations such as: a) non-issuance of share certificates in favour of borrower-shareholders, b) no distribution of dividends to borrower-shareholders, c) no return or benefit given to borrowers on their money deducted for taxes/insurance (5% of loan amount), d) misuse of donor/grant money, e) misuse of group funds (borrowers’ money), f) unauthorized fund transfers to other organisations to give them facilities, g) irregularities in appointing the Managing Director by passing the related clause²¹⁵ of the Ordinance, h) investing funds for commercial purposes instead of utilising them for the benefit of poor people, and so on. All these issues remained unsettled until February 2002, although Grameen Bank submitted its initial reply (compliance report) on 20 June 2001²¹⁶, which remained unacceptable²¹⁷ and unresolved by Bangladesh Bank.

In the meantime, Grameen Bank published a gazette notification on 19 November 2001 which specified the terms and conditions of appointing a Managing Director. The gazette notice said that the age limit and Grameen Bank’s staff rules would not apply to the MD. Later, on 15 January 2002, the Bangladesh Bank initiated a discussion or negotiation with Grameen Bank to settle all the aforementioned unresolved issues, upon the instructions of the Governor of BB, newly appointed on 09 January 2002. What instructions were given by the Governor to relevant officials of BB is not known, but it is evident that he wished to settle the issue and to keep the government informed about it. On the basis of that discussion²¹⁸, on 16 January 2002, Grameen Bank once again submitted its response to charges of irregularities and Bangladesh Bank finally accepted almost all explanations, though there was still scope to clarify matters further. However, the long drawn battle over contentious issues by and large came to an end for the time being.

Grameen Bank was brought under regular inspection of Bangladesh Bank in accordance with Clause 45²¹⁹ of the Bank Companies Act of 1991, though there are

²¹⁵ Section 14 (amended in 1990) which says: MD would be appointed by the Board with the prior approval of the Bangladesh Bank under the conditions as prescribed by regulations.

²¹⁶ http://www.grameen-info.org/index.php?option=com_content&task=view&id=1020&Itemid=924

²¹⁷ Revealed from a note initiated by the Bank Inspection Department-2, Bangladesh Bank (Sum 90)

²¹⁸ No recorded notes was found in the available files regarding this discussion

²¹⁹ On “Power of the Bangladesh Bank to give directions”,

differences of opinion regarding the exact timing of inspection²²⁰. Grameen Bank officially came under the BB's 'soft touch'²²¹ supervision, though the central bank could not really exercise any administrative power as such.

The recent debated issues concerning Grameen Bank became the subject of public discussion suddenly at the end of 2010, after the airing of a documentary on Norwegian television (NRK), "Caught in Micro Debt", by Tom Heinemann, which brought Bangladesh Bank into the picture again. Soon the Bangladesh government formed a review committee on 10 January 2011 to evaluate details of the overall management and position of Grameen Bank. As a consequence, Professor Yunus was removed by the Bangladesh Bank²²², from the post of Managing Director of Grameen Bank after a tenure of more than 27 years. The whole matter was brought under the purview of the Court, which confirmed the central bank's decision of removing him from the post of MD. The High Court found that

..(the) board had not obtained the Bangladesh Bank's sanction to re-appoint Dr Yunus (70), beyond the bank's official retirement age of 60.'²²³

On 15th May 2012, the government formed a special Commission under the Commission of Inquiry Act, 1956²²⁴, mainly to recommend the future of Grameen Bank after reviewing the Bank and its associated organisations. On 2nd August 2012, the government approved a draft of "Grameen Bank Ordinance 2012 to increase or reinstall government control of the bank. The Commission prepared an "Interim Report "and published it on the government's website²²⁵ on 9th February 2013 for public discussion. A workshop followed on 2nd July 2013, where most concerned individuals were invited to present their comments. Finally, the new Act (the Grameen Bank Act, 2013) which made the previous Ordinance, along with its amendments, ineffective, came into force on 10 November 2013. It also brought Bangladesh Bank into the picture again, compelling GB to follow the Bank's

²²⁰Grameen's website claims that BB's inspection was started since 1997 (http://www.grameen-info.org/index.php?option=com_content&task=view&id=1020&Itemid=924).

²²¹Bangladesh Bank conducts inspection on GB on regular basis but the ToR of that inspection is not as strict as it is the case for other commercial banks.

²²² Upon a verbal request from high up in government, as mentioned by one of the policy makers in an informal pre-interview discussion.

²²³<http://www.thehindu.com/news/international/bangladesh-supreme-court-rejects-dr-yunus-appeal/article1601856.ece> (accessed on 22 September 2014)

²²⁴ Bangladesh Gazette published on 27 May 2012

²²⁵ URL: http://www.mof.gov.bd/en/budget/gb/Grameen_Bank_Interim_Report.pdf (accessed on 22 September 2014)

directions in maintaining accounts, submitting reports, and seeking prior approval of the Bank before appointing an MD.

6.5 OWNERSHIP RIGHTS OF BORROWERS-SHAREHOLDERS: A GREY AREA

All the above-mentioned amendments, summarised in Appendix-C3, indicate there was always a disagreement between the government and Grameen Bank management on the issue of power and the question of ownership as well. GB management took the side of one group of owners (landless people) over the other (the government). It was also bargaining with the government to increase the number of shares in favour of landless shareholders and to increase the number of their representatives in the Board accordingly. At the same time, the government was claiming that it (GB) should protect the public interest since GB was a statutory body working in the public interest with government shares and the share capital of small investors, provided mostly by landless people on a large scale.

However, neither GB nor the government had thought about specific ‘ownership rights’ that could be enjoyed by the landless shareholders. They were engaged in protecting their own power in management instead. According to the Grameen Bank Commission report (section 186²²⁶), ‘shares’ are not evidence of ‘ownership’ but rather proof of a ‘certificate of deposit’, or even a ‘fixed deposit’, a contribution to the capital of the Bank without ‘ownership’.

A field survey in 2014²²⁷ also revealed that Grameen Bank, in fact, does not issue any certificate to its shareholders as a legal document to claim ownership; borrower passbooks are the only papers to claim owner membership in the bank. Bangladesh Bank’s second survey in 1999 raised this issue as well. It mentioned that Grameen Bank did not issue any ‘share script’ and it observed that 65 per cent of borrowers in the survey were not aware of their ownership at all. The 1999 report further added that until then, the bank did not provide any dividends to its shareholders. The field survey of 2014 revealed that in practice, shareholders are not allowed to sell shares or transfer them to their heirs, though the law permits them to

²²⁶Interim Report of the Grameen Bank Commission submitted to the Government on 09 February 2013.

[URL: http://www.mof.gov.bd/en/budget/gb/Grameen_Bank_Interim_Report.pdf (accessed on 22 September 2014)]

²²⁷Client survey under this research

do so. They only get back Taka 100 per person as the face value of that unseen and unissued 'share' when they leave the organisation.

The law does not define their ownership rights clearly, especially how to define shareholders, how to revalue shares, how to distribute dividends, how to claim ownership rights, and so on. The law and GB's Board also remained silent for long on the issue of electing Board members from among shareholding members; the process was not at all transparent as stated in the Commission Report in 2013. According to this report (section 148-150), shareholders do not directly vote to select Directors. Instead, it is a kind of tired 'Electoral College' process where the 'center leader' acts as the elector, which is again based on 'consensus building' from the lowest level under the supervision of the loan officers²²⁸.

Furthermore, according to the law, a landless shareholder representative would never be nominated as Chairman²²⁹. Moreover, neither the government nor GB management cared about the quality of Board Members. Board members were given all the power to run a legal body where they took all the decisions regarding financial management, business expansion, capital structure, and so on, but two thirds of those Board members were nominated, not elected according to the law²³⁰, nor had the expertise to understand such technical matters, especially financial literature. All the 'nominated' directors were rural women from a very backward socio-economic and conservative cultural society, where women generally are not encouraged to talk, argue, or be vocal publicly. So, they had no idea about what a 'share' stands for²³¹, what are the benefits associated with 'buying' shares²³², what a share certificate looks like²³³, why they were not given any dividends on their shares year after year²³⁴, why

²²⁸ Grameen Bank Commission Report, 2013; section 148-150.

²²⁹ Amended in 1990, where it mentioned that a Chairman would be appointed from amongst the appointed Directors, not from both appointed and elected Directors.

²³⁰ There existed no fare election procedure, as mentioned in a report prepared by the Grameen Bank Commission in 2013 and published in government website.

²³¹ As mentioned in an inspection report of the Bangladesh Bank which conducted in 1999.

²³² As per the survey conducted by the researcher in 2014

²³³ As per the survey conducted by the researcher in 2014. Borrowers/ members faces remained blanked when I asked them whether did they have a copy of a share certificate and would show it to me. They mentioned that they only had 'pass book', they asked me how it looked like and what that meant.

²³⁴ As mentioned in an inspection report of Bangladesh Bank (conducted in 1999). GB started giving dividends in a later phase, sometime from mid-2000; recent pass books of members documented it. But members are not generally aware of that dividend, and they do not count it as significant since it is just a small amount of money (taka 20-30 a year) posted in their pass books where they have a few thousand takas of debt and are paying interest on those debts every week at the rate of 20% per annum.

they do not have voting rights to elect their representatives²³⁵, why their savings (5% tax for group funds), instead of being returned to them, were deposited into a ‘welfare fund’ after they left the organisation²³⁶. They had no clue why they were given the ‘face value’ of shares instead of the ‘market value’ when they were given back their shares²³⁷, why they were not permitted to transfer shares to another person or heir²³⁸ when they left GB, though that was legally permitted. One might ask what benefits GB’s members received in their lifetimes from GB’s investment of their money in other businesses under its name²³⁹.

In this connection, I had the following conversation with Professor Yunus in 2014 (Yunus, 2014) about the unusual provision of giving only the ‘face value’ of a share instead of the much appreciated²⁴⁰ ‘real value’, when any shareholder wished to leave the organisation:

Lila: What happens to a share when a shareholder wants to leave the organisation? Can she/he transfer her/his share to another person as the law mentions?

Professor Yunus: She/he cannot hold the share (*if she/he wishes to leave GB*), that is the main message. As long as she/he is with GB she/he can enjoy the share. But that person should surrender the share if (*she/he*) wishes to leave.

Lila: How much does a shareholder get back if she/he wants to leave the organisation, just Taka 100 (*the face value*) or more?

Professor Yunus: (*shareholders*) would get Taka 100 back at book value/paper value since it (*share*) does not have a market (*not traded*). Branch takes it back; gives it to a new (*member*). (*The old member*) does not need to search another person, (*she/he*) will just give it back and take the value of Taka 100.

Lila: Generally, people get the share value at market price in other places. Why is it different here?

Professor Yunus: Since there does not exist any market for this (*share*). Nobody can buy this share except Grameen Bank’s borrower; therefore, the system is like this.” (Yunus, 2014; P. 463-464)²⁴¹

²³⁵ Survey in 2014; Commission report in 2013 and also confirmed by one of GB’s retired senior employees on condition that the researcher would not disclose the name.

²³⁶ Inspection report of BB, 1999

²³⁷ Survey conducted by researcher in 2014 and also information verified with Professor Yunus during interview in 2014. Two old GB members from the 1980s who continued membership for over 20 years, and received the same taka 100 after so many years (money even lost its face value over such a long period) after paying back all their dues when they left the organisation. Their daughters/ sons are now GB members who remained in almost the same economic condition, probably slightly uplifted, because now grand-children are going to school.

²³⁸ As mentioned by an old member of GB during survey, 2014.

²³⁹ GB opened many business ventures; some were under guarantee, some under direct financial support. (Monwaruddin’s Report of 2011 and Commission report, 2013)

²⁴⁰ It would be at least a few thousand takas if calculated on the basis of outstanding number of borrower-shareholders and actual net assets of GB.

²⁴¹ Italics inserted by the researcher.

These were not at all simple issues and not easily understood, even by many urban educated people, if they do not have minimal financial literacy. Therefore, these so called 'elected' directors' voice remained unheard by the Board on any policy matters²⁴². Neither the Board of GB, nor the government, nor civil society members, whether critical or supportive, nor foreign development partners or policy makers, asked any of these fundamental questions regarding how borrower shares were protected and what rights shareholders had, though everyone was saying that GB was owned by its member-shareholders²⁴³, the poor of the country. It also needs to be mentioned here that not all members-borrowers of GB were shareholder members²⁴⁴, but the general perception of the people was not so.

6.6 OUTCOMES OF ACTIONS AND COUNTERACTIONS LEADING TOWARDS THE DOMINANT STRATEGY EQUILIBRIUM

The historical development of institutional rules associated with GB described in the previous sections, reveals there are primarily three parties (figure-6.3) who have claims on the organisation with different levels of rights. The government has been claiming control and ownership rights from a 'public interest views of regulation'²⁴⁵ since the government created GB as a statutory body where it has shareholding rights as well. The 'borrower-shareholders' are another stakeholder; they have ownership rights as they provide the lion's share²⁴⁶ of paid-up capital, although their rights and obligations are not well defined in the law. They also lack the capacity to intervene or play a move because of their extremely vulnerable situation. Hence, they remain ineffective (on the weaker side of power and control).

Borrower-shareholders do not have very specific rights to exercise their power and control on the dynamic development of the organisation, except 'electing' their representatives to the Board, which in reality has also been snatched away from them. They are therefore logically not considered a party in the Game to decide the equilibrium outcome. So, the government and GB management (blue colour in figure-

²⁴² Monwaruddin's report of 2011 and Commission report of 2013

²⁴³ "This arrangement has made Grameen Bank virtually unique among the thousands of micro-finance institutions established in Bangladesh and now proliferating all over the world. The concept of ownership by the women borrowers was intended to both empower them as well as invest them with the responsibility to oversee the affairs of an organisation designed to serve them" comments made by Professor Rehman Sobhan in Dhaka Tribune, a national daily (Sobhan, 2013).

²⁴⁴ As mentioned in Commission report, 2013

²⁴⁵ As a desire to pursue collective goals with the aim of promoting the general welfare of the people (for further reading see Mercurio, Nicholas & Medema Steven G., 1997)

²⁴⁶ As per the law (Grameen Bank Act, 2013) they hold 75% of paid-up capital

6.3) are the two dominant players in the game who decide the final outcome. Though the government wishes to control the organisation with the help of the law, it does not clearly specify in the law, a mechanism for monitoring and supervising GB, other than nominating some directors to the Board, including the Chairman. The law does not even specify what actions the government will take if the Board does not comply with the provisions of the law (no specific sanction)²⁴⁷, which has created a serious enforcement problem. Thus, the game actually starts from this hazy area of “Getting More Control”.

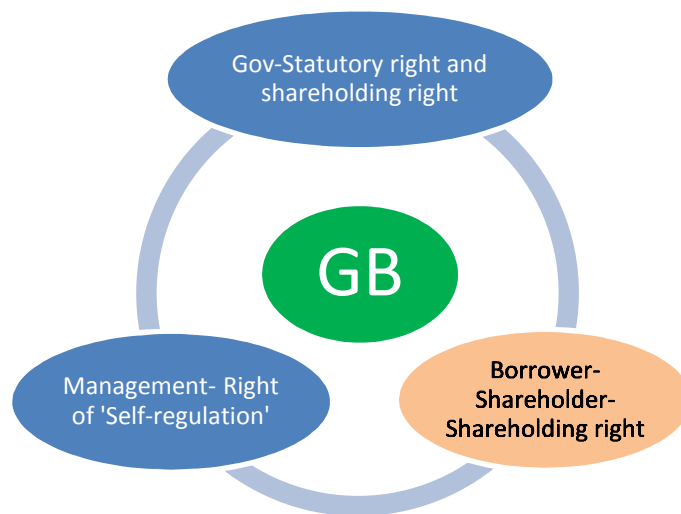


Figure-6.3: The Grameen Bank under the power of three major stakeholders

Both players would like to take policy decisions (actions) to gain control of the organisation (their preferences), this may create a dynamic GB game which can be modelled as a strategic game between the government and GB management. Table-6.1 shows the probable outcomes of the historical game as a matrix, where the column shows government strategy choices, and the row shows GB’s choice of strategies. Initially, before 2010, both government and management had available to them, two strategies, either to ‘do nothing’ or ‘move forward to get more control’ (2 by 2 matrix). However, after 2010, the third strategy of ‘battle’ emerged in the scenario (now 3 by 3 matrix), especially when the Government moved to remove Professor Yunus from the position of MD in March 2011. The action combinations result in certain payoffs for each player; the outcomes are shown as payoff vectors in table 6.1.

²⁴⁷ According to the grammar of institutions (Crawford & Ostrom, 1995) the provisions of the law act like norms/ shared strategies in the game instead of rules which are distinguished from norms by adding explicit consequences for violating rules.

Table-6.1: Strategic game between the government and GB (1983-2013)

		The Government		
		Strategies	Do nothing	Move forward to get more control
The GB Management	Do nothing	(0, 0)	(-1, 1)	(0, -1)
	Move forward to get more control	(1, -1)	(-1, -1)	(-1, -2)
	Battle	(-1, 0)	(-2, -1)	(-3, -3)
	Strategies			

The relative payoffs may be identified by some numbers like 0, 1, 2, 3 where (0, 0) is the most expected stable condition when none does anything to get control, and peaceful coexistence persists. $3 > 2 > 1$ as mathematical numbers indicate higher payoffs in terms of ordinal ranking. The signs before the numbers indicate whether the situation is good (positive) or bad (negative) for the respective players. For example, when one player takes a ‘move forward to get more control’ and achieves it, then that player also improves its control with an increased pay-off (+1), whereas the other player loses control power by -1. Therefore a ‘move forward to get control’ by both the players simultaneously creates a hostile situation, and both players are likely to lose points by -1 (row 2 and column 2).

However, when a 'Battle' starts, the situation becomes worse. Because a ‘battle’ makes them mutually suffer further, nobody gains anything. But the player, who makes the first 'battle' move unilaterally, loses more points due to an extra bad public reputation. When one player is in ‘battle’ and the other one does nothing, the first player loses points while the second player loses nothing. However, when the second player also moves forward, it makes the situation worse for both of them, and it follows that when both are engaged in battle aggressively, the most likely outcome would be a worse payoff for both (row 3 and column 3).

The step of ‘move forward to get control’ increases payoffs for the one who succeeds. However, the same step taken by both of them simultaneously on the same

front actually lowers both of their respective payoffs by '1' because this creates tension and mutual loss for each. Despite its lower payoff, 'move forward to get control' seems to be the dominant strategy in this game, and both the players ended up with (-1, -1), the dominant strategy equilibrium, which is also the Nash equilibrium²⁴⁸ in this case.

The game historically started after enactment of the law in 1983, which has gone through different stages under various combinations of strategies taken by both players, depending on their historical objective functions and historically available moves. In the extreme case when they are both engaged in battle, they reach (-3, -3), following the path shown by the red arrows. Since both the players are in very bad shape at that point, the game takes its path towards Nash equilibrium again, following the green arrow path with enactment of the new Act in 2013 (Grameen Bank Act, 2013). However, both have chances to again reach an expected equilibrium of (0, 0) if both go back to the 'do nothing' stage where the game began.

Interestingly enough, though the rationally desirable and ultimate expected equilibrium (0, 0) is maximizing social welfare (for all stakeholders) the players are at present pursuing individual self-interest and the game advances historically along the path of strategic interactions to the worst outcome. The Nash equilibrium identified here under certain assumptions is actually not improving the joint payoffs of the two players due to tension between the two strategic moves of 'do nothing' and 'move forward to get control'. Therefore, in this case, the dominant strategies are leading them to a socially undesirable outcome of mutual aggressiveness, and it is probably a case of non-Pareto optimal outcome which missed the chance of making the 'economic pie (social surplus)' bigger (Serrano & Feldman, 2013; P.266). Let me also point out here that the actual situation that prevails in this case today is highly similar to the predicted result of this model²⁴⁹.

6.7 CONCLUSION

The GBP of Bangladesh Bank transformed into a full-fledged Grameen Bank under a separate Ordinance, with direct support from the state, bypassing Bangladesh Bank's involvement. In this process, the government and the then project director played

²⁴⁸The state in which no participant can gain by change of strategy as long as the other participant remains unchanged (Serrano & Feldman, 2013; P: 242-249 and Osborne, 2004; P: 21)

²⁴⁹ Till December 2015 no regular MD has been appointed by the government, and no election held to determine GB's Board members (elected members).

major roles in deciding the future legal structure of the organisation. The Bangladesh Bank and the borrowers, the two other important stakeholders, were left out from the game during the process, due to the particular policy environment and interaction pattern between the participants. The government and Grameen management, especially the founder, became involved in a deal while they were negotiating the nature of the future organisational structure. In this phase of finalising the draft Ordinance, Grameen needed regulatory and financial support from the government and in response, the government demanded shares and control in the proposed organisation. Choices are often strategic, and here also the government and the founder played a mutually interactive game, negotiating with each other to reach an apparently acceptable solution regarding its ownership and legal structure. Accordingly, a new Ordinance was passed that treated it as a public organisation, mostly under government control.

Initially the government had more legal control over Grameen Bank management regarding ownership and other rights to intervene in governance related matters. On the flipside of cooperation, a battle was initiated between the government and Grameen management on the issue of 'ownership control' and 'management control'. Gradually those rights of the government reduced due to the continuous persuasion of Grameen Bank management which successfully managed to get favourable support from the state and state agencies.

As per provision of the law, the government acts as Principal, and the GB Board and management is the Agent appointed by the Principal to take care of the interests of shareholders (government 25 per cent and the members of GB 75 per cent). However, the law does not specify how the Principal shall monitor the Agent if it does not comply with the provisions of the law or does not act to protect the interest of shareholders. Both the government and GB's management were much concerned about establishing their own rights and control in the organisation; none paid any attention to the legal rights of shareholder-borrowers who own the major share and supply the lion's share of capital. So, the issue of their rights remains neglected in the law which also does not specify their specific rights and powers in the organisation. What little rights were stated in the law (e.g., the right to transfer shares and elect their members on the Board) was further reduced by the agent at a later phase of implementing the law. In the absence of any effective monitoring mechanism, the agent gained absolute power over time that has lately led to a battle with the principal.

The legal issue of Grameen Bank eventually emerges as a typical example of a Principal-Agent problem. Looking into this 'agency problem' with the game theory tool helps us understand the journey of Grameen Bank that was propelled by a continuous conflict between two interest groups such as 'private' versus 'public'. Professor Yunus claims his agency interest to be the 'private' interest and wishes to gain freedom for GB like a private business whereas the government claims to represent the 'public' and wishes to control GB using government and state machinery. The shareholders, the members, do not understand this debate. They are also handicapped by the hazy content of the law.

In this particular 'agency game' the rationally desirable expected outcome is the maximization of social welfare, but from both sides the major powerful players often exercise dominant strategies of pursuing pure self-interest (i.e. to establish hundred per cent control of the bank held either by government or management) which more often than not, brings forth the worst outcomes. Therefore, Nash equilibrium in this case, under certain assumptions, is not improving the joint payoffs, and it is a non-Pareto optimal outcome situation, where both players miss a good chance of making the 'economic pie' bigger and with larger mutual benefits.

CHAPTER 7

Microfinance Operations of NGOs in Bangladesh:

Law and Economics Discourses

7.1 INTRODUCTION

In general, Law has two roles: one is facilitative, where law is an instrument for controlling social behaviour (implicit price). The other is its expressive role, which says that law works to institutionalise values (economic efficiency, redistribution of resources, and other factors). The law operates as a threat that prescribes a code of conduct and provides punishment for violating that code of conduct. It not only legitimises threat but also realises or implements coercion. Additionally, theories of regulations view the emergence of law broadly from three perspectives such as the public interest perspective, the private interest perspective, and the institutionalist perspective. Public interest views of law aspire to ensure economic efficiency and address market failure, or address political goals such as social justice or redistribution of resources.

In contrast to public interest views, private interest views see law as trying to maximize private efficiency and interests by addressing regulatory failure. This approach has been gaining prominence with the rise of political ideologies in favour of deregulation, emphasizing state failure and the limitations of regulation to address such failure.

The institutionalist approach tends to embody both views. It sees law as an umpire between private and public actors, setting boundaries and policing the boundaries to ensure free and secure interaction between participants. The institutionalist approach tends to downplay law's role in directly controlling the pursuit of regulatory goals, emphasising non-legal organisational and systemic dynamics as crucial to regulatory trajectories. In this approach, law in its facilitative role forms part of the infrastructure that links discourses between the state and the market, community and individuals, and thereby contributes to delineating the boundary between them (Mercurio & Medema 1997; Cooter, & Ulen, 2000; Yeung & Morgan, 2007; Driese, 2012).

In the case of NGO-MFIs in Bangladesh, regulatory issues have emerged phase by phase to address both private and public interests, and hence can be explained by an institutionalist approach. The gradual intervention of NGOs in the financial market is unlike that of Grameen Bank. GB originated on national soil, mostly with the help of local sponsorship, though it was supported by neoliberal policy makers from within the nation and without (Bateman & Chang, 2012) at later stages of its success. Regulatory issues concerning Grameen Bank were very straight forward. Once it was decided to establish a formal financial organisation for the poor, it was done quickly by the state under a separate law. On the other hand, it took a decade to find an acceptable approach for legal rules to guide NGOs into the financial market.

NGOs have started gaining prominence all over the world since the Second World War as a response to ‘government failure’, and also with the rise of globalisation and liberalisation as cited by Issa, G. Shivji (2007)²⁵⁰ and many others²⁵¹. This chapter focuses on discussions around the kind of NGOs who have been involved in multidimensional development work in Bangladesh since the early seventies and have started microfinance operation prominently since the early nineties. The three fundamental characteristics of these NGOs are as follow:

- a. Autonomous organisation,
- b. Non-profit in nature,
- c. Getting funds from voluntary contributions or grants from many sources which include both private and government sources that are both national and foreign.

Therefore, the basic framework of these NGOs varies and that variation depends on many factors like their socio-political origin, sources of funds, the socio-economic environment they work in, the people for whom they work, and the historical path they have followed.

This chapter presents an analysis of the gradual transformation of Bangladeshi NGOs into financial organisations (popularly known as NGO-MFIs) from a legal perspective, as they have slowly become a part of the formal financial market under a

²⁵⁰ In an article on “Silence in NGO discourse: The role and future of NGOs in Africa” he says “I locate the rise, prominence and privileging of the NGO sector in the womb of the neoliberal offensive” (Issa, G. Shivji, 2007; Preface).

²⁵¹ Also see Bebbington & Farigen, 1992 and Edwards & Hulme, 1992

separate, non-conventional institutional framework, outside the traditional rules of the state. This chapter focuses its discussions mainly on the period from the 1990s, when NGO-MFIs started flourishing, to August 2006, just before enactment of the new law²⁵². There were many players in formulating this new regulatory approach where they went through a very complex and fascinating pattern of interaction.

Figure 7.1 presents the framework for analysing the transformation process of NGO-MFIs in Bangladesh from semi-formal to formal financial institutions; this framework is part of the macro IAD framework of this research. It helps to identify participant roles in transforming these organisations, as well as explains how the initial relaxed legal structure of the state helped NGO's microfinance activities flourish all over the country in a very short time. The donor driven NGOs²⁵³ were well connected with the international policy regime that also empowered them to influence the national government in making rules for the sector and in maintaining their autonomy in operation (Khan, Ahmad, & Quddus, 2009; P:16). The national government also helped the sector to grow.

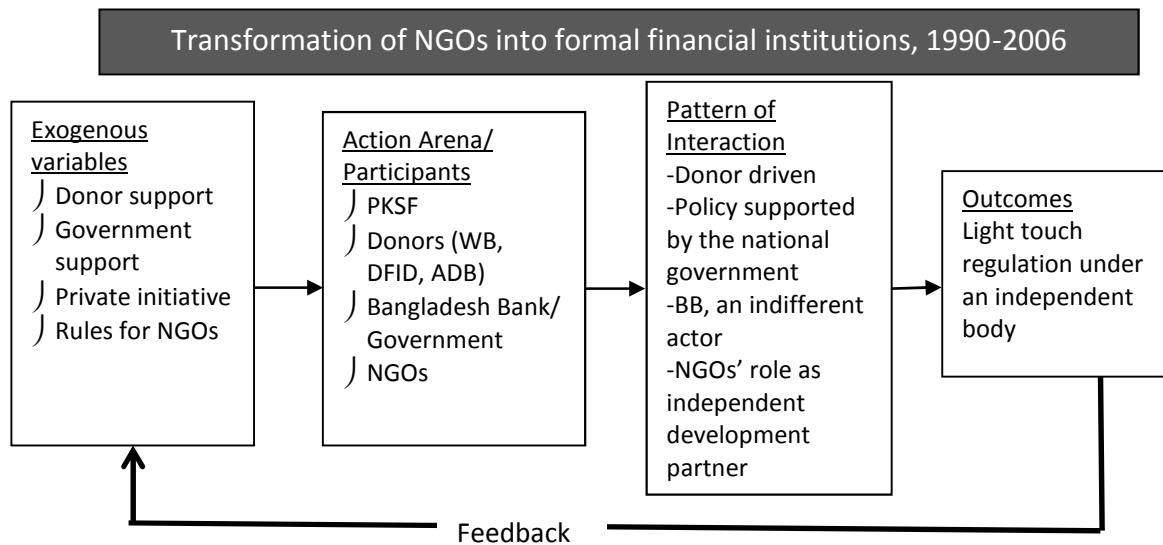


Figure-7.1: The legal transformation process of NGO-MFIs in Bangladesh

This chapter contains six broad sections. Immediately after the introduction, the second section identifies important participants in the game and their roles in developing the sector in a planned direction. Section three describes the general legal

²⁵² Microcredit Regulatory Authority Act, 2006

²⁵³“It was during the late 1980s that donors began to fund NGOs on a large scale....Grants to NGOs averaged \$160 million annually in the first half of the 1990s and have grown to about \$255 million annually since then.” (World Bank, 2007; P.4)

environment under which NGOs were operating before enactment of the new law, and it explains how a ‘policy gap’ was created, facilitating the discovery of new sources of funding for NGOs. The next section illustrates how different players interact with each other in a certain condition of political economy which results in definite outcomes. Outcomes of this game are described in section five, and the final section concludes the chapter.

7.2 A NEW BREAKTHROUGH: THE PARTICIPANTS

There are many views on the question of why NGO financial services started flourishing in Bangladesh after the 1990s. It is generally said that decreasing donor funds and the consequent pressure on financial sustainability in the absence of cheap funds from donors became very crucial for the survival of NGOs since the 1990s. Hence, they entered the financial market out of sheer survival needs. However, there isn't any hard evidence for the “declining trend of donor funds” during the 90s²⁵⁴. It had possibly been a kind of new policy signal to the NGO sector since donors from 1990 onwards, were favouring commercially sustainable microcredit services over other softer areas such as health, education, and advocacy. It probably happened for mixed reasons, such as: a) to lessen the financial dependency of NGOs on donor grant funds, as well as, b) to move their focus from social mobilisation and advocacy to more apolitical areas like social service delivery and microcredit, as mentioned in Quddus, et al. (2009).

The arguments of many of my thesis interviewees signify that there were many reasons which converged in the early 90s favouring NGOs to gradually step into the financial market. NGOs searching for some way out to cope with the changing political scenario, started gaining some insight from the experience of Grameen Bank²⁵⁵. The GB-model also fitted well with the NGO modality because there was an opportunity to blend commercial objectives with social agendas concerning the poor. Initially, NGO financial services were limited to ‘credit’ delivery, which also had an inbuilt feature of collecting a tiny amount of compulsory savings from clients as a precondition for gaining access to credit. This particular

²⁵⁴ For details see aid flows to NGOs in Bangladesh from 1990/91-2004/05 in World Bank (2007), P-60.

²⁵⁵ As mentioned by Sir Fazle Hasan Abed (in Rahman and Rashid, 2011; P.275) “ I would like to take this opportunity to recognize the contribution of Muhammad Yunus – his efforts in establishing microfinance as an effective means for alleviating poverty ...”.

feature of a 'compulsory savings' requirement was more or less designed after the Grameen or cooperative model, as part of credit discipline. However, later on these NGOs increasingly added other kinds of savings (such as voluntary deposits and term deposits) to their service portfolios, probably from the early 90s²⁵⁶. At the same time, they also started borrowing from formal financial institutions²⁵⁷ to meet their increasing needs to finance their loan expansion programmes.

However, the success of Grameen Bank inspired not only local NGOs, but also caught the attention of many international NGOs, and bilateral and multilateral agencies. So local NGOs, especially big NGOs like BRAC and PROSHIKA, received large amounts of funds for microcredit from different international sources during the late 80s to expand their microcredit programmes patterned after the GB model. It has been mentioned earlier in chapter five that donors had been searching for a successful market driven model of a rural financial institution since the late 70s. So, supporting NGOs in entering the microcredit market like GB, and pushing them to become sustainable, was possibly a strategic decision of donors. Khan, Ahmad, & Quddus (2009) have noted it accurately. They write:

The remarkable results of Grameen Bank reinforced the notion that international donors should fund poverty alleviation projects through NGOs rather than the state.(P.6)

The World Bank's less known or now forgotten initial proposal to the government in early 1984, to establish another bank like GB under the NGO banner²⁵⁸ by combining successful elements of Grameen (microcredit) and BRAC (education), to promote self-employment in the rural sector of Bangladesh is primary proof in favour of this interpretation (Shaptahik Bichitra, 19th May 1989).

The World Bank had also expressed interest in financing GB in late 1986 which was rejected by GB management. However, the World Bank, the most

²⁵⁶ BURO Tangail introduced open-access savings facilities to its clients since its inception in 1989 (Wright et al., 2001) and fixed term deposit for 5 years sometimes in mid-90s (A consultancy report submitted by DPC to BB in 1998 as part of the World Bank's Microfinance-1 project). ASA introduced long term deposit scheme for 'members' (same report of DPC) and accepted deposits from whom they call 'associate members' (A letter sent by CDF to BB on 14 December 1999 regarding regulatory framework, also Rashid, A., 2001; P. 273) since mid-90s (Wright et al., 2001).

²⁵⁷ Two significant examples are Swanivar Bangladesh-NCB and ASA-Agrani Bank linkage during mid-90s (Source: Donor/DFID/98-7)

²⁵⁸ Under UERC (Upazila Employment Resource Centre) programme.

influential lender in Bangladesh (Quibria, 2010, P: 24), continued to pursue delivering credit to the rural non-farm sector via NGOs to enhance self-employment for the poor.

Thus, the demonstrative effect of Grameen's success might have played an instrumental role in the expansion of microcredit via NGOs, though NGOs were struggling with a variety of models in the initial stages. They did not have a sustainability focus in the early stages of operation, and their recovery was also very poor. They only endorsed the idea that poor people needed financing along with other support, as stated by one of the senior executives of PKSF (Kader, 2014). In the context of financial sustainability, GB had a comparative advantage to improve its situation as it has access to cheap public deposits like a bank. However, NGOs were neither permitted to collect public savings like banks nor did they have easy access to other commercial sources of finance²⁵⁹ in the absence of a proper legal structure.

In the early stages, the issue of sustainability did not get much attention; overwhelming primary reactions to the poverty alleviating role of 'microfinance' hindered much of the analytical discussions from coming to the forefront. Gradually, the discussions around viability (Hussain et al., 2001) and subsidy came to the forefront. It has eventually become clear that providing continuous subsidy or external financial support to these "supposedly non-state, market-driven" institutions could lead them to become unsustainable and inefficient at the end (Khalily & Imam, 2001²⁶⁰). So, the sector's development towards institutionalisation from semi-formal type to formal organisations went in phases under special guidance.

Take off in a planned direction: Role of PKSF and the World Bank

With policy changes in the donor domain, the national government recognised that NGOs needed funds to expand microcredit operations to alleviate poverty and enhance their capacity, ensuring sustainable development of the country. In May 1990, the creation of PKSF, a wholesale funding agency, was the outcome of a like-minded government's concurrence with the aforementioned circumstances²⁶¹.

In the 80s, the World Bank had expressed interest in providing initial subsidised funds²⁶² to create an apex organisation like PKSF to lend to NGOs for their

²⁵⁹ Except a very few large NGOs like BRAC, ASA who could borrow from banks.

²⁶⁰ This paper discusses expense preference behaviour and inefficiencies of donor funded organisations in the context of regulation and supervision of NGOs.

²⁶¹ For more detail see Ahmed, M. U., 2010

²⁶² US\$50 million

microcredit operations. However, that offer of the World Bank could not be materialised due to some misunderstanding between the World Bank and the government in the final stages related to some conditionality attached to the loan terms (Ahmed, M. U., 2010). So, the government itself had to provide initial funds to PKSF²⁶³ so they could in turn provide loans to NGOs at subsidised interest rates²⁶⁴. The World Bank became involved with the PKSF much later in 1996 with an enormous amount of funds²⁶⁵ for the sector, especially for large NGOs like BRAC²⁶⁶. This subsidised funding available to NGOs through PKSF was considered as quasi-capital (Kader, 2014)²⁶⁷ for the sector. It functioned as a cushion for gradually replacing grant support withdrawn by international donors.

During the early-90s, this cheap funding from PKSF attracted many NGOs²⁶⁸ like ASA, TMSS, and others, which were relatively small in size compared to BRAC and PROSHIKA and did not have much access to financing from outside sources like the big NGOs did. ASA²⁶⁹, now one of two very big NGOs in Bangladesh, became PKSF's partner in late 91 and received particular attention²⁷⁰ from PKSF in its early stages of expansion due to its sole focus on delivering microfinance in a sustainable manner. By 1993, ASA emerged as an 'innovative'²⁷¹ organisation providing low-cost microcredit services which helped it to expand very quickly and to compete with others (Kader, 2014)²⁷². According to Kader (2014), partner organisations (POs) of PKSF were in a better position compared to GB. BRAC restructured its old model in 1994 with a particular focus on sustainability (Kader, 2014) and became PKSF's partner in 1995/96. PROSHIKA, another large NGO after BRAC, became PKSF's partner at about the same time. ASA's low-cost model became very popular among

²⁶³ Taka 110 crore

²⁶⁴ Initially it was 2% annually for all, later it was fixed at 4.5% for small (OOSA) and 7% for larger NGOs (BIPOOL) which have increased further very recently.

²⁶⁵ US\$105 million at the first stage (Microfinance-I) and US\$151 million at the second stage (Microfinance-II)

²⁶⁶ It has planned to provide near about one third of the total funding to BRAC

²⁶⁷ Continuous flow of subsidized funding was available for NGOs on a long term basis, which acted like quasi-capital for them (Kader, 2014).

²⁶⁸ PKSF had received near about 6000 applications by 1995 (Kader, 2014)

²⁶⁹ ASA started working since 1978, it undertook various development programmes during its early phases and finally transformed itself into a dedicated microfinance organisation in 1991.

²⁷⁰ ASA alone had received taka 26 crore out of a total taka 150 crore (110 crore of the gov and 40 crore from USAID) by 1996. As a result, PKSF was advised by the govt in 1998 to diversify its portfolio instead of investing it in a single organisation (official files of ACSPD/Bangladesh Bank)

²⁷¹ It started following the strategy --"no need to involve in social development, no need to build big offices like GB, the goal is to run the financial system", as commented by Hossain (2014)

²⁷² It 'started snatching group members of BRAC' stated by Kader (2014).

the smaller NGOs and the sector understood that one could earn a substantial profit by engaging in the business of microcredit (Hossain, 2014).

“No economic reason, it was PKSf reason”, was the response from Professor Khalily (2014), a researcher and specialist in this field, when I asked him about the reason for this sudden rise of NGO-MFIs in the early 90s. However, it is not clear whether this step of the government in creating an independent wholesale funding agency like PKSf was a self-driven, calculated step, or a donor-induced step from the outside. Most probably both happened simultaneously, as it was created to avoid government bureaucracy in supporting NGOs. This issue is debated because during the process of establishing PKSf, there were conflicting opinions among the decision makers regarding PKSf’s organisational setup (Ahmed, M., 2010). Some of them, toeing the donor line, were interested in keeping PKSf outside government bureaucracy, while some were afraid the government might lose all control of the organisation if it was too independent. Finally, the government decided to create it as a non-profit company under the Company Act with government guarantee. Ultimately PKSf has emerged as an independent organisation run by its own Board, and in absolute terms it is monitored by no government agency. The Government usually does not interfere in its daily operations and policy making, and no government audit enters there. Its independence from government bureaucracy allowed it to take many vital decisions related to the sector’s expansion and regulation. So PKSf is now a favoured model of NGO financing, both for the government and donors.

As an apex wholesale funding agency, PKSf undertook some strategies in selecting partner organisations which could be seen as the first organised approach to institutionalising microfinance operations of NGOs in Bangladesh. At a later phase, PKSf introduced some norms and standards to protect its own interests as an investor. As a promoter of microfinance, PKSf took especial care in developing a conducive policy environment for the sector. This development convinced the World Bank²⁷³ to invest in PKSf to ramp up microfinance in Bangladesh. Eventually, other donors and development partners joined this apex funding system to avoid possible leakage of funds and PKSf emerged as a successful apex funding model to secure investment in

²⁷³ ‘We had started discussion with PKSf at the end of 94. The basic aim was to increase PKSf’s liquidity. By that time PKSf had developed institutionally and had built up a relationship with POs. Then they needed some liquidity as an apex institution. We observed that there was no disaster in the sector so far’ (Islam, R., 2014). In the early 90s Dr Reazul Islam was Senior Project Economist of the World Bank, Dhaka Office, and was in charge of the World Bank’s PKSf Project.

microfinance. At the same time, this new system of getting subsidised single source funding helped NGOs avoid reporting to multiple donors in multiple manners. With funds under its control and the rules standardised, PKSf became an important organisational setup in shaping the microfinance sector of Bangladesh in a planned manner²⁷⁴. The funds given to PKSf by the World Bank in 1996 were important in growing microfinance institutions all over the country in a short span of time. By the late 90s, PKSf provided loans to about 200 organisations among a few thousand existing in the market. The portfolios of those POs of PKSf constituted almost the entire sector, since they were the prominent organisations of that time²⁷⁵.

As a result of a large infusion of subsidised microfinance resources, many NGOs of the 90s either completely shifted their focus to microcredit or added it as one of their core programmes, while many new NGOs also sprang up just to operate as microcredit organisations. Hossain (2014) thinks that not all of them took up microcredit as a social development agenda. Some of them took it up as pure business to make money, some considered it as an alternative to jobs in the absence of suitable jobs, and some pursued their political motives in capturing local power, as microcredit could mobilise people at a local level Hossain (2014). Khalily (2014) also thinks that microcredit fulfilled the political motives of some people who wished to gain power by organising people under microcredit. As a result, Bangladesh now has a few thousand NGOs who are involved in microcredit operations at various levels with differing motives.

PKSf had started with simple guidelines for accounting and financial management, but full and direct governance of NGO-MFIs was beyond its mandate since NGOs were not registered under PKSf (Ahmed, S., 2014). In this connection, Kader (2014) mentions that:

At the growing stage, first we wanted to encourage them to enhance outreach. We encouraged them to improve recovery rate, to spend less than what they earn, and to build up some equity. When it started working, they started showing their potential to be sustainable, and then we undertook the World Bank's project. After that we introduced the first set of prudent guidelines like Loan Loss Provisioning (LLP), Loan ageing report, debt-equity ratio etc. since 96. ...A major concern was to bring them under discipline and ensure their sustainability so that they could run like financial institutions, at least they could run professionally.....from all

²⁷⁴ Donor funding policy prepared by PKSf in 2002 to streamline the poverty alleviating role of multiple donors and to coordinate different agencies working in the field of microcredit.

²⁷⁵ There were a few emerging organisation's like BURO and Shakti Foundation who were not PKSf partners

these, the idea of performance standards crystallised and we introduced the first set of performance standards in 1998. [P.175]

This set of performance standards of PKSf (Kader, 2001) contained three main indicators such as ‘financial sustainability’, ‘institutional viability’ and ‘viability of borrowers’. In fact, the indicators related to institutional viability were given the highest weight and “borrower’s viability” got the lowest weight of these three indicators²⁷⁶. The number assigned to each level of performance and the weight allocated to a certain category indicated the desired future direction of an NGO-MFI expected by both donors and a state representative organisation like PKSf.

Getting major funding from the World Bank in 1996 not only enhanced PO capacity to increase outreach, but also enhanced PKSf’s capacity as a monitoring agency. PKSf’s viability and sustainability as an organisation was a major concern of the World Bank since the Bank had invested a lot of funds via PKSf. Eventually, PKSf evolved into a de-facto regulator for the sector, at least for its POs, in terms of providing financing, setting guidelines, in supervising POs, and in building their capacity in the absence of a specific monitoring agency for all. As Islam, Reazul (2014)²⁷⁷ of the World Bank recalls the situation:

More or less we thought that PKSf is de-facto working as a regulatory authority, at least with its POs ...it represented more or less almost 70 per cent of the industry. Then we thought that PKSf and the role it was playing was quite sufficient for the industry, there was no disaster till then ...It was better to take a soft attitude at this stage, we were not very much concerned about regulation. ...The supervision tools PKSf used were adequate, so we relied heavily on PKSf at that time. [P.206]

PKSf was seen as the trend setter not only for its POs but also for others, and it was successful in placing itself in the good books of both the national government²⁷⁸ and the donors. So, the World Bank further proposed to provide assistance in creating an

²⁷⁶These indicators contain an exhaustive list of other sub-indicators including governance issues. However, the indicator under borrower’s viability does not reflect any real indicator of a borrower’s programme viability such as whether they could really run viable businesses for which they are borrowing. The whole structure of this performance standard seems like an intellectual exercise rather than based on real life experiences considering the complexity of practicing it in reality, especially in consideration of NGOs’ organisational setup at field. There is a lot of scope for criteria setting to manipulate data as well as to show good performance of an NGO.

²⁷⁷ Senior Project Economist of the World Bank Dhaka Office in early 90s

²⁷⁸ Government heavily relied on PKSf for any matters related to microfinance, remarked by Ahmed, S., (2014) & Kader (2014) in many places during interviews.

oversight body for MFIs, which would protect PKSF as well against default²⁷⁹. This was the most crucial pronouncement of the World Bank that triggered the birth of the MRA at a later stage. Therefore, PKSF continued in the role of a quasi-regulator setting ‘industry standards’, till the MRA was established in 2006.

7.3 LEGAL ENVIRONMENT AND ‘POLICY GAP’

Both policy makers and practitioners view credit programmes of NGOs within the broader definition of ‘social development’ instead of considering them as pure financial programmes. Hence, the central bank’s involvement was not expected here as noted by respondents to this research effort and as cited in many official and unofficial documents of donors and others. These views are prominent in their general declarations or conversations, in policy papers, and in their treatment of microcredit in the social arena. The confusion regarding the dual roles of microcredit still persists among major policy makers in the country. How much of this programme should be evaluated from a ‘poverty approach’ and how much from a ‘financial system approach’, and how to make a good blend of these two apparently conflicting approaches to achieve ‘multiple goals’ of reaching clients, alleviating poverty, and achieving organisational sustainability at the same time, has remained a subject of debate. This became the major concern for policy makers when trying to link NGO-MFIs with the broader financial market to give them access to other sources of financing while maintaining their non-profit nature and pro-poor character. This complex, interlinked issue, finally compelled the Bangladesh Bank to become involved with the sector in the later phase of development in 2000.

The question of a right kind of umpire and ‘proper code of conduct’ or ‘rules of the game’, in other words the question of ‘regulation’ and ‘regulator’, came to the forefront. However, monitoring of the NGO sector in Bangladesh as a whole was very poor as successive governments took a “laissez-faire”²⁸⁰ approach to this sector (Khan, Ahmad, & Quddus 2009). As Professor Khalily (2014) notes, in Bangladesh the terms, ‘liberalisation’, ‘market economy’ and ‘laissez-faire’ were being used

²⁷⁹ Microfinance II Preparation Mission, February-March 1999, Final Aide-Memoire, The World Bank

²⁸⁰ The theory or system of government that upholds the autonomous character of the economic order, believing that government should intervene as little as possible in the direction of economic affairs (URL: <http://www.dictionary.com/browse/laissez-faire?qsrc=2446>)

interchangeably²⁸¹ by many, including top level policy makers, in relation to the programme of private sector development. Nonetheless, the state's role in the financial market cannot be denied on the basis of an ideological commitment to liberalisation because "financial markets are markedly different from other markets; that market failures are likely to be more pervasive in these markets" (Stiglitz, 1994).

At this stage, we need to examine the then-existing legal structure of NGOs, before enactment of the new law in 2006, to understand what kind of legal organisations they were. Furthermore, we need to identify why there was a 'policy gap' between NGO 'development activities' and 'financial activities', and who was supposed to deal with the regulatory matters of NGO-MFIs. NGOs are being registered under many laws of the country which permit them to work as social development agencies, but none of these legal statements allow them to operate financial services like formal financial institutions. There are basically four prominent sets of legal rules that permit anybody to form an NGO, either as a voluntary association, or as a trust/charity/ foundation, or as a not for profit company. Table-1 in Appendix-D presents the general profile of these laws, including the names of related enforcement authorities.

The provisions of these laws are very flexible which allow any organisation to work, almost as an autonomous entity, and to get funds from anywhere. The legal statements of these laws related to the formation of an organisation, its extent of operation, and its monitoring mechanism are more or less loosely defined. So, NGOs have enough freedom to operate under these laws. However, if they are considered from the perspective of their goal of developmental service, or from the standpoint of enforcing rules, then all these four sets of laws will appear non-uniform in nature.

The Societies Registration Act of 1860 is over 150 years old, and has been amended twice; once in 1973 and again in 1978 (these amendments are not at all compatible with the evolving role of NGOs). The purpose of this law is mainly to provide facilities to form societies or charitable organisations for the promotion of literature, science, knowledge, arts, and so on, for the general use of members or the public. On the other hand, the primary aim of the Trust law of 1982 is to promote private trusts and a trustee; it is also not compatible with the nature of NGO objectives. The Voluntary Social Welfare Agencies Ordinance of 1961 is relatively

²⁸¹He thinks that it is a completely wrong conception. According to him, under a 'market economy' things run freely within a broader framework, not in a 'laissez faire' condition.

contemporary, though not fully matched with the current nature of NGOs. It is basically for the purpose of rendering welfare services for the society, and it allows the organisation to accept resources as a public subscription, donation, or government aid. The Companies Act of 1913 has been amended in 1994 which seems to be the most up to date in nature. However, it addresses very limited areas regarding the so-called non-profit nature of companies.

Among all these four laws, only the Voluntary Social Welfare Agencies Ordinance of 1961 has some specific provisions related to monitoring an organisation, such as maintaining account and audit, and publishing annual reports. It also contains provisions for dissolving an organisation and suspension of the governing body by the government in relatively greater detail. This particular law seems to go well with the care and welfare nature of NGOs, but it is not compatible with the developmental character of NGOs, since ‘development functions’ are associated with improving the conditions and prospects of people in a nation through many other ways, both commercial and non-commercial.

In the absence of any comprehensive data on the number of NGOs in Bangladesh, it is hard to say exactly how many organisations are under which registration authority and how many of them were involved in microcredit. Recent data from the Microcredit Regulatory Authority indicates, only about 501 among 4241 applicants²⁸² have provided information regarding their primary registration authorities and corresponding laws. It seems that many of them might not have any registration at all, while some are registered with multiple agencies. Table-2 in Appendix-D shows the Voluntary Social Welfare Agencies Ordinance of 1961 is the most preferred law by the NGOs, although the Registration Authority of this law (Department of Social Services or DSS, under the Ministry of Social Welfare) regularly and frequently raises objections to the microcredit operations of NGOs²⁸³ in general. It can be noted here that none of these NGOs, those who applied for a license from the MRA, have registered under the Companies Act as a non-profit company, and a very few of them registered under the Trust Act.

Relevant NGO representatives could provide no clear answer about their criteria for choosing a particular law and registration authority. It was generally a

²⁸²Who were interested in getting license from the Authority in 2007

²⁸³Mentioned by NGOs’ representatives in a Focus Group Discussion on 17th March 2014 and also confirmed by officials of the MRA (Focus Group Discussion on 27 April 2014).

matter of convenience and demonstration effect, or a necessity arising from the nature of particular activities. However, there was no single dominant pattern. The DSS has branch offices all across the country, allowing them to provide easy registration facilities to local NGOs. In some cases, the practice of registering with the DSS has come to be seen as necessary for NGOs to conduct development work related to for example, family planning, health facilities, women's affairs, while there are others, for whom such registration is not necessarily clearly specified by any law. Therefore, the whole issue of registering with an appropriate authority remains a grey area for many NGOs and the public as well. If something can be said at all, then the Department of Social Services (DSS) may be considered the main authority, because both the official and public image of an NGO in our society is that of a 'social welfare' agency.

The Foreign Donations (Voluntary Activities) Regulation Ordinance, 1978, was specifically instituted to address the flow of foreign assistance to all non-state bodies like NGOs who are also non-state bodies and receive foreign donations. Back in the 90s, as a donor dependent country, the government had considerable interest in aid, where NGOs had a significant share²⁸⁴. So, the government created the NGO Affairs Bureau (NGOAB) in 1990 under this law to provide one-stop services to grant receiving NGOs and to track foreign donations used by these NGOs. Despite NGOAB's many limitations, it tries to address microcredit operations of NGOs as a separate agenda under monitoring functions²⁸⁵. However, it cannot do much because of its legal and infrastructural constraints as mentioned by Dr Salehuddin Ahmed (2014), former Director General of NGOAB during the early 90s.

Generally, laws cannot change the past, but they help institutions to take future shape (Driesen, 2012). Nonetheless, many of the legal details applicable to NGOs in Bangladesh do not support the evolving roles of NGOs. Therefore, these organisations started seeking new routes in the absence of any facilitating rule/law to accommodate their newly emerging needs, such as credit delivery and savings operations that have emerged in course of time. Any NGO interested in microcredit operations at any point in time had no stated restrictions to begin with. However, there were always a few very enthusiastic government officials or politicians who tried to impose a restriction on the microfinance operations of NGOs (Ahmed, S., 2014) in the past on legal

²⁸⁴ 10.5% in 1990-91, 24.2% in 1995-96, 24.3% in 2000-2001, and 27.8% in 2004-05 of total aid to Bangladesh (World Bank, 2007)

²⁸⁵ Developed some reporting formats for microcredit operation to monitor revolving loan fund for credit.

grounds. Those opinions were either ignored or remained un-discussed, or had been settled through negotiation prior to the MRA Act, 2006²⁸⁶.

In a real sense, legal issues of NGO-MFIs did not get much government attention in the early 90s since NGO microcredit operations were not very prominent then, especially their savings service. Moreover, the government perceived the microcredit operations of NGOs as donor activities as is acknowledged by Ahmed, S. (2014). Hossain (2014) also has a similar view. He thinks,

they (*the government*) thought it's a kind of miniscule sort of area. Government had so many problems to deal with....It (*microcredit operation of NGOs*) had an insignificant amount of transaction, no need to interfere, let them do it.[P.307]²⁸⁷

So, probably both the following statements regarding the government's views on this subject at that important and transitional juncture of time truly reflect the reality:

- On the one hand, provide continuous support for institutional development of MFIs through wholesale organisations like PKSF and others, and allow them tax rebates;
- On the contrary, consider it a 'minuscule' area with 'nothing to be very serious about'.

Changing economic dynamics (Driesen, 2012) necessitate government's role in facilitating legal frameworks of an institution to minimize systemic risk²⁸⁸ without imposing rules to suppress economic development or efficient allocation of resources. This evolving process is called an *adaptive efficiency* role of laws by Douglas North (as cited in Driesen, 2012). As such, a few important questions arise here--how did the emerging above mentioned legal setup or policy guidelines in the field of microcredit ensure adaptive efficiency or minimise systemic risk to society? Whom does it empower and who gains economic incentives from these policies, rules, or laws? These rules or laws just act like a thin thread or bond between the government and organisations. The Trust Act, the Societies Registration Act, and the Companies Act all perform like a very loosely connected thread. While the Voluntary Social Welfare Ordinance has a relatively more clearly defined objective, it lacks the ability

²⁸⁶ Dr Salehuddin Ahmed had negotiated a number of times both as a DG of NGOAB and a MD of PKSF when DSS raised complaint against NGOs' savings collection (Ahmed, S., 2014).

²⁸⁷ Italics inserted by the researcher

²⁸⁸The risks that may spill over from one institution to another, which includes the risks that destroy the basis of trust in a society (Driesen, 2012).

for proper monitoring and supervisory functions to oversee a few thousand NGOs registered with it. Moreover, registration with multiple agencies also creates problems of coordination and enforcement between the various registration authorities. This is especially true when one particular rule under a particular law contradicts or is not compatible with the same of other agencies.

Figure 7.2 portrays the ‘Policy Gap’ and “inconsistencies” in the legal statements of NGO-MFIs which created a kind of constraint for their development as financial institutions.

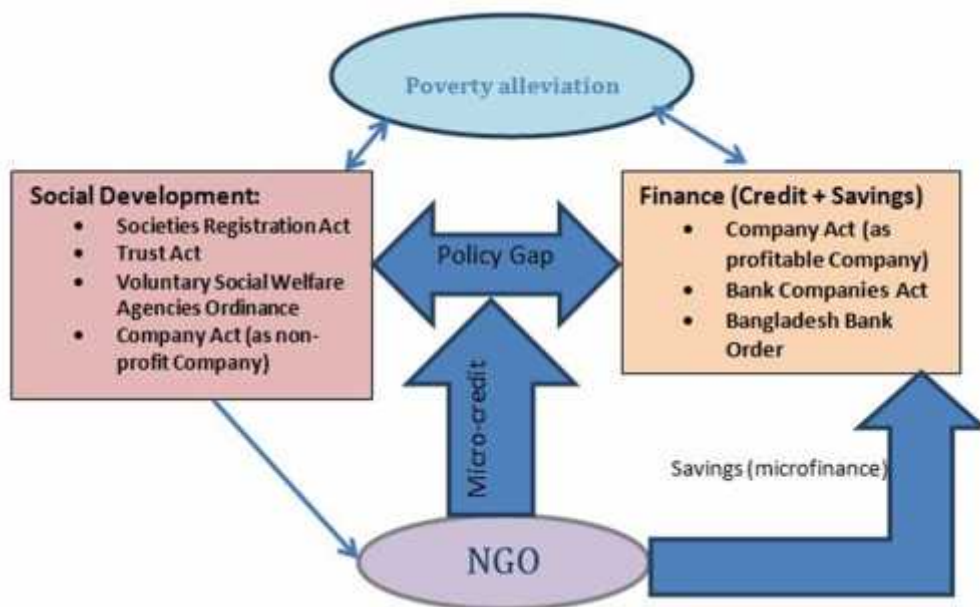


Figure 7.2: Policy gap between social development agenda and finance, NGO-MFIs

Before discussing this diagram let me put forward two quotations from Professor Yunus and Professor Mahmud²⁸⁹ which will suffice here to establish the crux of the issue-

- 1) They (*NGO-MFIs*) are blamed that they always remain donor dependent. It is pointed out that they cannot scale up their programmes because they do not have absorptive capacity. But in reality most of the programmes neither want to be dependent on donors, nor do they have to be donor dependent at all if they are allowed to take public deposits. But law does not allow them to do so, because they are not financial institutions. Once they can take deposits they

²⁸⁹ Professor Wahiduddin Mahmud, Former Chairman, PKSf

can be totally independent from the donor money and scale up their programmes with the money they mobilize.²⁹⁰

- 2) Can microcredit programs attain full commercial viability and self-reliance? They perhaps can, but only if, like commercial banks, they can mobilize deposits from the general public. The time has come to think about allowing some of the mature microcredit institutions to convert themselves into deposit banks under an appropriate legal framework.²⁹¹

It is clear from the above comments that these organisations were expected to run viably like financial institutions though they were registered as social development organisations. Here lies the gap. There was no such big problem as long as they were just acting as credit organisations out of their own pockets or donors' pockets. However, problems surfaced once they wished to 'mobilise deposits from the general public'. So, the crucial gap in policy was the "Savings Policy" gap for NGOs. Banks invest equity capital and mobilise savings or capital from the general market and use it to expand their lending business while NGO-MFIs are starved of capital. Policies do not allow them to mobilise either equity capital or others savings from the general capital market.

Searching new route to address 'Policy Gap'

Savings collection by NGOs from their so called 'members'²⁹² remained unaddressed for long considering its insignificant volume in the total portfolio of the sector. Over time, savings have emerged as one of the important sources of revolving loan funds for many NGOs. Discussions on the various natures of NGO savings have surfaced since the late 90s (Wright, 1999; Wright et al., 2001). The changed circumstances demanded NGOs to move towards commercial sources of funds as many of them did not have access to either donor grants or PKSF, for various reasons. Moreover, some of them wished to achieve long-term sustainability and wanted to diversify their sources of funds to reduce dependency on donors as well as to reduce the cost of borrowing. Therefore, NGOs, especially smaller NGOs, who did not have easy access to other sources rushed to collect 'voluntary savings', in addition to compulsory

²⁹⁰International Seminar on Attacking Poverty with Microcredit, Dhaka, January 8 & 9, 2003, Paper on Expanding Microcredit Outreach to Reach the Millennium Development Goals-Some issues for Attention.

²⁹¹ International Seminar on Attacking Poverty with Microcredit, Inaugural Session, Dhaka, January 8, 2003

²⁹² The term 'member' is the most confusing perception in differentiating NGOs from GB. NGO's 'members' are beneficiaries but not shareholding members, as they are in the case of GB.

savings from their clients. As underprivileged and smaller NGOs responded to market demand for providing various kinds of savings, larger MFIs also started facing pressure from their clients²⁹³. In reality, this savings facility offered a win-win situation for both the service provider and its clients. As a result, many arguments in favour of these savings surfaced, which are as follows:

- 1) An NGO is a kind of solidarity; savings service is essential to keep them (clients) cohesive. Otherwise, how will they maintain their bonds with clients? They (clients) may leave the organisation at any time. So, this is a kind of collateral; in fact, group collateral. It ensures security. (Ahmed, S., 2014)
- 2) All beneficiaries are net borrowers from the MFI, and so, even if an MFI becomes insolvent, most beneficiaries would be net gainers (the World Bank)²⁹⁴.
- 3) Savings service may help beneficiaries to build up a savings habit; it will be their future security during an emergency (a consultancy report)²⁹⁵.
- 4) Formal institutions do not provide this facility of depositing tiny amounts. NGOs do not have extra costs to collect it; for them it is easy to collect from their clients. They may also use it as a revolving loan fund. It is a useful service for poor people as well (Hossain, 2014).

Arguments like these in favour of savings collection were finally endorsed by policy makers, not in the form of written rules but in the form of accepted norms since it were supported by donors and other important stakeholders. Hence, the collection of various types of savings by NGOs has received a kind of legitimacy in the form of consensus among policy makers, practitioners, and donors. Gradually, many of the NGOs have introduced various types of savings facilities to meet market demands as well as their own. As a result, the whole microcredit market scenario changed in a very short time by the late 90s. Thereafter, the word ‘microcredit’ became ‘microfinance’.

²⁹³ By the end of 1995 Grameen Bank had faced pressure from its members in Tangail District to get open access to savings. Again in the same year BRAC faced similar kind of problems of programme discontinuation due to clients’ demand to get access to group savings during emergencies (Wright, 2000)

²⁹⁴ The World Bank in a draft ToR for consultant, May 1997 (Bangladesh Bank file no. ACD (Poli)76/97-99; S-7)

²⁹⁵ A consultancy report to Bangladesh Bank, April 1998 (Bangladesh Bank file no. ACD (Poli)76/97-99)

By the late 90s, the issue of savings protection in the absence of any central monitoring agency came to the forefront. Savings collection by NGOs without any legal basis raised tension among donors considering the potential danger²⁹⁶ of mismanagement. They assumed that the situation could jeopardise their investment. However, they were not in favour of raising a general alarm that might spur intervention by the central bank. Hence, they repeatedly emphasised that NGOs were collecting savings from ‘members only’, which was not as risky as general public savings. The issue of external monitoring came into discussion where different players played different roles according to their vested interests.

7.4 PATTERN OF INTERACTION AND RESPONSES OF THE PLAYERS

In the late 90s, there were only two agencies, the Bangladesh Bank and the PKSF, which had the right and competence to address issues of monitoring and supervising NGO financial activities. However, donors and the NGO network also had vital interests in influencing decisions. Discourses on this regulatory issue and interaction among the different players finally decided the legal steps taken in 2006. In this context, we need to understand the regulatory responses of the two most important agencies mentioned above, the Bangladesh Bank and PKSF.

The Bangladesh Bank an indifferent actor

Already mentioned in chapter four, the Bangladesh Bank was very indifferent regarding the microfinance operations of NGOs till the late 90s. Yet, ultimately it could not avoid its regulatory role. During the early 90s when NGOs started stepping into the market, the Bangladesh Bank was preoccupied with the financial sector reform programme (FSRP) as prescribed by the World Bank under a structural adjustment program, or SAP. Its major focus was on privatisation of the banking sector and improving the “health” of the overall financial market. This silence on the part of the central bank might have been due to the insignificant investment portfolio of NGO-MFIs, compared to that of the banking sector. It might also have been

²⁹⁶ “..this is essential to safeguard the savings deposits of clients/members...Furthermore, there is a demand for savings services from non-members and if this was allowed it would significantly increase the number of net creditors on the NGO-MFIs and thus expose many more to the risk of losing their net savings if an NGO-MFI collapses. An additional point is that PKSF’s interests are not the same as those of the individual savers; PKSF’s primary interest is in recovering the loans it makes to NGO-MFIs....” (Joint Donor Strategy on Microfinance, Draft Summary, Volume-1, P:25)

influenced by the public views that NGOs were not collecting public deposits, and that they had a net infusion of money at the field level.

PKSF as quasi-regulator

PKSF officially was not in favour of this kind of savings collection by NGOs on grounds that NGOs needed a strong and transparent internal control system in place to protect savings, which was absent (Kader, 2014). However, it could not stop the trend mainly because of its legal limitations. Though PKSF was performing an important role in setting industry standards and developing the market, it did not have legal power to enforce any rules. PKSF as a financing agency was also not able to bind everyone to its standards. Dr Salehuddin Ahmed, former MD of PKSF, made the following comments on the issue:

PKSF can give some kind of guidelines, even it could be some prudential norms, and it may be followed by POs of PKSF only, outside NGOs may not follow it. It was difficult to enforce.because they (*all*) are not registered under PKSF, PKSF is just a fund giver. They (*NGO-MFIs*) are registered under Voluntary Societies Act, if that authority doesn't say anything then PKSF cannot order.. (Ahmed, S., 2014; P.55)²⁹⁷

Ahmed (Ahmed, S., 2014) also added that there were some other limitations of PKSF. For example, other government agencies might not take PKSF seriously at a time when it really needed their help to solve local problems related to NGOs, since it was not a pure government body.

However, PKSF certainly had great influence on government decisions regarding policy issues concerning the microfinance sector, which might not have otherwise originated from legal statements of the state. It sometimes acted like a shield for NGO-MFIs when government representatives harshly criticized the high-interest rates of microcredit, or when the government wanted to remove tax incentives for the sector in order to ensure a level plain field in the financial market, or when they were against savings collection by NGOs and many such other issues, as echoed by many respondents (Ahmed, S., 2014; Ahmad, Q., 2014; Kader, 2014). 'PKSF is a Company, not a regulatory authority', it feels 'comfortable to work with NGOs in a flexible way' as is noted by Ahmed, S. (2004). Therefore, PKSF was never in a position to perform as a regulatory body in a real sense.

²⁹⁷ Italics inserted by the researcher.

Choices that determined the future course of action

Regulatory issues for the sector remained ignored until the end of 1996, during the first phase of expansion. Later there was a study conducted by the Bangladesh Bank under a project of the World Bank²⁹⁸, which brought these issues forward for public discussion in 1998/99. The critical question was-- which route would be the most desirable and acceptable to all stakeholders considering the strong affinity of NGOs with international donors and their relative freedom in operations. One route was to transform NGOs into commercially viable microfinance banks, and the other route was to keep them as they were, i.e., like quasi-banks with mixed objectives—both social and commercial.

On the part of the NGO-MFIs, they had the following three options to choose from (as depicted in figure-7.3) in deciding their future direction to maintain financial sustainability:

Path-1: Depend on donors for soft or subsidised loans and gradually build up capacity.

Path-2: Establish linkages with banks for commercial financing.

Path-3: Legal transformation into formal banks/FIs to gain access to cheap deposits.

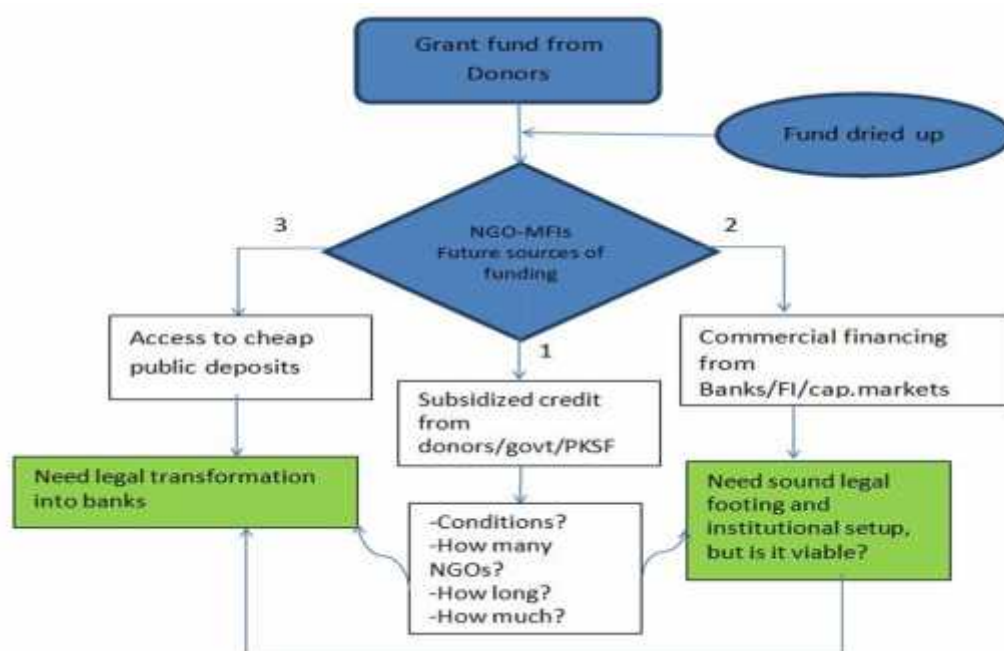


Figure-7.3: Possible routes to gain access to different sources of financing and to be linked to the formal financial market

²⁹⁸ Second Poverty Alleviation Microfinance Project of the World Bank (IDA Cr. No. 2922 BD).

None of these paths are entirely mutually exclusive, so an organisation can either follow a single path or consider a combination. However, which path they choose depends mostly on their ultimate objectives since each path has its own course of action, and mutually exclusive consequences.

The first path of getting a soft loan from donors or government is the simplest one which offers the opportunity to take time to adjust to the new situation of decreasing foreign grants and grow gradually, using ‘smart subsidies’²⁹⁹ intelligently and efficiently. The major question regarding this situation is how long an organisation will avail subsidised loans, whether everyone will get it, and on what terms and conditions? The inefficiency of grant financing is well known and not supported by donors anymore, especially in the Neo-liberal paradigm of a free market economy.

The second path of getting commercial financing from banks or other financial institutions is not as easy for everyone as the first path³⁰⁰. Banks may ask for guarantees or collateral, a bank may not provide loans to an NGO that does not stand on clear legal charter and it may demand a good credit history or rating. Moreover, borrowing from banks/FIs at a commercial rate of interest may not be a viable option for everyone. The option of floating shares to collect capital from the share market is also not possible unless they can transform themselves into private or public limited companies, or microfinance banks.

The third path of gaining access to general public deposits, therefore seems to be the most desirable path, considering the insignificant cost of collecting savings from clients (Hossain, 2014). But from a legal point of view, it is the toughest path since it demands full transformation into a regulated institution. It has many follow up consequences like compliance with many rules and regulations of a central body. The issues of good governance and clearly defined ownership structure also become important in this case. They then become subject to external monitoring and control, not much liked by NGOs. So, the decision about funding sources for an NGO is not an easy one, since this indirectly defines the nature of regulation which an NGO would be subject to.

²⁹⁹ The approach that prefers market mechanisms justifies subsidy by calling it ‘start-up’ capital or ‘smart subsidy’ (Morduch, 2000).

³⁰⁰ “..the poor legal status of the NGO-MFIs made unbreakable wall between them in establishing sustainable linkage (with the banks)” commented by NGOs during survey conducted by DPC as part of its consultancy under BB in 1998.

Discussions on 'Right Kind' of regulation

Two studies of the World Bank in 1997, conducted by a private consulting firm under Bangladesh Bank, played a trigger role in bringing discussions about the appropriate regulatory nature for NGO-MFIs into the public domain. The objectives of this study (two studies combined into one) of Bangladesh Bank are: a) to identify an appropriate regulatory framework for monitoring MFIs and NGOs engaged in deposit-taking, and b) to define the role of Bangladesh Bank as the central bank, and PKSF as a second tier institution, in regulating and monitoring these institutions. This work is related to the second and the third routes described in figure 7.3. It indicates that donors were trying to find some legal options for NGO-MFIs which would help these organisations to collect public deposits and gain access to commercial resources. The elaborated ToRs prepared by the World Bank, for the consulting firm, further specified that this study should offer policy suggestions on transforming MFIs into banks. The other related papers of the World Bank signify there were the two following major concerns among donors and they expected to find:

- a. A regulatory structure that would support market-based operations of NGO-MFIs, and
- b. An appropriate regulatory agency that would not hinder the' existing freedom of NGOs to work.

At the time, there was no significant ideological disagreement between stakeholders on the first issue, since the national government was already implementing market-based liberalisation programmes for the financial market. So, the second issue became the most important agenda for all. Ultimately, most of the discussions concentrated on this issue related to the choice of an appropriate regulatory agency to monitor NGO microfinance operations. Who will it be?—PKSF or Bangladesh Bank, or some other agency? None of the donors denied Bangladesh Bank's existence as a financial market regulator. However, they might have had an implicit preference for other alternative options instead of the Bangladesh Bank in regulating NGO-MFIs. The following statement from the same ToRs³⁰¹ of the World Bank provides a clue in support of this assumption. It says:

³⁰¹ Draft ToRs prepared by the World Bank, 09 May, 1996 (Bangladesh Bank file no: ACD(Poli)76/96; S-7)

As regulator of all formal deposit taking institutions, the BB should regulate MFIs engaged in deposit taking. ...Should BB be involved in regulating MFIs that do not raise deposits from non-members? Could it delegate this function to another institution and/or just rely on MFI external audit reports and PKSf's monitoring...[P.2]

It seems from the above statements that the World Bank had been requesting the consulting firm to find an answer to whether the Bangladesh Bank would agree that if MFIs collected deposits from the public ('non-members') then only should they be regulated by the central bank. Otherwise, that responsibility could be assigned to another independent agency which perhaps they implicitly preferred. However, the exact intention is not clear from the statements. It seems like an indirect hint to policy makers to consider and to manage approval from the Bangladesh Bank, or to get assurance that the Bangladesh Bank would not come into the picture as a regulator of this sector.

It was not only the donors, but PKSf too, who expressed similar views³⁰². As a quasi-regulator, PKSf was apprehensive about this study of the Bangladesh Bank. It requested the government to advise BB to maintain close consultation with PKSf³⁰³ in conducting this study since it might affect its POs. In this connection, Khalily (2014) recalls a discussion³⁰⁴ in the late-90s with the sector on the issue when NGO-MFIs, especially the larger MFIs, had expressed their strong disagreement with any outside regulation, especially under the Bangladesh Bank, which would sacrifice their freedom to work. Similar views about keeping BB out of this discussion are reflected in some other donor documents³⁰⁵. Khalily (2014) again mentions that the sector finally agreed to submit to a regulatory system on condition that nothing would be done without discussions with the sector.

At last, all active stakeholders arrived at an understanding to find an appropriate regulatory framework for the sector; though each major stakeholder held its own distinct and detailed view. Figure-7.4 summarizes the converging ideas related to the emergence of regulatory issues for NGO-MFIs in Bangladesh to fill the 'policy gap'. The government wished to protect public and political

³⁰² PKSf's 9th Board Meeting held on 12th December 1998

³⁰³ Letter sent on May 7, 1997 (Bangladesh Bank file no: ACD (Poli)76/97-99; S/8)

³⁰⁴ PROSHIKA (IDPAA) organized a workshop jointly with PKSf in 1998 on 'Poverty and Finance in Bangladesh: Emerging Institutional Issues in microfinance'.

³⁰⁵ David Cracknell's (Enterprise Development Field Manager, DFID, Bangladesh) correspondence with other donors and individuals during August 1998 related to a workshop on Regulatory Framework for MFIs in Bangladesh (DFID Bangladesh Resource Centre 4472/ E-0110, MF Regulation)

interests, donors, and investors like PKSF, wished to minimize risk for their own investments, and the sector wished to achieve a legal footing to gain access to different sources of funds, especially deposits.

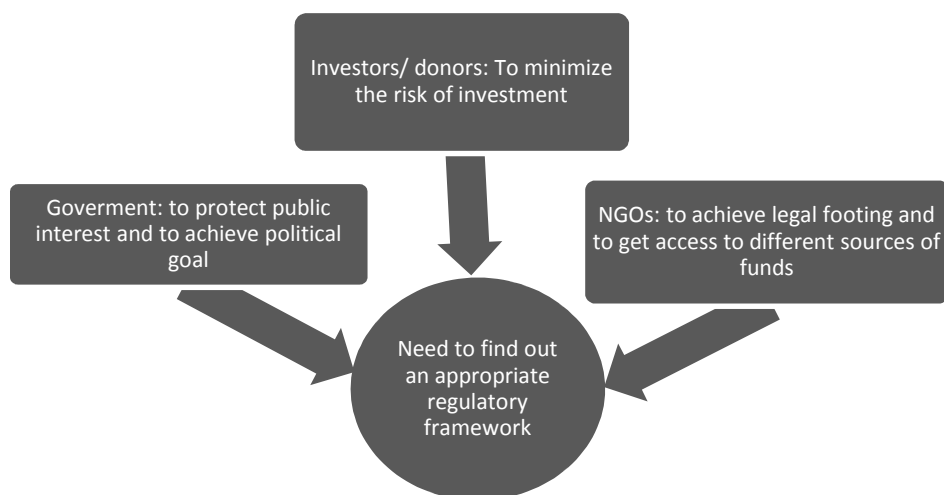


Figure-7.4: Necessity of regulation: a converging demand of many stakeholders

Consensus about a pragmatic solution

The final report of this study came out in January 1999 after detail consultation with all stakeholders, including NGOs and their clients. This report reconfirms the’ willingness of NGOs to gain legal recognition. It states:

Almost all the NGO-MFIs ventilated their opinion unanimously about the above legal recognition as the prime need right now. Without this formal legal entity the sustainable growth of the NGO-MFIs would be hampered seriously in a number of ways. Among those, the most important is the lack of access to formal sources of national and international funds for effectively carrying out the micro-finance programme for poverty alleviation on a sustainable basis. (Final Report: Synthesis, P: 4)

The above excerpted report also confirms larger NGO-MFIs’ resentment of outside regulation³⁰⁶. It states that MFIs thought their internal self-regulatory arrangement was enough to handle their activities. It again stated that initially the term ‘regulation’ was difficult to use in any discussion with NGOs; instead, people used the term ‘strategic monitoring’. According to this report, the sector expected there would be an agreed

³⁰⁶ “.. there is no need of any regulatory institution to regulate us ...When the world as wider family is endeavouring to liberalization of economic policies to explore people’s potentials, we, in Bangladesh are dewaving towards regulatory concept..” comments made by larger NGO-MFIs during survey conducted by DPC as part of consultancy under BB in 1998.

‘Code of Norms/ Conducts’, which “*should be formulated in such a way that the organizations themselves are able to develop and strengthen their self-regulatory mechanism*” on the basis of that ‘code of norms’. ‘Self-regulation’ was considered the best regulatory option by NGOs, which was also supported by many supporters of the NGO-modality at home and abroad³⁰⁷. However, the meaning of ‘self-regulation’ varied widely.

As the term implies, it is a kind of agreed ‘Code of Norms/Conducts’ or ‘industry standards’ that NGO-MFIs must abide by. A list of characteristics under this term was provided in the same study report of the Bangladesh Bank. It mentions that an NGO should have at least a capable board of directors, financial and risk management policies, a standard accounting system, effective internal control, efficient management, and quality external auditing to ensure appropriate self-regulation. Wright (2000, P-91) notes that self-regulation is possible if the following three elements are combined with transparent disclosure:

- “an independent board with the technical expertise, and authority, to hold management accountable”,
- “well formulated and properly implemented internal control and risk management policies”, and
- “High quality auditors who are educated about micro finance.”

Over-emphasis on ‘self-regulation’ by the sector, suggests their idea of ‘self-regulation’ is based on the assumption of an ‘ideal’ organisation, because it does not match real life field circumstances. Most of the NGO-MFIs would not qualify for a self-monitoring system, if the above qualifying characteristics are taken into account. Therefore, the idea of self-regulation did not receive much attention from policy makers, though the NGO sector tried to push it further with the help of their network organisations³⁰⁸.

At this point of discussion during the late 90s, British DFID was very active in organising a follow-up workshop built around this study report of BB. Some

³⁰⁷ PKSF (9th Board meeting), NGOs (NGO/CDF/99-1), CDF (NGO/CDF/99-2), WB (Final Aid Memoire of MF-II preparation mission, February-March 1999), DFID (DFID Bangladesh Resource Centre-MF Regulation, Call No. 4472/E-0110)

³⁰⁸ Such as ADAB (Association of Development Agencies in Bangladesh) and CDF (Credit and Development Forum)

correspondence³⁰⁹ of the DFID-Bangladesh office with other agencies and individuals indicates that they (DFID) tried to manoeuvre the discussion in an ‘adroitly constructed’ way to protect NGO-MFIs from possible collapse due to the increasing involvement of NGOs in savings collection. All of them were very anxious, and thought the situation might prompt BB intervention. So, they were frantically trying to keep the Bangladesh Bank from getting involved by keeping it ‘reasonably happy’ yet ‘abreast’ about the potential dangers. All of them undertook ‘careful planning’ to convince BB not to take a lead role in this discussion. Finally, they brought PKSF in the picture as a mediator. Though final recommendations of the Bangladesh Bank’s study were not conclusive, it proposed to form an independent “Apex body of NGO-MFIs’ through government legislation that would be expected to monitor these organisations along the lines of an agreed ‘Code of Norms/Conducts’. This report tried to accommodate all stakeholder views, though DFID remarked that it was biased towards the NGO sector³¹⁰. These discussions among stakeholders finally guided policy makers to initiate some concrete decisions at a later stage about regulatory matters.

In this negotiation, PKSF played a crucial role in representing a government voice, acceptable to all parties. PKSF was considered a common mediating platform for negotiation. After many discussions, all the parties came to a conclusion that there was no rationale for any strict regulation of the NGO-MFIs in Bangladesh, considering their scope of operations and objectives, as well as the overall macro-economic policy of the country favouring a market economy. However, the central debate around the question of an appropriate regulatory authority remained unresolved. Who would be that regulator? The report proposed some options such as: a) Bangladesh Bank, b) PKSF, c) Credit and Development Forum (CDF), or d) an independent body.

Bangladesh Bank was a natural choice if NGOs were interested in collecting public deposits. Did they collect public deposits? How did they define public deposits? The sector argued that no organisations were involved in collecting any public deposits. They said the deposits were from their ‘members’, which should not

³⁰⁹ DFID Bangladesh Resource Centre-MF Regulation, Call No. 4472/E-0110 (correspondence from June 1998 to March 2000)

³¹⁰ David Cracknell’s (DFID Bangladesh) correspondence with Reazul Islam (World Bank, Dhaka) on 25 August, 1998 on the draft report of consulting firm under BB (DFID Bangladesh Resource Centre-MF Regulation, Call No. 4472/E-0110, section 19, Chapter 6]

be categorised as ‘public deposits’. There was not much disagreement with this statement of the NGOs as long as it pertained only to ‘compulsory’ deposits from clients as part of a loan contract.

But disagreement grew from the gradual involvement of NGOs in other kinds of deposit collection. Major questions arose: Were they permitted to collect ‘voluntary’ deposits from their clients, whom they called ‘members’ (BURO Tangail was one of the pioneer organisations of this type which received moral support from many³¹¹)? Were they permitted to collect deposits from clients who did not borrow from the organisation (ASA used to call them ‘associate member’)? The answer was, ‘probably not’, because an NGO’s client was not a ‘member’ of the organisation. These targeted clients of NGO-MFIs had no contractual or legally recognised affiliation with the organisations as they had with Grameen Bank and cooperative organisations. There was no clearly defined written definition of ‘member’ in any law that permitted NGOs to collect deposits from their clients, so they perhaps operated outside the law. No attempts were made by the registration authorities of NGOs or by the BB, to clarify this situation. They should have provided a workable policy guideline that made it clear to NGO-MFIs whether and how they could mobilise savings.

In the absence of any such guideline or policy, savings collection by these organisations remained an area of confusion for long. Supporters of the NGO modality did not see any risk in the collection of savings by NGO-MFIs since they were net creditors at the field level as ‘all beneficiaries were net borrowers from the MFI’³¹². By this simple argument, NGOs’ savings collection from their clients got a kind of informal acceptance and remained outside the legal definition of ‘public deposit’. Hence, it was agreed to keep it outside any regulatory bindings from the central bank.

At last, the idea of establishing an independent monitoring agency affiliated to PKSF and able to manage some form of savings protection scheme, seemed a ‘pragmatic’ solution to concerned players for protecting the sector from nosy government bureaucracy and Bangladesh Bank’s interference. However, there were divergent views on involving PKSF as the key instrument of regulation or central

³¹¹ Such as Graham Wright, Stuart Rutherford (Rutherford, 1998; Wright, 1999; Wright, Hossain, & Rutherford, 2001)

³¹² The World Bank in a draft ToR for consultant, May 1997 (Bangladesh Bank file no. ACD (Poli)76/97-99; S-7)

body. The World Bank wished to see PKSF in the role of a lending institution rather than a regulator; it was mostly concerned about PKSF's protection against loan defaults by its POs. The NGO-MFIs had mixed opinions in selecting PKSF as a central monitoring and supervising body³¹³. The Bangladesh Bank disagreed with the decision in selecting PKSF as a regulator on the grounds that there would be a conflict of interest. PKSF did not deny that a conflict of interest existed; however, it too expressed mixed opinions. On the one hand, PKSF said it had all the expertise and knowledge to act as a regulator of this sector. On the other hand, it expressed unwillingness to act as a regulator after considering the pros and cons related to regulation (Ahmed, S., 2014; Kader, 2014).

Finally, the ball was pushed into the government's court for resolving the dilemma. Despite recognizing PKSF's expertise and knowledge about the sector, the government preferred a legal body like the Bangladesh Bank that represented the government, to undertake the responsibility of formulating a regulatory framework for the sector. However, instead of taking the final decision at that moment, in October 1999 the government assigned the responsibility of recommending the appropriate nature of regulation and regulator, to a committee headed by the governor of Bangladesh Bank³¹⁴. This committee was comprised of members from MFIs³¹⁵ and PKSF, in addition to the government and Bangladesh Bank³¹⁶. All the parties extended their cooperation to that committee in formulating some strategic policies for the sector by balancing both private and public views.

Formal steps towards institutionalisation

Step-1: A national committee headed by the governor

The government requested this committee, headed by the governor of the Bangladesh Bank, to provide suggestions mainly for:

- a. Policies to ensure transparency into the operations of NGO-MFIs;
- b. A regulatory framework to supervise and regulate the financial and banking business of NGOs; and
- c. Selecting a regulatory body.

³¹³ Bangladesh Bank Study Report (1999)

³¹⁴ Circular No. Ag/Aw/e'vsk/Kr-9/179/99-126 dated 19th October 1999

³¹⁵ Fazle H Abed, Brac & President, ADAB

³¹⁶ Other members were 1) Governor, BB, 2) Secretary, Ministry of Social Welfare, 3) DG, NGOAB, 4) MD, PKSF, 5) A member, BB

The Committee submitted its report to the government in March 2000 after discussing the issues not only with its members but also with civil society members like intellectuals, academicians, and professionals including bankers, researchers, journalists, and others. Their major recommendations or comments were:

- a. Financial activities of NGOs should be brought under a regulatory framework;
- b. Self-regulation was not effective, so there must be some supervisory oversight;
- c. NGOs are involved in collecting savings linked to money creation. So the Bangladesh Bank should participate in supervisory activities of NGOs.
- d. Those who have already collected savings of more than Taka 50 lac and disbursed credit above Taka 2 crores, should seek registration from the Bangladesh Bank;
- e. There should be a clear definition of 'member' and 'non-member'. NGO-MFIs who had collected savings from non-members should be licensed by the BB;
- f. The government should establish either a subsidiary of the BB or a separate independent body to monitor and supervise NGO-MFIs, that could be run by a Board comprising of members, mainly from the private sector, where the governor of the BB could act as Chair.

The MD of PKSF was one of the members of the Committee, who sent separate comments³¹⁷ that had a slightly different opinion on the recommendation regarding BB's involvement in the supervisory process. It opposed BB's involvement in the matter. Instead, it highlighted PKSF's expertise in the field and pointed out possible difficulties that BB might face in establishing a monitoring body for the sector. PKSF offered help in establishing a body it thought would be more cost-effective in every way. PKSF also added that it would provide all kinds of assistance, including staff support, in building this new body. This objection from PKSF to BB's involvement in the supervisory process created a complex situation for the government in selecting a body to take responsibility, at least at some level.

Step-2: A Unit under the Bangladesh Bank

After getting suggestions from this Committee, the government again formed another committee and established a Unit (Microfinance Research & Reference Unit) in

³¹⁷ Letter sent to BB on 16th February 2000 (Bangladesh file no: ACD (micro)95/2000)

Bangladesh Bank on 18 June 2000³¹⁸. It added four new members to the Committee. Among them were: a) a representative from the Ministry of Finance, b) the MD, Grameen Bank, c) the Executive Director of CDF, and d) a representative of small NGOs. The governor of Bangladesh Bank was nominated as the Chair again for the new Committee under the Unit. The two major concerns the government expressed in the relevant circular were:

- a. Ensuring transparency and accountability in the operations of NGO-MFIs, and
- b. Protecting clients and depositors from possible financial loss and disaster.

The recorded notes³¹⁹ of the meeting under the Ministry of Finance, before issuing the above circular, revealed that the state bureaucracy was much more aware of the situation by 2000. Hence, it was cautious in creating an enabling legal environment for the sector, keeping all the parties in a good mood. The World Bank expressed its concerns again while it supported this initiative of the government. It mentioned in its Aid Memoire³²⁰ of July 2000:

IDA will support the Government's initiative to develop a regulatory framework for the industry, which accommodates broad stakeholders' consultations and leverages their knowledge. However, MFIs, which are not engaged in public deposit taking, should be regulated through performance or industry standards. Such regulations should be exercised as incentives for them to be self-regulated and rated to increase their creditworthiness and sustainability in order to link them to the market. Since PKSf has developed performance standards for its POs, it would be an appropriate institution to develop industry or performance standards. The mechanism for compliance with these standards is critical and the stakeholder's preference is for an independent apex organization. The Research and Reference Unit on Microfinance recently formed in the Bangladesh Bank will closely work with PKSf and PKSf will be responsible for developing TORs for implementing regulatory framework component. (P-6)

The new circular of the government regarding establishing the MRRU and forming the Committee, in fact, created a new institutional setup (organisations and rules). The assigned duty of this Unit was to run as a temporary agency to implement the Committee's suggestions, where the Committee functioned like a Board³²¹. It was a

³¹⁸ Government's circular no. Ag/Aw/e/vs/Ks/Kv-9/179/99-78 dated 18th June 2000

³¹⁹ Meeting minutes of MoF, meeting held on 28th May 2000 on the issue

³²⁰ Final Aid-Memoire of Poverty Alleviation Microfinance Project (Cr. 2922 BD) sent to the government on 9th July 2000

³²¹ There were 11 members in the Committee including the governor, BB. Other members were-1) DG, NGOB, 2) a representative from Ministry of Finance, 3) a representative from Ministry of Social Welfare, 4) Chairman, ADAB, 5) Fazle H Abed, ED, BRAC, 6) Managing Director, GB, 7) Managing

platform to start the process of establishing a legal framework for NGO-MFIs with the joint efforts of both the private and public sectors. The government finally assigned the last ToR, (ToR, d), the duty of finding an ‘appropriate regulatory body’, to this Committee. It said the Committee should recommend a regulatory framework, in support of this Unit, or of a new regulatory body in its place.

This MRRU at Bangladesh Bank initially worked for three years, which was extended for two more years. During the initial three years, it formulated some policies and guidelines³²², according to the first three tasks of the ToR. In these three years, the committee members met in nine meetings, but things did not move as smoothly as expected. In the second meeting of this Committee, some members again raised the same issue that the central bank should not be involved in this process of formulating policy for MFIs, and they suggested transferring this responsibility to PKSF or some other experienced organisation. So, in the third meeting, the Committee decided to form a technical committee under the leadership of the MD, PKSF, which would help the committee in completing the tasks. Furthermore, CDF, the network organisation of NGO-MFIs was nominated as the secretariat of this technical committee, and members were drawn from all related organisations, including BB, GB, and NGOAB. At the same time, the Committee decided to use funds from the World Bank MF-II project, to continue the MRRU's tasks.

It is interesting to note here that the task of formulating policies for the sector had finally been transferred to the hands of NGO-MFI sector representatives as initially desired by the donors and MFIs, but things happened indirectly. Meanwhile, the interested parties were able to manage support from the government. Since the Bangladesh Bank’s ‘signboard’ was tagged to all the activities of the MRRU, no legal

Director, PKSF, 8) ED, CDF, 9) a representative of small NGOs , 10) a representative of BB. In both these committees three members were common, they were- a) MD, PKSF, b) Fazle H Abed, ED, BRAC, and c) Chairman, ADAB.

³²² Such as :

-) No NGO-MFIs would be permitted to collect savings from non-members (clients who only participate in savings programme).
-) If any organisation had already done so, and if the amount exceeded taka 1 crore, then that organisation should seek licensing from the BB as a financial institution.
-) NGO-MFIs should report to the MRRU on a regular basis according to its prescribed formats.
-) Organisations should follow the uniform Accounting and Audit guidelines that had been developed already.

question was raised against any decision or action taken by the MRRU³²³. The public took it seriously, and the MRRU gained acceptance from all.

In the final report submitted after three years, the Committee requested the government to extend its time for two more years to complete the last task of formulating a legal framework for the sector, which the government allowed. The Committee's report to the government reveals that two of its decisions had major potential consequences in the market, such as:

- a) Defining 'Member' and 'non-member': It defined 'member' as any individual from among target clients who may participate in the credit programmes of the organisation. As opposed to this definition, a 'non-member' was a person who only participates in savings programmes and who does not borrow. It meant that only the credit clients of an organisation would be considered as 'members' of that organisation. Thus, the new definition of membership of NGOs had the risk of forcing a person to become a borrower to justify his or her position as a 'member' and indirectly closed the option of collecting savings from all non-borrowers.
- b) The justification for charging 15 per cent interest on the loan at a flat rate³²⁴: The Committee collected data on the interest rates of microcredit for examination, considering its importance and sensitivity in the public sphere. It reinforced justification for the existing market rate of 15 per cent (which would be around 30 per cent if calculated by standard methods practiced by the banking sector) by stating that charging an interest rate of 15 per cent by most of the MFIs in Bangladesh was 'tolerable', comparing it to other countries. It had not, however, provided any economic and financial justification like the actual cost of providing services, real yield earned by NGOs, and other factors. By its simplistic observation, it recommended that it would not be a right decision at that moment to establish any strict policy on the interest rate or to impose any upper limit or cap on it. Hence, in the absence of any clearly defined policy guideline, various

³²³The MRRU's decision to warn the public about illegal public deposit collection by unlawful organisations was published in national dailies under the Bangladesh Bank's name (the Daily Star, 01 August 2004, Page-10). Reporters used Bangladesh Bank's name while reporting news about the activities of the MRRU.

³²⁴Straight 15% on the whole amount for the entire period of loan, does not consider the fact that the outstanding balance of loan is declined with the instalment payment as per payment schedule. Therefore, the actual interest on loan becomes almost double if it is calculated on declining balance method as banks do.

methods were observed in the market which apparently showed a 15 per cent interest rate but which would be much higher than 15 per cent if calculated on the basis of standard practices³²⁵ in the financial market.

Step-3: the legal framework

In the second term, the Steering Committee of the MRRU initiated the final task of formulating a legal framework by engaging lawyers and specialists. Initially, there was a plan that this legal framework would address not only NGOs but also government microcredit programmes³²⁶, and the idea of establishing Micro-Capital Banks (MCB), though the ToRs of the Committee covered only NGO-MFIs.

So the first draft of the law had four main chapters. The first chapter was about forming an independent 'Regulatory Commission' to issue a license to MFIs (NGO-MFIs, MCB, and Government Programmes), and to oversee their operations. The second, third and fourth chapters addressed issues related to NGO-MFIs, MCBs, and Government programmes, respectively. This draft went through several revisions on the basis of member comments before submitting the final draft to the government in September 2005. It was brought into discussion at the stakeholder meeting before finalising, where 124 NGO-MFIs participated along with other stakeholders. Since the initial draft was prepared with the help of the sector's representatives and it had gone through several revisions, it already reflected the NGO sector view in a broader sense. Therefore, there was no significant MFI resistance at the stakeholder meeting.

The final draft, after removal of the parts related to forming MCB and incorporating government programmes, as per the government's decision, it contained basically two chapters. The first chapter concerned matters related to the formation of an independent regulatory authority and the second chapter dealt with issues related to the formation and operation of NGO-MFIs. The second chapter on MFIs covered only basic matters such as how to get a license, what activities should be permitted under the law, how to punish an MFI if required, how to create a reserve fund, and other such issues. It was formulated in such a way that an existing NGO-MFI would not have to re-adjust many things to perform as a licensed organisation under the law. It did not bring up controversial issues and did not touch upon any sensitive matters like

³²⁵ If considered upfront deduction of credit before disbursement, loan repayment period, frequency of instalment, compulsory savings requirement, insurance payment etc.

³²⁶ There were 48 microfinance programmes under 14 Ministry/ Department of the government by June 2003

‘interest rates’, ‘public savings’, ‘utilisation of profit’, ‘governance’, or ‘ownership’. Therefore, there was no significant resistance from any quarter. Since the task was done by NGO-MFI sector leaders and representatives under a ‘Bangladesh Bank’ banner, the process moved very smoothly and all parties were happy, including the government. The final draft proposed to establish an independent regulatory agency outside the Bangladesh Bank system.

7.5 OUTCOMES UNDER TWO PHASES OF THE GAME

The final outcomes of this game were achieved in two stages. In the first stage, participants reached a decision on some sort of industry standard and code of conduct or strategic monitoring. In the second phase, they finally reached consensus in favour of an independent body to monitor the NGO-MFI sector under separate rules.

Game-1: Cooperation for strategic monitoring

So, we see that the game over NGO regulation has finally reached an acceptable equilibrium for some industry standard, and it seems to have emerged as a historical necessity, though the nature of regulation remained undecided until that point in time. There were many players involved in the game. However, the game was basically between state agencies and MFIs, and here it was the NGOs. The path which the game followed during this phase is shown in Game-1 below (table 7.1). It also presents respective payoffs for each level of strategy of each player. In this stage, the central bank was a passive player in the game though its passive role was itself a very strong signal for changing and influencing the other player’s decisions.

Table-7.1: Game-1: Agreed strategy among the players for regulation/ monitoring

MFIs (NGO-MFIs)	Strategies of state authority		
	Strategies	No Regulation	Regulation
Against Regulation	(Full freedom, Possible disaster) [1]	↓	(Non-cooperation, difficult to implement) [3]
For Regulation	(Self-regulation under cooperation, No monitoring agency) [2]	↙	(Agreement on some sort of monitoring/ industry standards) [4]

In this game, the two strategies of the state were: 1) to remain silent (no regulation) or 2) to impose regulation. Whereas, NGO-MFIs could either take a position against imposed regulation or take part in favour of some kind of desirable regulation. The first set of strategies [1] would allow MFIs full freedom, and disaster would be inevitable. In the case of the second set [2] when MFIs have agreed to follow self-regulation, where there is no monitoring agency to oversee them, the situation would always have the possibility of disaster if short-term self-interest prevails over self-regulation on the part of the NGO-MFIs. The situation under strategy combination [3] is simply ineffective since it would not be possible to implement government regulation if NGO-MFIs were not in favour of it. Finally, both players might have extended their cooperation to develop some kind of industry-friendly regulation or strategic monitoring [4]. Only this situation can ensure goal equilibrium for both sides. The black arrows show the historic journey of the game from one strategy combination to another. Only in the last phase (4) do concrete issues arise, of searching for new routes and a new set of rules to link NGO-MFIs with the broader financial market of the country.

Game-2: Mutually acceptable solution for an independent body and separate rules

Different strategies of the government and the NGO-MFIs in the second phase of the game are shown in Game-2 below (table-7.2). It had already been decided that neither 'self-regulation' nor 'banking regulation' would be considered to bring the sector into a legal framework. Instead, it was decided that the rules and regulations would be user-friendly and would be prepared in consultation with industry representatives. The only question which remained unresolved was, which agency would act as regulator.

There were many options, such as Bangladesh Bank, or PKSF, or another independent body under separate legal charter. Some favoured BB, some PKSF. But the sector and donors favoured an independent body. The government shifted the responsibility of negotiation on its behalf, to the Bangladesh Bank to avoid any controversy and possible contradictions. In a later phase of discussions, both the Bangladesh Bank and PKSF were excluded from the picture as possible options. So the only mutually acceptable solution left for all was to come to a conclusion for an independent body under a separate law (payoff under [4]).

Table-7.2: Game-2: Cooperation for ‘light touch’ Regulation under an Independent body.

MFIs (NGO-MFIs)	State agencies		
	Strategies	Regulated by Bangladesh Bank	Separate independent regulator
	Customized regulation under BB	(Resistance from the sector, Huge task on BB’s shoulder) [1]	Mutually Exclusive Solution [2]
Customized regulation under a separate agency.	Mutually exclusive situation [3]	Cooperation for ‘light touch’ regulation under a separate independent agency. [4]	

Finally, the Microcredit Regulatory Authority Act was passed by the Parliament in July 2006, the first comprehensive law that brought microfinance operation of NGOs in Bangladesh under some ‘light touch’ (Ahmed, F. 2013 & Rahman, A. 2013)³²⁷ regulation by creating a separate regulatory authority for the sector, under separate law.

7.6 CONCLUSION

NGOs in Bangladesh slowly entered into the financial market since the mid-eighties. They entered the market under a favourable socio-political environment to grow with the support of complimentary seed funds both from international donors and the national government. They emerged with a development agenda flag such as credit operations for income generating activities of the poor, to address the government’s failure in serving the poor. There was a successful ready-made model to follow at hand, which was the ‘Grameen model’ of microcredit. Nonetheless, significant differences in legal structure existed between the Grameen Bank and the NGOs. NGOs did not have any equity shareholder or owner, and they had more flexibility in management control compared to GB. In the absence of any regulatory binding, monitoring, or supervisory oversight till 2006, they grew with full control of their

³²⁷ The term ‘Regulating with a light touch’ is used in Ahmed, Brown, & Williams (2013) in relation to microfinance regulation. Dr Atiur Rahman used ‘light touch regulation’ in his keynote speech on ‘Microfinance in Bangladesh: Challenges and Future Directions’, organized by PKSf on 3 November 2011 (Rahman, 2013).

own management style. They wished to enter the microcredit market like GB as this was the only activity in the ‘development work’ category which had potential to generate income and to be self-sustaining, the dire need of the time.

Gradually NGO-MFIs emerged as important providers of microcredit. Over time, their aggressive move for deposit collection brought tension in the market, which finally called for regulatory oversight. The time by which state agencies became aware of the possible risks and benefits, NGOs moved forward boldly with the support of various internal and external agencies and individuals. By then they had produced an extensive social network and many social outcomes, so it became quite impossible for the state to dismantle such a huge social force. Moreover, there was little scope to undo the past actions of NGOs as they meanwhile became important development partners of the government. So the state had to accommodate NGOs’ microfinance operations as an ex-post event and the only available option was to legitimise these operations under a new legal framework.

Given this background, the period of early expansion till the enactment of the new law, which means from the 1990s to 2006, can be summarized into four major sub-periods or phases from the perspective of institution formation, in terms of both organisational setup and legal setting. Figure 7.5 highlights the step by step institutional development of NGO-MFIs during this period, each phase describing the major organisational and legal landmarks of that particular period, although the whole period has some persistent, continuous, common features.



Figure-7.5: Step by step progress of NGO-MFIs towards institutionalisation (1990-2006)

The first phase went to take off with the core focus of financial viability; the second phase concentrated on setting some industry standards and in developing professionalism. NGO-MFIs expanded business during these two phases, and gained some confidence as a new set of financial organisations in serving the rural poor. Finding new routes to link them with the formal financial market was the major

agenda of the third phase and finally the formulation of a new kind of 'light touch' regulation, under a separate regulatory authority, was the fourth and last phase in institutionalising NGO-MFIs in Bangladesh.

There were many participants such as the government, MFIs, and donors in these developments where they interacted with each other in a very complex and interesting manner. However, the final game was played between the state and the NGO-MFIs. They successfully reached mutually beneficial outcomes under two phases of the game. In the first phase, the state had two options, to regulate the sector, or not. Likewise, NGOs also had two choices: 'be regulated' or 'not be regulated'. However, due to historical necessity both players mutually cooperated to bring the microfinance services of NGOs within some regulatory oversight, though they were not sure about the nature of that regulation or strategic monitoring at that time.

So the first phase of the game could reach an equilibrium outcome for both without much disagreement. In the second phase, the state had options to bring the sector either under the Bangladesh Bank, or PKSF, or any other independent authority. However, the sector with the support of other stakeholders had a preference for an independent authority. Later, Bangladesh Bank and PKSF were excluded from the list. So finally, the state and the NGO-MFIs mutually cooperated in formulating enabling rules and regulations for the sector, and in developing an independent regulatory agency, the Microcredit Regulatory Authority, under a separate Act.

CHAPTER 8

NGO-MFIs under the New Law:

Towards a Bilateral Game Model

8.1 INTRODUCTION

Certain rules and regulations, for the microfinance operation of NGOs in Bangladesh, have attained more or less final shape after long interaction between relevant actors. Parliament passed the Microcredit Regulatory Authority Act³²⁸ in July 2006 and established a regulatory authority (the MRA) the same year. This new Authority initiated the process of executing the legal rules. The Act provides a basic framework for NGO-MFIs to operate in Bangladesh, though there is plenty of room for expansion.

This chapter discusses the post-law actions and reactions of key players. There are two main players, the MRA and the NGO-MFIs, who negotiate with each other to operate the law in each one's own favour. The MRA as regulator responds to this push and pull. The nature of its responses depends on factors such as legal strength, internal capacity and quality, external support, and other related factors. A bilateral game model will explain finally, how the concrete law along with its rules, sub-rules, regulations, and circulars evolve from this game.

Figure 8.1 presents a graphic representation of an IAD framework I use to explain this bilateral microfinance game between the MRA and the NGO-MFIs. The MRA evolved as a new player in the 'microfinance game' with the enactment of the new law. The government created this authority to monitor and supervise NGO-MFIs, are responsible for managing and protecting the 'public good'³²⁹, the microfinance fund. The self-appointed management team of an NGO-MFI comprised of its governing body members and Chief Executive, including the founder, take decisions and run the organisation with the professed objective of best utilising this 'public good' for public benefit, especially to achieve poverty alleviation.

³²⁸Act number 32 of 2006 of Bangladesh Government

³²⁹NGOs have been described, in the 'International Encyclopaedia of Economics' (Magill, 1997), as an agency alternative to government for the provision of public goods. In Bangladesh, the microcredit fund supplied by the NGOs may thus be treated as a public good since it has neither been created by any direct private investment money, nor is it owned by any private body.

Institutional transformation, 2006-2014

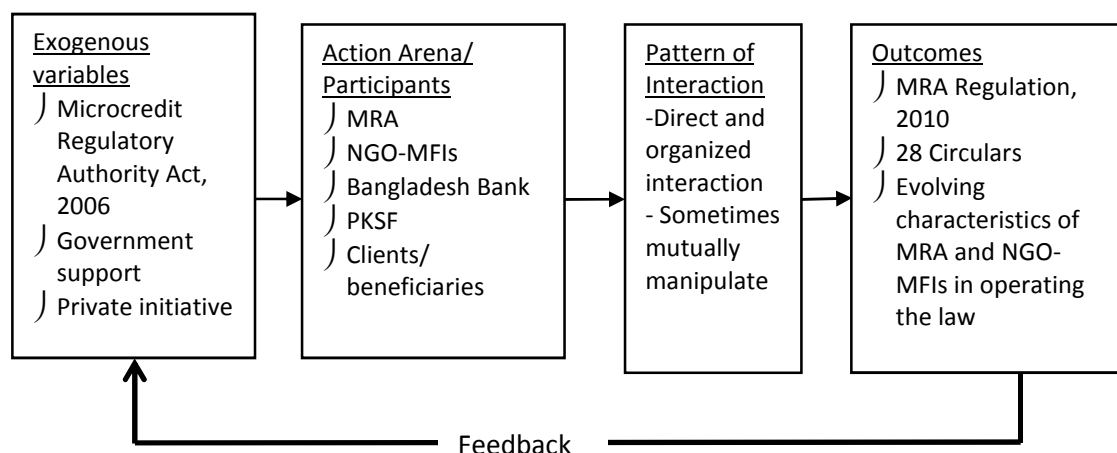


Figure-8.1: Institutional transformation of NGO-MFIs under the new law

There are three more participants in this discussion: Bangladesh Bank, PKSF, and the clients. Bangladesh Bank and PKSF may not play a direct role in influencing the game between the two key players, but they certainly have indirect influence on them. In the short run, a few million NGO-MFI clients may not have any direct power in changing institutional rules, but they have significant roles to play in the long term, when and if they become active subjects rather than passive objects. They are linked to NGO-MFIs as ‘beneficiaries’ of their services while they have neither any equity participation nor any voice in the lending organisations’ decision-making process. Information asymmetry between NGO-MFIs and their clients are therefore quite huge, where the MRA has a significant role in preventing the causes of market failure.

In the process of negotiation, a new set of rules was formulated in 2010³³⁰ by the MRA. This new set of rules is the second layer of the framework, which is the expansion or activation of the main Act to meet legal requirements and filling the gaps. It also circulated another set of sub-rules (administrative circulars)³³¹, the third layer of the rules, which are the most flexible outer layer. These are the three layers or boundaries which eventually regulate licensed NGO-MFIs.

³³⁰ Microcredit Regulatory Authority Regulations, 2010 (S.R.O. no. 394-Law/2010 dated 19 December 2010, circulated for public on 17 January 2011). In addition, The MRA has circulated another set of regulation on 01 January 2015 (Depositors’ Protection Fund Rules, 2014), which is not part of discussion of this paper

³³¹Till December 2014 the MRA has issued 28 circulars on its administrative capacity

This chapter has seven sections including introduction. The next section presents an analysis of the basic features of the Act, the first layer of rules. Section three discusses the process of establishing the MRA and its organisational attributes. The formulation process of the other two layers of the rules (MRA Regulation, 2010 and administrative circulars), the debates around these, the content of these rules and sub-rules, and stakeholder responses to the rules are the focus of section four. The fifth section provides stakeholder opinions regarding the MRA, and an analysis that identifies its strengths and weaknesses. Section six describes the game between the MRA and the NGO-MFIs by presenting the end state of the policy environment as a historical outcome of the various initiatives and interactions. The final section concludes the chapter.

8.2 MICROCREDIT REGULATORY AUTHORITY ACT, 2006: THE FIRST LAYER OF RULES

The government passed the Microcredit Regulatory Authority Act on 11 July 2006 at the 22nd meeting of the 8th Parliament, which was the last Parliament session of the government in power at that time. The Finance Minister presented the draft bill to Parliament on 7 June 2006 at the first meeting of that session. Parliament proceedings reflect that the bill passed into an Act rapidly, without any contentious discussions in the sessions and without bringing significant changes to the draft³³². This probably was due to political unrest in the country and most of the discussions in Parliament concerning this bill, were of a general nature. During discussions, a few Parliament members criticised NGO involvement in political matters, their ‘Fly by night’ practices, their integrity in managing funds, and their high microcredit interest rates. It seems Members were favouring this law mainly to control NGO-MFIs, though a few raised the issue of hindering NGO innovations due to external interventions. At last, a few minor ornamental changes were made to the final Act, mainly in its structure and in the language. But the basic framework of the draft prepared by the National Committee remained unchanged.

The stated objective of this Act was to ensure transparency and accountability in the microcredit operations of NGOs, fundamentally associated with governance issues of these organisations. The structure of the law is based on an incentive and punishment mechanism, where ensuring efficiency and equity are considered to be the

³³² Parliament proceedings (Part 22, 2006, P.48-97)

two inevitable outcomes of the whole regulation process. As mentioned earlier in chapter seven, this law was drafted by representatives of the sector and government officials who were more or less sympathetic to the sector. Hence, it tried to accommodate the general practices of then existing common market trends as far as possible, and allowed plenty of flexibility for NGO-MFIs to readjust their operations to the new law.

Main features of the Act and a few observations

The Act has 52 sections in seven chapters altogether. The first chapter, after the preamble, provides definitions of key words. The second and third chapters deal with matters related to the establishment of the regulatory authority, the MRA. The issue of getting a license from the regulator to run a microcredit organisation is the main content of chapter four. Chapter five addresses formation of a ‘Depositors’ protection fund’, protection of the financing organisation, duties of NGO-MFIs, qualification of a Governing Body member of an MFI, and other such matters. Chapter six covers all the punishment clauses. The last chapter deals with issues such as the MRA’s power in formulating follow-up rules and sub-rules, its accountability in submitting annual reports to the government, and other such matters. A brief chapter-wise summary of the law is presented in Appendix-E1.

The law defines ‘microcredit’ as credit facilities for alleviating poverty by creating job opportunities for ‘landless’ and ‘destitute’ people. But in the absence of any clear definition of the words ‘landless’ and ‘destitute’, virtually all poor people belong to the target population of NGO-MFIs. Hence, they are labelled either as ‘clients’ (*grahok*) or as ‘members’ (*shodosha*). The terms ‘client’ and ‘member’ are used in the Act interchangeably to refer to any target population who receive microcredit services from any NGO-MFI. It actually boils down to mean any low-income person with low endowment ownership. This definition of “client” seems very vast and unspecific, which allows MFIs to expand their business all over the country both rural and urban without any specific social class boundary. Within the framework of this Act, a ‘member’ of an NGO-MFI primarily means a client or borrower without any share or ownership in the organisation.

This Act defines a microcredit organisation as a registered NGO under specific registration authority(s)³³³ that has microcredit operations in the field after obtaining a license from the newly created MRA. The first chapter of this law defines three other important words: ‘deposit’, ‘depositor’, and ‘service charge’. According to the Act definition, ‘deposit’ means deposited amount to an MFI by its client or member that is payable by the organisation on demand, and ‘depositor’ means the one who deposits. The law has not used the word ‘interest rate’ anywhere in the text. Instead, it has used ‘service charge’ to mean the exchange value of credit or price of credit.

The second chapter of the law specifies procedures to establish the Regulatory Authority and provides a list of its duties. According to the Act, the Authority is a statutory body, and the power to run its operations is granted to a Board of eight members. The Governor of Bangladesh Bank is the Chair of this Board, and the other seven members, including the Chief of the MRA, are government nominated persons for a fixed term of three years. The chief executive known as Executive Vice-Chairman (EVC), acts as the member-secretary of the Board. Issuing licenses to NGOs for running microcredit operations is mentioned as one of the main duties of the MRA. The other important duties are: a) formulate operational rules, b) monitor and supervise licensed organisations, and c) help financing organisations. The MRA Board is fully empowered to run the Authority and make policies for the sector. It has the power to fund itself with government grants, fees from licensed organisations, and funds from international agencies. The MRA is allowed to use these funds according to government policy. It needs to submit a regular annual budget to the government for approval, and the government is to provide necessary budgetary support accordingly. Like many other government offices, the Office of the Auditor General is responsible for its financial audit.

The next two chapters of the law address broader operational procedures related to NGO-MFIs. As a rule, no NGO is permitted to run microcredit operations without a license from this Authority. Older organisations that already had microcredit operations, before the enactment of the law, were given the first chance to apply for a license to legalise their past actions. In fact, legalising existing NGOs’

³³³ From- a) Joint Stock Companies under the Societies Registration Act, 1860, b) Department of Social Services under the Voluntary Social Welfare Agencies Ordinance, 1961, c) Ministry of Law under the Trust Act, 1982, and d) Ministry of Commerce under the Companies Act, 1994 [Section 1(21), MRA Act, 2006]

microfinance operations was a very urgent priority, so the objective criteria for them to get a license were relaxed by the Authority. Practically, it was difficult for the MRA not to approve licenses for existing NGO-MFIs, especially the big ones that had already received financial support from donors or the government before applying for a license. This situation created a moral hazard for the Authority where there was every chance of making a wrong choice in legitimising the past operations of an existing organisation. If the license were not approved for a good, performing NGO, unknowingly or wrongly, that could also create additional social problems. Again, if a license was approved for a fraudulent or corrupt organisation, it may have other negative consequences³³⁴. Therefore, the law kept a discretionary option open for existing NGOs under section 15 (3). It stated that any existing NGO-MFI, who applied for a license within the given specified time, was permitted to continue operating until the Authority took a final decision.

A licensed MFI is allowed to provide all kinds of financial services such as credit, deposit and insurance for their clients, in addition to other assistance required to run clients' businesses. It allows NGO-MFIs to accept deposits from the target 'clients' while it prohibits accepting deposits from persons other than its 'members' (clients)³³⁵. It should be noted here again that the word 'member', in the context of an NGO framework, has every chance of being misused by many. The law, in fact, allows a licensed NGO-MFI to collect deposits from anybody who is 'landless' and 'destitute'. It mentions maintaining a 'Depositors' protection fund'³³⁶ to protect deposits and depositors under this law. However, MFIs are not given permission to run any business activity that is in conflict with the general poverty alleviation objective. The Act does not allow MFIs to distribute any dividend or profit without permission from the Authority; nonetheless, the act remains silent and unclear on the issue of ownership. Since the concept of ownership is blurred, the issue of capital requirements or other prudential standard requirements of banks remain absent too. Instead of maintaining a required amount of capital, MFIs are requested to keep a reserve fund from its surplus earnings.

³³⁴PROSHIKA, one of the largest NGO-MFIs, is a typical example of this kind (as explained in Appendix F3 under chapter 9).

³³⁵ Section 24(2)(ga), Microcredit Regulatory Authority Act, 2006

³³⁶ MRA has circulated Depositors' Protection Fund Rules, 2014 on 01 January 2015

The law has some gaps in addressing the current legal structure of an NGO properly. Section 34 of the law states a licensed organisation is permitted to run other poverty alleviation activities under the same legal and organisational setup. It mentions that this law permits an NGO to be registered with different registration authorities, allowing multiple registrations with multiple authorities. Hence, a parent legal entity can run various kinds of operations under different laws. According to the current law, an NGO is not obliged to separate its financial operations from its multi-portfolio holder parent organisation. As such there is every chance for lack of coordination or conflict between the different registration, monitoring, and supervising authorities or agencies. Conflict between different legal agencies can jeopardise the whole programme if any one agency takes action against the governing or management body of an NGO for a particular misconduct in a particular operation, which can have dire consequences for other programmes in the NGO's portfolio. This overlapping of regulatory authority and function can also make the law ineffective if one agency believes another agency should be responsible for regulatory oversight of a particular misconduct of an NGO and hence, it has no responsibility itself. This issue is important because the MRA law is only effective for microfinance activity of an NGO, and does not cover all NGO operations. Hence, questions about one NGO activity impacting another, and protecting fund transfers from one profitable activity to a losing one remain of great concern.

Nonetheless, the law tries to separate the policy making body from the operational body of an organisation. It states that no professional (salaried) person is allowed to be a member of a board or governing body of an organisation that includes its Chief Executive (CEO)³³⁷ as well. The law empowers the Authority to remove a governing body member or the CEO of an MFI, if needed to protect client interests³³⁸. According to section 45 of the Act, the Authority is directly accountable to the Parliament of the country and hence, it has full freedom to run like an independent constitutional body. It is connected to the Bangladesh Bank by its Board where the governor of the Bank is the Chair. There is, however, no other formal coordinating mechanism between Bangladesh Bank and the MRA. Only, section 48 of the law instructs the MRA to follow Bangladesh Bank's broader policies for the financial market when formulating policies for this particular sector.

³³⁷ Section 27(3)

³³⁸ Section 29 of the Act

Though the law does not explicitly announce an incentive package for any good deeds, it has specific punishment clauses for specific offenses and misconduct. However, the authority for practical reasons licensed NGO-MFIs, legitimizing their past, potentially illegal operations, and permitted them to collect deposits from their clients. This can be viewed as an implicit granting of incentives to NGOs.

Chapter six of the Act is fully dedicated to all kinds of punishment clauses. Besides this, there are other clauses which also specify punishment for doing anything harmful to clients or the public. There are different degrees of punishment in the law as well and some can be implemented at an administrative level by the MRA, which has provisions for a penalty, and jail. The law mentions that any offense under this law will be considered a criminal offense and will be treated accordingly under the Code of Criminal Procedures. The Authority also has the right to cancel a license anytime if an MFI does not comply with the terms and conditions applicable to it.

The overall analysis of this law indicates that it does not touch the core operational areas of existing practices, except one. The law pronounces the CEO of an NGO-MFI as a non-voting salaried person who should act as a member-secretary of its Board, and is not granted the full status of a member. In reality, the founder generally acts as CEO or Chairperson, draws a regular salary from the organisation, and controls the Board as an important, powerful member. This particular clause³³⁹ of the law has created difficulties for NGOs to readjust their current practices, as well as created a rule enforcement problem for the authority. The overall framework of the law provides the Authority enough room to frame monitoring and other sub-rules/tools within the purview of the law. It specifically gives power (section 50 & 51) to the MRA to formulate rules and sub-rules on several issues.

8.3 NEW PARTICIPANT: MICROCREDIT REGULATORY AUTHORITY (MRA)

The MRA is an outcome of the collective expectations of stakeholders, realised with the help of this Act. As state machinery, protecting the public interest is the MRA's fundamental duty, although this is not explicitly stated in the law. Instead, ensuring accountability and transparency in the operations of NGO-MFIs have been stated as its objective. The legal sanctioning of power alone is not enough to empower a regulatory agency. It needs legal autonomy, economic independence, statutory

³³⁹ Section 27 of the Act

prescriptions³⁴⁰, and organisational independence (Gilardi & Maggetti, 2012)³⁴¹ to be effectively operational, and even then these are not sufficient conditions to build a proper monitoring and implementation capacity.

The final performance of such a body depends on many internal and external factors. It needs to understand the market, make strategic decisions to act in a flexible and pragmatic manner. It should have a clear vision for future direction, and should be able to maintain the internal coherence of its working team. A regulatory body of such significance should have the strength to realise its vision, and must have visionary leadership. It needs to know how to properly coordinate with other stakeholders, and above all it needs the necessary supply of resources. In short a regulatory body such as the MRA differs from any other economic body in many ways; pure economic or financial sustainability cannot be its primary goal alone. Besides, as a government body MRA nested within the bureaucracy of the government system that necessarily influences its functions, the MRA has to be vigilant in maintaining its autonomy.

The Authority initiated its operations with the support of Bangladesh Bank. The Bank provided the MRA all kinds of secretarial and staff support till it recruited its own staff in 2010³⁴². As such it clearly has ties to Bangladesh Bank since its inception regardless of the resentment of some stakeholders regarding the central bank's involvement in microfinance. This initial arrangement with Bangladesh Bank helped the MRA to get started. Direct government support came much later. Regardless of the many criticisms to date, most of its top level positions are held by central bank staff. The first Chief Executive³⁴³ was the operational head of the MRRU and has continued in this role since the MRA's inception when he was an executive at the Central Bank. Bangladesh Bank's staff members at the MRA have played an instrumental role in building an amiable working relationship between these two financial regulators, though there is no formal coordination between them.

³⁴⁰ Gilardi & Maggetti (2012) mention, appointment procedure of Board members, CEO, their status, terms and conditions of appointing them, etc. as statutory prescription.

³⁴¹ Whether budget comes from the government or other sources, whether the agency is free to organize its internal structures and to determine its staff policy such as salary structure.

³⁴² MRA could not recruit its regular staff immediately after its establishment because of many procedural and bureaucratic arrangement related to this.

³⁴³ His contract expired in March 2015

Donors were not very active in this phase of establishing the MRA. In fact, they declared publicly as a group that they would not³⁴⁴ get involved in creating the MRA. However, some were interested³⁴⁵ to become involved in the process of building this new organisation. The British DFID was one of the leading donors in this group which did not want to miss the opportunity to join the effort to create MRA in the second phase, as it played an active role in shaping the initial ideas during the late 90s³⁴⁶. So DFID (currently UK-AID) signed an agreement with the government in May 2007 to provide grant support to the MRA for seven years as a microfinance project (PROSPER). This funding from DFID helped MRA get started; the MRA quickly recruited some project staff³⁴⁷ and moved off the Bangladesh Bank premises to its new rented offices³⁴⁸.

However, the MRA was unable to recruit its regular staff before mid-2010 due to many bureaucratic and procedural issues associated with the recruitment. It needed a few years to set up the organisation, to hire staff, train them, and to place them in the new environment. One of the former Board members of the MRA commented (Islam, R., 2014) that the first 2/3 years went by just to set up office. Then, issuing licenses to NGO-MFIs was a huge task and the MRA needed to do some ground work to set the criteria for issuing licenses, she added. Although the Board had legal power to appoint employees to the terms and conditions fixed by itself (section 11 of the Act), practically this power of the Board was ineffective. It had to seek government approval each time and for every matter to take any decisions regarding the MRA's organisational structure. The MRA had to follow government pay-scale for regular staff so it was difficult to attract qualified young staff to a new organisation like the MRA with that compensation package. The Board wished to add some extra facilities for its staff but this was beyond its capacity because of a shortage of funds. Many of its young staff joined the MRA with a wrong notion that they would be a part of Bangladesh Bank. They expected an attractive salary package like Bangladesh Bank

³⁴⁴ In the Joint Donor Strategy on Microfinance (Draft summary: 20 June 2003) donors had decided that they should not actively seek to involve with the matter since it was a matter for Bangladesh itself to decide which route to follow.

³⁴⁵ A group of donors, (CIDA, IFAD, DFID and some others) led mainly by DFID, came to the forefront at the end of 2004 with a comprehensive project proposal (FSP-Financial Services for the Poor, later renamed PROSPER) that contained a component for helping the future regulatory agency in place. But no other donors participated in the project at later stages except DFID as mentioned in the initial project documents.

³⁴⁶ For details see chapter seven

³⁴⁷ Some consultants were recruited in 2008 and the first batch of officers were recruited in 2009

³⁴⁸ Rented new office from 01 March 2009

staff working at the MRA, which they did not, with mounting frustration among these staff members.

The MRA Annual Reports 2006-2007 & 2007-2008 show the government approved an organisational structure of only 69 staff members for a regulator like the MRA responsible for monitoring and supervising a few hundred MFIs operating all over the country. Of these 69 sanctioned posts only 43 were reserved for decision-making positions, and the rest were support staff positions. Later, the government added 18 more support staff with no added posts for officers. MRA's request to the government to revise its organisational structure and sanction more posts has been awaiting approval since long. The first batch of 53 staff members joined in 2010, but seven of the 23 young, entry level officers left within a very short period (table-1 in Appendix-E2). The high dropout rate of employees, especially at the entry-level, has also been reported by the Chief of the MRA. Newly hired staff members were frustrated with the existing poor compensation packages and limited career paths³⁴⁹. Both the current Chairman and the EVC have mentioned that a seed fund for the organisation would be a great help in preventing staff drop out. The MRA has been trying to get those funds from the government for some time, in vain. This new regulatory agency is highly dependent on the government's yearly budget allocation for every matter since the government started providing regular budgetary support in 2009 (table-2 in Appendix-E2). Initially, the amount was very tiny but it increased with the gradual decrease of DFID funds. Paradoxically, the MRA could not utilise the entire funds allocated for a particular year due to attached conditionality and also because of MRA's internal incoherent nature of work procedures³⁵⁰. Even after all these obstacles, the MRA's annual reports³⁵¹ and its website contain a long list of its performance and achievements. A few are noted below:

- a. Processed over 4000 applications and issued licenses for a few hundred MFIs;
- b. Developed some policy guidelines to monitor and supervise licensed MFIs that include MRA Regulation 2010, Depositors' Protection Fund of 2014, circulars and other internal guidelines;
- c. Recruited new staff and trained them;

³⁴⁹ FGDs with the staffs in April 2014

³⁵⁰ Such as a pre-scheduled field inspection had been cancelled due to some internal urgent matter [FGD with the staffs in April 2014, P: 391]. So, funds allocated for inspection purposes for that particular year could not be used fully.

³⁵¹ Annual Reports 2006-2013

- d. Arranged training for the sector on how to comply with regulations and how to prepare standard financial reports to fulfil the requirements of the law;
- e. Prepared a list of over 100 audit firms to conduct MFI audits and arranged training for these companies on how to comply with audit requirements as per the legal needs of the Authority;
- f. Developed on-line based reporting system and data warehouse;
- g. Published regular statistics on the NGO-MFIs' operation and performance;
- h. Conducted regular on-site inspection of this enormous sector all over the country, along with off-site vigilance;
- i. Conducted issue-based research on certain topics relevant to policies;
- j. Arranged regular consultative discussions both at national and international level with relevant stakeholders and others concerned.

8.4 ARGUMENTS THAT DETERMINE PATTERN OF INTERACTION AND OUTCOMES

A. Operationalizing the law

i. The second layer of rules: Microcredit Regulatory Authority Regulations 2010
 Immediately after establishment, MRA started working on the second layer of rules on the foundation of the main Act, which was essential for proper functioning of the Authority. The MRA took careful attempts before intensifying intervention in formulating further rules because there were high chances that the sector might react fiercely if any policy went against its interest. Under this uncertainty, MRA addressed some more operational and governance issues with the gradual understanding of the market and business. The attempts of the MRA to enter deeper into the market with more regulatory tools did not always progress smoothly despite exercising extreme caution. All patterns of usual social behaviour like negotiation, coalition, conflict, syndication, and others were present within the various interest groups around these economic institutions. MRA also reacted accordingly. It negotiated, adjusted, and sometimes compromised with the situation in formulating supplementary rules and sub-rules to make the law operational. This complex behavioural pattern between the MRA and the NGO-MFIs still exists.

The MRA finalised a set of second layer rules at the end of 2010 after four years of active consultation with the various interest groups. It finally published the

rules as a gazette notification³⁵² in January 2011. The Board approved the final draft of this set of rules that passed through Finance Ministry and was vetted by the Law Ministry before becoming a public document. MRA conducted a series of discussions on this set of regulations with leading representatives of the sector, both before and after making the draft final. It arranged a workshop on “Regulation of Microfinance Institutions- Dialogue for better understanding”, on 16th February 2009³⁵³ to minimise confusion around it and to seek public opinion. Even so, the draft was repeatedly cancelled and revised due to lobbying and resistance from the sector. At a crucial stage, high officials from the government and political authority had to intervene in order to resolve the conflict situation between the MRA and the sector³⁵⁴. Disagreement was mainly on following three important matters:

- a. Governance issue: MRA proposed to fix a term of three years for holding a position either as a Chair or a member of a governing body of an NGO-MFI;
- b. Deposit collection: MRA proposed to introduce some preventive criteria on free collection of voluntary and term deposits;
- c. Interest rate or service charge on credit: MRA proposed to announce an upper limit of interest rate³⁵⁵, and to replace non-standardised ‘flat method’³⁵⁶ of interest calculation by the standard practice of declining balance method.

Other subjects of disagreements with the sector were issues like utilisation of excess fund, maintenance of reserve fund and provision for liquidity reserve. Negotiations, readjustments, and compromises continued till the last moment. Appendix-E3 presents a summary of these second layer regulations that have a significant influence on reshaping the sector.

Content analysis of these regulations reveals that this legal document is quite exhaustive in nature and has standardised the various behavioural policies, codes of conduct, forms, formats, procedures, and practices as well as it filled up most of the

³⁵² S.R.O No. 394-Ain/2010, dated 17 January 2011

³⁵³ Meeting held at CIRDAP Auditorium, Dhaka. The EVC, MRA, had presented the main paper and the researcher was one of the discussants among four others.

³⁵⁴ Ministry of Finance arranged a meeting on 4th April 2009 on the issue of regulation under the chairmanship of the Finance Minister where all the important stakeholders including high officials from the Ministry of Finance, Bangladesh Bank, MRA, PKSf, and MFIs were present. The researcher was also present in this meeting.

³⁵⁵ The MRA proposed the highest rate at 26 per cent (6% as cost of fund+12% operational cost+ 8% other cost and margin).

³⁵⁶ Under this method, interest is calculated as a percentage of the initial loan that is not based on the outstanding amount after payment of each instalment though clients repay the loan through weekly or monthly instalments. Interest is calculated by multiplying the initial amount by the nominal interest rate irrespective of the repayment plan.

gaps that had remained unclear in the Act. This set of regulations specifies terms and conditions of getting a license, license cancellation procedures, the procedural arrangement to form a general body and governing body, operational and financial guidelines, guidelines for external audit, and related other sub-rules. Most importantly, it elaborates some important governance and management issues, such as how to form a governing body in an NGO, who can hold the position of the chair or a CEO and how long a member of a governing body can hold a position and other related factors. It mentions that at any point in time the total amount of deposit of any NGO-MFI should not be over 80 per cent of its total loan outstanding, which provides a threshold for unlimited collection of deposit. It means an NGO-MFI should always be a net creditor in the field, which binds them against flying away overnight with the deposited money of poor depositors. In particular, it introduces some preventive measures in collecting voluntary and term deposits from the clients. According to this rule, no NGO-MFI is permitted to collect voluntary and term deposit as per its free will; it must abide by certain principles before it can do so. The rule provides a full set of accounting procedures. Some other issues like utilisation of surplus funds, composition of the loan portfolio, submission of reports to the MRA, maintenance of loan loss provision, conducting an external audit, and requirements of field inspection are also clarified.

However, MRA could not resolve the crucial issue related to interest rate calculation before submitting the final draft to the government. This was due to strong resistance from the sector. In fact, MRA initiated negotiation on this issue in 2008. Appendix-E4 illustrates the historic negotiation, over two years, on the matter of fixing and standardising interest rate of microcredit in Bangladesh. So, an important component of the rules³⁵⁷ remained pending to be resolved subsequently. MRA did that part later in late 2010, by issuing an administrative circular separately. This incident indicates how complex and strong the resistance was against a few issues.

ii. The third layer of rules: Circulars of the MRA

Till December 2014, the MRA issued 28 circulars both on administrative and regulatory matters. Appendix-E5 contains a list and summary of ten important regulatory circulars. Among these circulars, circular number 5 addresses the pending issue of interest rate. It has fixed the highest interest rate on credit at 27 per cent and

³⁵⁷Section 26, Microcredit Regulatory Authority Regulation 2010

lowest rate on deposit at 6 per cent. It contains instructions to follow declining balance method in calculating interest instead of the so-called flat method. The new method of calculation helps people in getting a better idea about the actual effective rate of interest on credit. This circular further provides instructions on a minimum grace period of a loan, on the minimum number of instalments to repay a loan, and on the maximum claimable amount of total fees for admission, application form, and passbook. MRA has revised this circular twice (circular no. 8 & 23). Firstly, it reduces the number of the instalment from 50 to 46, and secondly raises the fees from Taka 15 to Taka 25 while other associated issues remain unchanged.

The MRA has issued two more circulars to prevent the sector from non-compliance of rules. Circular number 13 mentions about unauthorised use of the surplus funds, and circular number 27 warns about the compulsory provision for maintaining a reserve fund³⁵⁸. It further redefines the definition ‘Capital’ by another circular, number 17, that actually helps NGO-MFIs in broadening the amount of collectable voluntary and term deposit. Circular number 25 opens the door for large MFIs to invest in small MFIs like a wholesale funding agency. This particular circular may promote large MFIs to influence the small organisations through their asymmetric power relationships. This is more likely since the market is already skewed in favour of large groups. The last circular of 2014 (number 28) reflects the social commitment of the MRA towards some clients. It instructed NGO-MFIs not to collect loan, for the time being, from some particular clients affected by natural disasters like floods.

So, it is evident from these circulars that the MRA has been trying to strike a balance between the clients’ interest and the MFIs’ interest as well as government’s demand for ensuring general transparency and realising their mutual benefits.

B. Stakeholders response to the new law

As mentioned in chapter two I have interviewed some important stakeholders to understand their views about these new rules. Their response regarding the law and rules can mainly be divided into two categories:

- a. General response on the overall rules; and

³⁵⁸ As per the Act an NGO-MFI should maintain at least 10% of its surplus fund as reserve which is a kind of client protection against possible failure. But, MRA’s study reveals that only about 29.56% maintains reserve above 10% in 2014 (13.41% in 2013). Further, 58% does not maintain any reserve in 2014 that was above 76% in 2013. (Source: Management report of MRA to its 40th Board meeting)

- b. Specific response on certain specific items of the rules and regulation.

Their overall response towards the new rules on the whole is optimistic; that largely covers basic purpose of the law. As some disputes still remain, I tried to incorporate their opinions on those issues under specific responses. These are:

- a. Governance issues such as tenure of governing body member, CEO's status, and other related issues;
- b. Interest rate on credit, especially the cap on the rate; and
- c. Deposit collection by the NGO-MFIs.

General outlook of the three governors, who were directly engaged, at some stage, either in rule formulation process or in operationalization of rules, is presented here separately. It provides valuable insights into the overall macro views of the sector that reflect government's views as well. Appendix-E6 contains a summary of their responses along with their brief personal antecedents. The table-1 in the same Appendix E6 recapitulates their opinions on certain issues that highlighted the macro policy direction of the sector.

Macro views: three Governors of the Bangladesh Bank

a) Dr Fakhruddin Ahmed joined the Bangladesh Bank in November 2001. Before joining the Bank, he worked with the World Bank for over twenty years. He took the active initiative in speeding up the job related to the MRRU as the Chair of the National Steering Committee. The draft of the law was prepared and completed under this leadership. His major focus was on the financial sustainability of the NGO-MFIs by linking them with the broader financial market without damaging the innovation of the sector. He was in favour of transforming some capable organisations into Microfinance Bank and not in favour of imposing a direct cap on the interest rates. According to him, the Bangladesh Bank played an insignificant role in the process of institutionalising the sector.

b) Dr Salehuddin Ahmed and Dr Fakhruddin Ahmed, in fact, exchanged their chairs. Dr F Ahmed joined PKSF as MD after completing his tenure in Bangladesh Bank while Dr S. Ahmed joined the Bangladesh Bank from the PKSF as Governor in May 2005. Since Dr S. Ahmed was one of the important members of the National Steering Committee under the MRRU and had a long experience in working with the sector, he took special interest in formalising the sector and in bringing it under a

uniform system. The microcredit sector started getting prominence in the Bangladesh Bank under his guidance. His initiative played an important role in the passing of the law by the Parliament during the political crisis in 2006. Dr S. Ahmed also took an active interest in implementing the law. His major focus was improving governance and financial management of the microfinance sector since he thought governance of this sector was a major failure. He was in favour of creating Microfinance Bank at some level while he blamed the Bangladesh Bank for not taking a proactive role in creating appropriate institutional set up to address the problem of the rural financial market over a course of time. According to him, the interest rate of microcredit should be maintained at a reasonable level; however, he has not delivered any specific comment on the current policy on the interest rate.

c) Dr Atiur Rahman took the charge immediately after Dr S. Ahmed retired in May 2009. Before joining the Bank, he was both a professor of economics and a researcher. He was directly involved in the sector as well; he was the chair of a network organisation of the NGO-MFIs, the CDF. Bangladesh Bank's view towards the rural financial market has changed tremendously under his leadership. He has introduced the idea of 'financial inclusion or inclusive finance' in the banking sector that covers the MFIs as well. It helps in neutralising the current government's (AL) antipathy towards the vocabulary 'microcredit' (*khudroreen*)³⁵⁹ by popularising the new term 'financial inclusion'. Dr Rahman appreciates the current nature of 'light touch' regulation. His major focus is on reaching the rural poor with the help of NGO-MFIs by linking them with the banks. He considers this situation as a win-win for both the poor people and the NGOs because it also helps NGO-MFIs in solving their liquidity problems at the same time. So, the Bangladesh Bank has been continuously guiding banks to provide funds to the rural sector via NGOs under his direction. The Bank has opened various windows for the NGO-MFIs to get different types of funds from the banking sector and to come closer to the central bank because of his special interest in financing NGOs. He, however, seems uncomfortable in facing political criticism about microcredit as a whole and about high-interest rate (27 per cent) of microcredit in particular. He is in favour of the previous method of calculation, i.e. the flat method which he perceives as an easier method to calculate the rate and a better option in presenting the published rate lower.

³⁵⁹ A development since 2010 resulting mainly from Professor Yunus' clash with the government.

General response of the stakeholders

The general response of all the participants towards the rules is broadly positive though there are some diverse opinions regarding its essence and efficacy in addressing the main issues related to ensuring MFIs' accountability and transparency. A brief summary of their statements indicates that this set of rules is a kind of 'soft landing' or 'light touch' regulation which may not address all the relevant issues right now, but, they believe that it is not going to end here with a single stroke. They are hopeful that gradually many issues will evolve and come to the forefront to be addressed within the fold of rules with the growing maturity of the sector. The sector representatives also have the same views. They all believe that it is a good start considering the size of the sector, diversity and the number of people involved in it. Thus, it can be said that the new rules have broadly been accepted positively both by the policymakers and by the sector, which is an indicator of the strength of the rule.

The sector representatives specially mentioned about the usefulness of this law in helping them to run their microfinance operations legally. They also feel that it has helped them in building public confidence on the NGO-MFIs. Getting access to the public has become easier for them after the enactment of this law. They are no longer afraid of the complaint of illegal activities as they used to be in the past. Yet, they have pointed out some difficulties that they have been facing due to legal binding. According to them, ninety per cent of the regulations are friendly, and they hope that remainder ten per cent problems will be solved soon.

Specific responses on certain issues

a) Governance under debate

The following quote of a researcher can help in understanding the debate around governance issues related to the NGO-MFIs:

I had expectation (from the law) around two major issues; a) savers' protection, protect the interest of savings, and b) regulation that would address the issue of ownership, governance. First part of the expectation has been fulfilled but the second one hasn't. These organisations are still family based, driven by individuals. I have been observing the shifting nature over a generation, there were organisations where none of the family members was involved, but now their (founder's) children and siblings are entering into the organisations. [Res-3/Intvw/P-339]

Most of the respondents have expressed similar views regarding the nature of governance of the NGO-MFIs and related issues. Another respondent [FA-1/Intvw/P-201-202] thinks that 'they are running like single proprietorship' that is 'like family business' which he believes may not change overnight. These participants reiterate that NGOs are neither membership based nor equity-based organisations. Therefore, they think, governance issues particularly from the perspective of the decision-making process in deciding their strategic role in poverty alleviation as well as in ensuring accountability and transparency of their operations, demand special focus on the rules and serious attention from the government.

In the traditional NGO setting, the governance issue is mainly focused on its composition and term of the Board members, and on the appointing procedure and status of the CEO. The same researcher [RES-3/Intvw/ P-340] further points out a peculiar nature of NGOs' capital formation (either from donors' grant or government or the public), which he classifies as 'Social Capital'. According to him, there is no original concept of private ownership as there is no equity investment. He considers an NGO as an informal cooperative that is managed by an external team. So, he emphasises on ensuring good governance in the management to protect this 'social capital'. Another respondent, a policymaker [PM-2/Intvw/P-56], endorses the same. He mentions that 'governance is a failure' in this case, and that is why the regulation is needed, he adds. In their opinion, there is no doubt that founders have a significant contribution; that does not mean that these NGO-MFIs can be run like a private business. They acknowledge the fact that these organisations should still be brought under standard good governance in that they should have a proper succession plan, a definite term to hold the position of a governing body member, and the governing body members should not get undue privileges from the organisations. Some of them expressed concern about the current trend of second generation family members controlling these organisations. Unlike policymakers, participants from the funding agencies generally do not have strong opinions regarding this issue. Researchers, except one [Res-3], also generally have not expressed a very strong opinion on the ownership and governance issue. But, they all support the idea of good corporate governance.

MRA [MRA-1 & MRA-3] mentions that it has a special focus on governance issues in implementing rules. The respondents from MRA have specifically brought attention to the facts that the law has aimed to separate the decision-making body

(governing body) from the operational body (management) to ensure accountability of the management to its governing body. They, however, face problems in implementing related clauses of the law. According to them, these problems are mainly generated from the inherent contradiction between different laws, such as laws related to registration authorities. It also arises due to rigidity in the current practices in the NGOs, and resistance from the existing management (Appendix-E7 elaborates the matters further). NGO-MFIs expressed [PRAC-1/FGD/P-426-441] their dissatisfaction regarding non-voting legal status of a CEO and fixed tenure of a governing body member. As per the new regulation, a member cannot hold a position in a governing body forever.

Current legal requirements do not match with the prevailing practices of the industry. Founders of the NGO-MFIs are generally not ready to accept non-voting lower status of a CEO and to leave the position (either as CEO or Chair) at this moment. Hence, this issue has created implementation problems of related rules for the MRA. The central questions in this discussion are—how to recognise the contribution of the founders to the organisation without giving the person the usual property rights of a private proprietor? How long should founders have ‘dictatorial’ control in the organisations? How to establish a proper balance between these two questions to ensure safe and efficient leadership and good governance in the organisations?

The general response of the sector in this respect is that the clause related to the tenure of a governing body member is the most serious attack on the strength and leadership of NGO-MFIs. They mentioned that they raised the issue about the voting rights of CEO and other issues in the discussion with the MRA, and the response of the MRA was that the matter be shelved for the time being. MRA also assured them that it would not be immediately implementing the rules strictly in accordance with the rules. According to the sector representatives, NGOs will not work without the founders’ support, and that the CEO should have a voting right. They agreed that a succession plan should exist, but nothing could be restricted by the law. In turn they have raised the question whether any succession plan exists in the corporate culture. One NGO chief, a prominent face among NGOs, has made following comments in the focus group discussion:

NGOs are a separate stream; no one can swim here. This is a different river; different warmth, different wave and that proved that it should run under this unique system in a unique manner. Here it is useless to talk about imaginary governance, this is [the current practice] the good governance.[PRAC-1/FGD/P-435]

This fleeting comment from the sector reflects their powerful and assertive voice in the actual situation on ground. One respondent from a donor agency now thinks that “*NGOs’ governance is another important area, which requires government’s support to manage*” [FA-2/Intvw/P-207-211], but twenty years back this issue did not get much attention from them. A recent report comments on this - “*MFI’s seem not comfortable with the tenure rule of members—both for general body and governing body*” [MRA and InM’s joint study on the effectiveness of regulation, draft report prepared on 01 November 2012, P-17-18].

It is obvious from the above discussions that the expected good governance has not been completely achieved as some governance issues like electing governing body members, selecting CEO, their tenure of service, voting rights, succession plan of the organisations, separating decision-making body from the operational body, and other related issues are yet to be settled.

b) Interest rate on loan, still a burning issue

The interest rate is the next overly discussed topic among the respondents. It always remains a debatable issue within the policymakers and politicians from the perspective of public interest (Faruquee & Khalily, 2011). However, policymakers who participated in interviews for this research have not made any concrete suggestions on the issue, though all of them were actively involved in the process of formulating rules including interest rate at different phases. It appears to be too sensitive a topic to specify any comment. One of them briefly mentioned that there should not be any cap, other instruments could be tried instead. Another policy maker said that it should be kept at a ‘reasonable’ level without clarifying the term ‘reasonable’. Funding agencies consider 27% cap on interest rate as ‘not unjustified’, [FA-1/Intvw/P: 202-202] ‘alright’ [FA-2/Intvw/P: 210] and ‘right balance or fair cap’ [FA-3/Intvw/P: 220-221] for the welfare of poor consumers as well as for the benefit of the sector. Contrary to the statements of the funding agencies, researcher group perceive this cap as ‘significantly high’ and ‘on the very high side’; they feel that it should be reviewed. Both the researchers and funding agencies do, however, agree on

the fact that borrowers do not understand how much they really pay for credit. According to them, borrowers may know about this interest payment in absolute value terms rather than in terms of percentage.

In this context, two of the participants [FA-4 & RES-3] recalled the intense debate they had with the sector while fixing the upper limit. They also confirmed that they (selected members of a committee who assisted MRA in negotiating on the issue) had to make a compromise with the sector on this matter. Both these respondents believe that the current rate of interest can be reduced further without making much difference to the industry. But, respondents differ on the procedural issues for implementing it. One researcher [RES-3/Intvw/P: 350] says that the sector itself should be more efficient in reducing this rate, which means that competition in the market and capability of the organisations matter. Another participant [FA-1/Intvw/P:200-202] from a funding agency states that if NGO-MFIs have access to money market and public deposits like Grameen Bank, then they can easily operate at 20 per cent rate of interest. This last statement indicates that MFIs cost of funding is an important matter of concern in this case. These two views regarding the methods of reducing interest rate demand further in-depth study on the issue and, therefore, require supplementary evidence and economic arguments.

Typically three major types of costs are involved in deciding interest rate from the supply side point of view. One is operating cost, which depends on many things like the salary structure of an organisation, market infrastructure, technology, efficiency of the organisations and others. The second is the cost of funds such as the cost of borrowing the loanable fund that includes deposit. The last cost is related to loan loss due to default. From the demand side, factors like alternative options available to borrowers, the vulnerability of borrowers, rate of return on investment of the borrowers, and other such factors decide how much borrowers are ready to pay for the loan. So, finding the right balance between these two views is essential to arrive at an appropriate solution. There are a few empirical published and unpublished literature, though limited, on the interest rate of MFIs in Bangladesh from the point of view of the supply side (Dehejia et al., 2012; MFT, August 2009³⁶⁰; MRA, August

³⁶⁰ Recommendation presented to the MRA, InM, and PKSf on 25th August 2009 by MFTransparency, a US based consultancy firm, after a seminar held on 11-12 August in Dhaka. It reviewed data gathered from MFIs directly. Researcher represented the MRA in this seminar.

2010³⁶¹; Khalily, 2011; Farueee & Khalily, 2011). However, there is none purely from the perspective of the demand side.

Farueee & Khalily (2011) have mentioned that in Bangladesh the average cost of lending for NGO-MFIs was Taka 23-24 per Tk 100 during 2006-2009, and 70 per cent of this cost was operating cost i.e. Taka 16.10 to 16.80. According to them, the cost of fund of MFIs was only Taka 4-5, and rest Taka 1-3 was the default cost. The findings of a recent survey³⁶² of the MRA confirm the above results. So, the cost of fund for the MFIs is actually very low because they get an important part of their loanable fund from their clients' deposits and subsidised fund either from the PKSF or other agencies. Moreover, many of them have received initial capital as donors' grant without any cost and they also generally pay less to their depositors. Table-8.1 shows that NGO-MFIs operating cost is much higher compared to the Grameen Bank though both have been operating in the same market and providing similar kinds of service to the same group of target clients. It is also evident from the same table that the size of the NGO-MFIs does not have any correlation with their cost structure which generally would have shown an inverse relationship on account of economy of scale.

Table-8.1: Average operating cost of MFIs (per Taka 100 loan)

MFI Type	2006	2007
Grameen	9.28	10.0
Medium MFIs	26.11	29.1
Large MFIs	23.30	17.2
Very large	30.71	26.4

Source: Quayes & Khalily (2009) as mentioned in Farueee & Khalily (2011)

Dehejia et al. (2012) attempted to ascertain the views of borrowers in Dhaka, Bangladesh during 1999-2001 to find out how elastic the interest rate was with the demand of credit in case of *Safe Save*'s programme. They found that "*individuals with low borrowing capacity are less able to respond to changes in interest rates than*

³⁶¹ Researcher presented a paper in the Workshop held on 4th August 2010 in Dhaka on the issue which was uploaded on the MRA's website immediately after the workshop. This paper was based on field level operational data collected by the MRA. BB's Governor Dr Atiur Rahman chaired the workshop, Dr Kholiquzzaman Ahmad, Chairman PKSF, was also present there as special guest. All the important stakeholders including sector representatives, donor representatives, and clients' representatives were present in this national workshop arranged by the MRA.

³⁶² MRA's recent study (report presented to the Board on 11 June 2015) pointed out that on an average the sector's actual financial cost, administrative cost, and cost for loan loss were Taka 4.05, Taka 17.05, and Taka 1.47 respectively in total cost of Taka 22.57 in the FY 2013-14.

individuals with higher capacity” (P: 440). This finding reflects the fact of the vulnerability of borrowers in response to increases in interest rate by the lenders. Farueee & Khalily (2011) have also said that there was potential danger related to transparency of the actual interest rate especially in the case of the vulnerability of the borrower (facing emergency) which could lead them to agree on a secretly negotiated exploitative interest rate.

Farueee & Khalily (2011) have found that NGO-MFIs in Bangladesh are less efficient as compared to the Grameen Bank. Another finding (Khalily& Imam, 1998) reveals that there exists expense preference behaviour in subsidised MFIs. Therefore, Farueee & Khalily (2011) raised the concern that it might be true that the borrowers were paying a price for the inefficiency of the operations of MFIs, and there were reasons to believe that there existed some distortion in the market due to lack of transparency and lack of competition (in Executive Summary). They have described this kind of situation as a case of market failure due to monopoly rent and vulnerable consumers (P: 19). The absence of proper disclosure of information in this market has also been pointed out by the MFT³⁶³ which conducted a survey in August 2009 to study the Bangladesh market³⁶⁴. A recent paper of MRA³⁶⁵ also supports the argument that MFIs’ efficiency matters a lot in fixing the interest rate at a reasonable level.

There is no disagreement that NGO-MFIs can further reduce interest rate on credit though there are differences in opinion regarding the ways of doing that. Some respondents have pointed out as the cause of higher interest charges to their inefficiency in operation while others have mentioned higher cost of funds. But it is evident from the established economic facts that the argument behind NGO-MFIs’ operational inefficiency is more to be explained by the facts of their high operational cost than their low cost of managing funds.

MRA staff [MRA-5/FGD/P-425] in charge of supervising NGO-MFIs stated that NGO-MFIs at field level seemed to be not so unhappy about this cap on interest rate while central NGO-MFI representatives expressed [FGD] an opposite view.

³⁶³ A US based organisation working for ensuring price transparency in Microfinance industry (<http://www.mftransparency.org/>)

³⁶⁴ The ex-chief of this organisation (MFT) has again brought up the same issue of difficulties in setting transparent pricing in microfinance market worldwide including Bangladesh, in a personal email to the researcher in December 2015.

³⁶⁵ A policy paper on ‘Determining appropriate service charge based on Microfinance Institutions (MFIs) operational costs data’ has later been published on the MRA website ([http:// www.mra.gov.bd](http://www.mra.gov.bd)) in 2014, which is based on the MRA’s survey conducted during 2008-2010. (Paper prepared jointly by MRA and AFI Financial Inclusion Data Working Group).

MFIs' representatives from head offices opined that the policy is biased towards borrowers [PRAC-1/FGD/P-438]. A researcher [RES-2/Intvw/P: 320-322] however, expressed concern that this interest rate cap might have pushed MFIs to move out from microcredit to microenterprise loan i.e. to larger loans in order to reduce costs. So, this policy on interest rate could affect poorer borrowers at large, he added. But, most importantly, the MRA has not reviewed the interest rate policy yet³⁶⁶ though MRA indicated in the circular that it would review the matter in a year.

Informal news from the market conveys that the MRA has been facing pressure from the government to reduce the rate further. In response, there was some attempt, within the MRA, in reinstalling the flat method of calculation again with the hope of 'reducing the public image of rate'. As is clear from the above, the issue of interest rate is yet to be settled.

c) Saving policy and access to funds

The savings policies and related issues to get access to funds dominate discussions (FGD) with the sector representatives at head office level. They would like to get more flexible policies to get easy access to deposits [PRAC/FGD/P: 426-441], so they are still working towards that. As mentioned earlier, the current rules allow them to accept deposits from their clients though there are restrictions on unlimited collection of deposits. "MRA is now allowing public deposit mobilisation, phase by phase"—the comment made by one of the researchers [RES-3/Intvw/P: 353 & 358] reflects the image that MRA is favouring the sector with suitable policy support. He expects this policy to be gradually relaxed with the governance based responsible behaviour and maturity of the sector. As per rules³⁶⁷, generally total savings of an MFI would not exceed 80 per cent of its total outstanding loan at any certain point in time. The rule recognises three types of savings or deposits that the NGO-MFIs are allowed to collect from the clients. These are –

- a. Compulsory or general savings which are a package programme under credit services;
- b. Voluntary savings in addition to compulsory savings; and
- c. Term deposit.

³⁶⁶ Till December 2014, which it did later in 2015

³⁶⁷ Section 27-29, Microcredit Regulatory Authority Regulations 2010 (Appendix E3 for summary)

But there are certain regulations and restrictions on unlimited collection of voluntary savings and term deposits. As per the rules, they will have to maintain a specific amount of 'Capital' base to collect voluntary and term deposits. The NGOs now offer term deposit facilities of different natures, and the features of these savings products are similar to the savings products of the banks. However, unlike banks, loan outstanding of MFIs at the field is the only safeguard against savings as MFIs do not have to follow banking rules like maintaining SLR and CRR³⁶⁸.

During focus group discussions, representatives of the MFIs have drawn attention to their fund crisis especially having it at a lower cost. They have identified fund crisis as one of their major problems in expanding business and in achieving sustainability. They believe that NGO-MFIs can attain sustainability if they are allowed to get access to cheap savings like Grameen Bank. However, their operational data on savings indicates that they still have enough scope to reach the maximum level of 80 per cent of loan outstanding. By June 2012, average savings as a whole constituted only about 35.61 per cent of their total amount of loan outstanding, which is a little over 50 per cent for two large NGO-MFIs like BRAC and ASA. Despite having enough opportunity to collect more savings, the sector has already started pursuing the MRA to revise the policy further to get flexible access to two additional forms of savings e.g. term and voluntary savings³⁶⁹.

The sector not only demands more access to savings facility, but they also have been arguing for relaxing other conditions associated with savings protection. As per the rule, the NGO-MFIs have to maintain 15 per cent of total deposit as liquid money of which 5 per cent will have to be in the form of fixed deposit in any bank account. But, the sector has been pursuing MRA to reduce that percentage further to increase the amount of loanable fund. They further have expressed unwillingness to keep liquid money in the form of fixed deposit as it incurs income tax on deposited amount³⁷⁰. They have also expressed their reluctance³⁷¹ in paying fees to the depositors' protection fund which is mandatory³⁷² for all the NGO-MFIs who collect deposit from the clients. They argue, there is no risk involved with savings since all the depositors of the MFIs are their borrowers at the same time. But in practice, it is

³⁶⁸ Statutory Liquidity Reserve (SLR) and Cash Reserve Ration (CRR) with the Central Bank

³⁶⁹ Sector's recommendation no- 9 & 10 to the MRA to revise the rule, October 2013

³⁷⁰ MRA-1/Intvw/P: 375 & Sector's recommendation no-11 to the MRA in October 2013

³⁷¹ Sector's recommendation no.1 submitted to MRA in October 2013

³⁷² Depositors Protection Fund 2014, S.R. O.no. 270/2014

not necessarily true for every saver. Generally at any certain point in time, around 22 per cent³⁷³ of savers were found to be clients (members) but non-borrowers. One of the respondents [FA-1/Intvw/P: 190] has termed these clients as ‘waiting to be borrowers’, who would get credit soon. According to this respondent, if these clients do not get credit within a specified time then the collected deposit from this group can be identified as a public deposit. In this connection, some of my observations during a field survey in 2014 can be mentioned here. I met some relatively affluent borrowers who were not interested in borrowing from the MFIs; they were rather interested in deposit facilities. But, they have to borrow upon request from the MFIs, and they have borrowed a token amount to maintain their identity as borrowers. So, there remains a serious policy loophole in defining deposit collection from the so called ‘members’, which I discussed earlier.

The MRA representatives [MRA-5/FGD/P: 418-419] discuss their field experiences on other savings related issues like savings withdrawal facility, interest on savings, calculation of interest, and other factors. They point out the manipulative calculation method of interest on savings by the MFIs that includes- not paying any interest on deposits if it is not kept at least for one year or if it is drawn in the middle of the year, which is in violation of clear policy guidelines on how to calculate that rate³⁷⁴. A joint study conducted by the MRA and InM (2012) on Impact of MRA’s regulation has found that the saving rate offered by the NGO-MFIs varied around the average 5 per cent rate though MRA circular no. 5 has mentioned that MFIs should pay at least 6 per cent on savings.

8.5 STAKEHOLDERS’ VIEWS TOWARDS THE MRA: EXPECTATIONS AND DISAPPOINTMENT

Varied comments on the MRA by respondents’ can be classified under following seven major indicators (as shown in table 8.2):

- a. Its acceptability to the sector,
- b. Its performance and knowledge base,
- c. Its capacity to monitor and supervise the sector,
- d. Its independence in decision-making,
- e. Its quality of management,

³⁷³ MRA Statistics 2013 (NGO-MFIs in Bangladesh, 2013)

³⁷⁴ Section 32(3), Microcredit Regulatory Authority Regulation 2010.

- Public confidence in the MRA and its image to public,
- Coordination with the government.

Each of the above indicators is marked as successful and unsuccessful depending on respondents' comments. The table shows a number of respondents under the each of the seven major indicators. Since each respondent has multiple opinions, the total frequency is higher than the total number of respondents.

Table-8.2: Stakeholders' opinions on the performance of MRA

Major indicators		Number of respondents under	
		Successful	Unsuccessful
1.	Acceptability to the sector	4	1
2.	Performance and knowledge base	1	4
3.	Capacity to monitor and supervise	1	5
4.	Independence in decision-making	0	4
5.	Quality of management	1	6
6.	Public confidence and image	0	2
7.	Coordination with the government	0	1

It is apparent from the table above that the MRA is mostly successful in getting acceptability by the sector though it lacks public confidence and image [PM-2, FA-4& MRA-3]. According to FA-1, this is because the MRA has intervened into the sector just at a minimum critical level which he believes is a good strategy to begin with. FA-2 identifies MRA's help to the sector in getting funds from the banking sector as one of the reasons behind its high acceptability to the sector. The sector representatives also support the two views mentioned above; they mention about their good and friendly relationship with the MRA. However, many of the respondents [FA-1, FA-2, FA-3, RES-2, RES-3, PRAC-1], from all groups, believe that the MRA is unsuccessful in building a knowledge base, the capacity to monitor and supervise, and in developing quality management. The high officials from the MRA disagree with these remarks. According to these officials, monitoring of the sector is not a very difficult job for them because there are only two or three very large organisations, and most of the organisations are tiny in size. They emphasise that it is because NGOs

microfinance operations are not as complex as the banking business. They added, MFIs activities are more or less homogenous in nature, and they have a small portfolio of limited operations which make the job relatively easier. So, according to them, MRA is functioning successfully.

Some of the respondents [PM-4, FA-3, FA-4, PRAC-3] feel that the MRA requires inside drive to work independently, and it needs people of dynamic thinking. But RES-1 views these issues differently. According to this respondent, many things were not clear to the MRA during early phases of implementation of rules. So, this respondent believes that things will mature overtime and MRA will become successful if it gets support from the government as well as from the sector. FA-1 also admits that the MRA has to work in a very unfavourable environment because the sector representatives are highly influential and powerful. According to him, the MRA has reached this level only within seven years; it took the first few years in building the initial setup. On the contrary, FA-2 states that the MRA has failed to establish a good relationship with the government, which he considers as one of its weaknesses in acquiring proper recognition from the government. Discussions with PM-3, FA-1, FA-4, RES-3, MRA-1, MRA-3 as well as the content of MRA's annual reports regarding its coordination with other stakeholders reveals that the MRA does not have effective institutional coordination with some important stakeholders in the market that are considered useful in strengthening its capacity, image, and integrity as an independent and successful regulator.

Overall views of the stakeholders towards the MRA can be classified into four categories, such as –

- a. Successful;
- b. Unsuccessful;
- c. Partially successful; and
- d. Neutral.

If any respondent mentions that the MRA has implemented the rules successfully without much fault, the views of that person can be categorised as 'successful', and the opposite views as 'unsuccessful'. The views which state that the MRA has performed some of its duties successfully but it should do more or there are some areas which it has not yet reached, can be considered 'partially successful'. Some respondents have expressed neither a positive nor negative comment; such views do not come under any of the above groups, so their views can be categorised as

‘neutral’. From this analysis, it appears that only one respondent considers that the MRA is ‘successful’ in implementing the rules; whereas four respondents consider it as ‘partially successful’ and five respondents consider that the MRA is ‘unsuccessful’. Opinions of four other respondents can be classified under the category ‘neutral’. It is apparent that different respondents perceive MRA differently depending upon the individual’s expectations. Some of the participants express the views that the MRA should concentrate more on big MFIs in making policies and in developing strategic monitoring. According to them, these big organisations occupy the lion’s share of the market and have already created a monopoly condition in the market; hence more focus is needed here. They believe that the MRA could achieve more if it would utilise its legal strength appropriately despite the constraints of human resources and funding. According to them, the joint efforts both from inside the organisation as well as from outside like necessary and timely support from the government could accomplish more in raising its effectiveness and in achieving its confidence in the public forum. FA-4 has further states that the related high officials within the government are not fully aware of the independent status of the MRA for a long time. Government perceives MRA as the part of the Bangladesh Bank, he added.

Though government’s views towards the sector have been criticised by many, direct or indirect intervention by the government in policy matters of the MRA has been reported by none. PM-2 & 3, FA-1 & 2, and RES-2 & 3 argue that the government may not recognise the contribution of microcredit in the economic development of the country properly, which is reflected in the sluggish nature of its support to the MRA. However, FA-3 disagrees with these views. According to him government’s support in allowing tax rebate for the sector and its budgetary support for the MRA reflect the opposite. Some of these respondents believe that the government’s response towards this sector is reactive to pressures from outside agencies. They further add that the government may not have the ‘inner impetus’ to support the sector.

All typical complications of setting up a new regulatory organisation within the government’s system exist in this case, establishing MRA. Figure-8.2 presents a classified-categorised list of MRA’s problems which have identified by the respondents in this research. Many of them [PM-4, FA-2, MRA-3] express great

concern regarding MRA's future after the DFID's project ends³⁷⁵. It is because many of its experienced project staff will leave the organisation after the flow of foreign aid is over. MRA may not have the finances to hire experts at a high salary as it is possible now for the project. Their apprehension is that the MRA may then face a deep management crisis due to conditional use of government's fund. Recent attempts by the MRA³⁷⁶ to manage funds from other sources and to generate some extra income from other avenues, lend support to this concern of the participants.

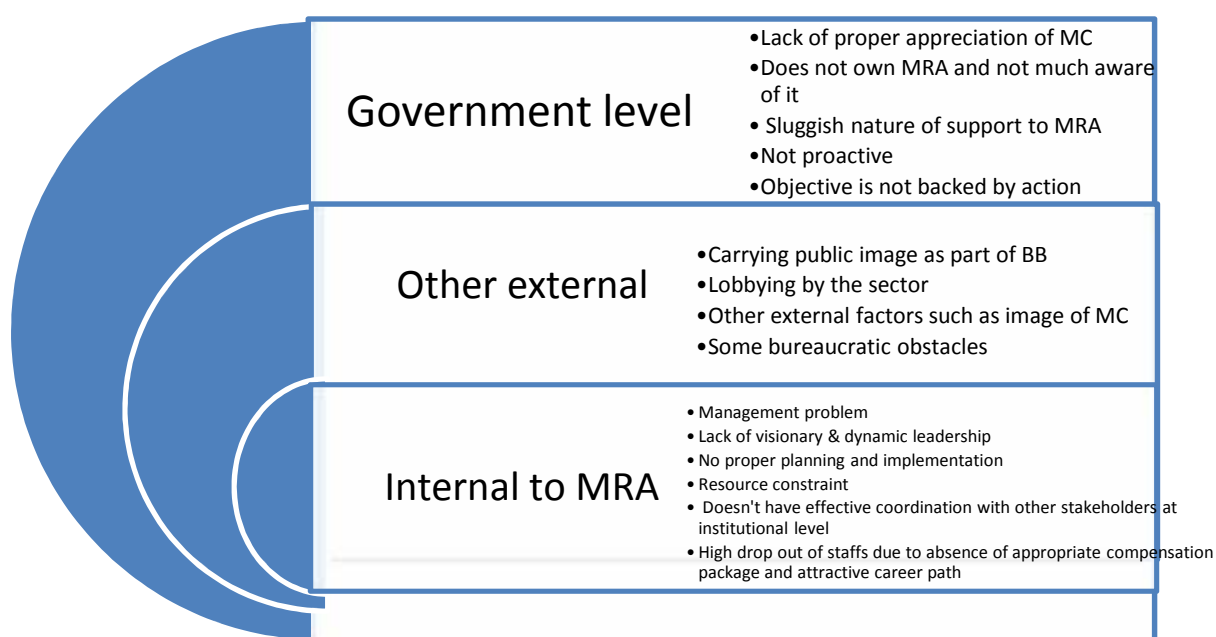


Figure-8.2: Major areas of problems at different levels for MRA

Some other external factors also have affected MRA's ability to function properly as a regulatory authority. It is clear from the discussions and interviews that MRA is under immense pressure by strong lobbying from the sector to ease some policies. This is an area of concern since the demand is backed by persons of authority in the higher echelons of the sector. Other outside factors like recent debates around Grameen Bank and its impact on the sector may be an important factor in influencing the pattern of interaction among the various actors as mentioned by one of the policy makers [PM-3/Intvw/P: 113-114]. Finally, Bangladesh Bank's recent policy

³⁷⁵ It has been extended for one more year that means till mid-2015

³⁷⁶ 1) Requested Bangladesh Bank to provide some funds [PM-3/Intvw/P:119 & PM-4/Intvw/P-133], 2) Planning to reduce interest rate at 26 per cent from 27 but may fix it at 26.25 per cent, and from which the MRA will get 0.25 per cent as earning [PM-4/Intvw/P:134 & FA-2/Intvw/P:210], 3) Exploring the possibility of earning from some donors by acting as an evaluator in the process [PM-4/Intvw/P:147]

attempts³⁷⁷ in establishing an inclusive financial market that has directly addressed some relevant issues, especially MFIs linkage with the banking sector, can influence the MRA by changing some of its rules. In addition, policy changes by the PKSF³⁷⁸ may influence the market dynamics further and hence, the MRA may need to adjust its strategic decisions accordingly.

SWOT Analysis of the MRA

All the opinions of the stakeholders related to the MRA and the information from other sources can be summarised under four key categories of SWOT analysis, which are as follows:

Strengths of MRA

- A statutory body backed by special law;
- Strong independent Board chaired by the Governor of Bangladesh Bank;
- Policies formulated after long consultation process with the stakeholders;
- Operations are based on government approved policies;
- Knowledge and information already gathered;
- IT based information processing system and disclosure of information to the public.

Weaknesses of MRA

- Sluggish nature of support by the government;
- Limited career prospects for staff in the organisational structure;
- Lack of appropriate number of qualified staff;
- Fund constraints;
- Lack of strategic planning;
- Large number of MFIs are working throughout the country, but MRA does not have presence outside Dhaka;
- Attached to the image of Bangladesh Bank;
- Weak attachment with the clients;
- Ineffective coordination with relevant stakeholders;

Opportunities for MRA

- High acceptability by the sector;
- Partial success acknowledged by the stakeholders;

³⁷⁷ As mentioned by the current Governor of the Bangladesh Bank (Rahman, 2014).

³⁷⁸ Promoting vertical expansion in developing micro-enterprise sector and inclusive finance by adding other services with the microfinance

- Internal cooperative work environment;
- Expertise of the existing employees;
- Access to other government agencies;
- Good connection with Bangladesh Bank;

Threats for MRA

- Sudden change in government policy might inhibit the operations of MRA;
- Huge number of formal and informal microcredit organisations in the field;
- Chances of corruption in future due to limited compensation package for employees compared to their workload and power;
- External influence in decision making cannot be ignored, since there are some leading MFIs/ network agencies with very strong lobbying power at the national as well as international level.

8.6 TOWARDS A BILATERAL GAME MODEL: MRA VERSUS NGO-MFIs

The MRA is still in the process of full implementation of its existing rules, and in realising its full potential. The NGO-MFIs are also in the process of complying with the evolving legal requirements. So, the game between these two principal actors is yet to unfold fully to take a stable shape within the new environment of a stable legal setup. All local actors are vibrant now; donors, however, are not seen to be so active, but they exist. For the MRA, the game is a play of compromise; ranging from compromise at full scale to no compromise at all with different degrees of compromise between these two extreme options, depending on MRA's internal strength, capability, and external support. For the NGO-MFIs, it is a game of compliance. They can choose strategies ranging from full compliance of rules to no compliance, with degrees of partial compliance in between, depending on their internal capacity and intention as well as external support and pressures.

In this game, value '1' is assigned to the highest possible payoff and '0' is the lowest payoff for both parties, where '1' implies positive social good will for both player and '0' means a bad reputation for either player. That means, NGO-MFIs will get payoff [1] for full compliance with rules, and MRA will get payoff [1] for no compromise. Similarly, NGO-MFIs will be getting payoff [0] for no compliance of rules, and MRA will get payoff [0] for full compromise. Under these given ranges of potential strategic options and payoffs both the players choose their optimal strategies, which ultimately decide the equilibrium or mutually agreed on payoffs.

The table-8.3 displays the setting of the game and payoffs under each ultimate choice for the both players. In case, MRA plays at the level of full compromise and MFIs do not comply with the rules at all [0, 0], then the rules will be easily violated, and both may share some illegal benefits. This outcome can be termed as ‘Mutually accommodating manipulation’. The combination of ‘no compliance’ and ‘no compromise’ [0, 1] may create a situation of ‘Absolute Conflict’ between the two, which will give rise to a very unstable market. ‘Full compliance’ with rules and ‘complete compromise’ by the MRA [1, 0] may imply a situation of spontaneous regulation without any need for intervention of the regulator. However, it keeps the option for influencing the regulator open, and the chance of creating a manipulative environment will always exist. Similarly, ‘full compliance’ with rules and ‘no compromise’ by MRA [1, 1] has the chance of generating an ‘Ideal or Effective’ environment, which all the stakeholders who support the law may desire.

Table-8.3: The game between the MRA and the NGO-MFIs

		MRA (Level of Compromise)	
		Full	None
NGO- MFIs (Level of Compliance)	Full	[1,0] Manipulation from top	[1,1] The ideal situation of mutual compliance.
	None	[0,0] Mutually manipulative	[0,1] Absolutely conflicting

The game can be played at different levels (of compromise and compliance) instead of two extreme points for both producing different outcomes accordingly. Even so, the whole game can repeatedly be played over a long period, and payoffs may move from one stage to another depending on the players’ moves. However, there remains a high chance of shifting the payoffs from [0, 0] to [1, 1] or vice versa because the subsequent outcomes may not ensure any stable payoff at all, at least in the short run. As of now this game has still not reached ‘equilibrium’ level as such.

Hence, players will have to wait longer to arrive at an equilibrium institutional structure based on their experiences in a repeated game situation. An unstable market and a state of constant fight is not be good for either player, hence should be avoided. Moreover, as long as there is noncompliance and manipulation from the sector and MRA responds with weak compromises, the equilibrium outcome will be a manipulation dominant situation, full of corruption. Only with a strong and strict MRA and a compliant sector can we have an ideal equilibrium situation. So far we have been observing a “Mutual Manipulation Situation” [0, 0] moving neither towards absolute control nor extreme anarchy.

If this situation continues indefinitely or if it moves further towards more of a non-compliance with rules by the NGOs and/or full compromise by the MRA, then the possibility of a situation like regulatory capture (Stigler, 1971; Peltzman, 1976; Dal Bo, 2006; Baxter, 2011; Carpenter & Moss, 2014) cannot be ruled out³⁷⁹. Some evidence indicates a tendency of a regulatory capture situation. For example, initially for a certain period, the sector and some members of the regulatory Board desired or lobbied for restoring the flat method of interest rate calculation. There is also a persisting high-interest rate of microcredit due to ‘expense preference behavior’ or ‘inefficiency’ of the organisations which has been tolerated by the MRA. And again, during this initial period, MRA continuously faced difficulties in implementing governance-related policies due to request or lobby or pressure from the sector.

The intent and action of the Bangladeshi NGO-MFIs in pursuing and protecting their interests by manipulating the rule-making and implementing agencies are evident here, though the idea of jeopardising every rule and going back to the old situation of complete ‘deregulation’ did not occur yet. Hence, it can be said that till now the game is continuing with partial regulation and partial compliance.

8.7 CONCLUSION

Presently different layers of legal rules are in place, and the rule implementing agency is active. This has finally brought the microfinance activities of NGOs under the formal regulation of the government after a much awaited and long interval. It was expected that this set of rules would help in ensuring accountability and transparency

³⁷⁹ If regulatory capture defines as ‘the result or process by which regulation, in law or application, is consistently or repeatedly directed away from the public interest and toward the interests of the regulated industry, by the intend and action of the industry itself’ (Carpenter & Moss, 2014; P.15)

in the NGO-MFIs' operation and which would ultimately bring benefits for the clients as well as help organisations in attaining sustainability. However, things are not straightforward, there are many players; some are highly active and some less; some are more responsive and some are not.

The main law addresses the basic things without touching some of the sensitive issues. It has given sufficient space to the existing NGO-MFIs to adjust with the new law, though there are some areas that have brought tension within the sector. There are some serious loopholes in the law that cause difficulties in operationalizing the law. It allows opportunities to MRA to expand the rules further by formulating supplementary rules and sub-rules. The new regulatory authority is in place. It is legally empowered to function independently. However, it is highly dependent on government's decision regarding economic matters and matters related to organisational setup. It suffers from inadequate numbers of quality staff, and lack of proper recognition from the government.

The new authority interacts with the NGO-MFIs directly, in a well-organised manner. However, things do not always move very smoothly. MRA' negotiation with the NGO-MFIs in preparing the second and third layers of operational rules and sub-rules reflects the situation well. There are still some areas that are under debate, among them are proper implementation of governance related rules, reviewing of interest rate policy and further relaxation of rules pertaining to savings. The respondents under this thesis view the new regulations positively. According to them, it is a good start, which may evolve further with the maturity of the sector. However, they also have expressed concerns on above mentioned difficult issues. Though most of the respondents expect to have a stricter policy on governance issues, the sector representatives consider existing policy as an obstacle to running organisations smoothly. On the surface, it seems that interest rate issue has been settled, but it has not. Some believe that there is scope to reduce the rate further. Moreover, there is disagreement on the issue whether NGO-MFIs should be given full access to savings collection like Grameen Bank.

Respondents view MRA as a partially successful regulator. They think that the MRA could perform better if it receives proper and timely support from the government and if it has visionary and strategic planning. According to them, on the one hand, it has strength and opportunities as empowered by the law, and acceptability to the sector. On the other hand, it also has some weaknesses and threats

such as dependence on government for budgetary support and operational approval, external influence on the sector, negative image of microcredit to the government, and insufficient staff-strength.

Within this condition, the MRA and the NGO-MFIs have been interacting to play the game to find out their optimal level of payoff. So far the worst outcome of the 'absolute conflict' of complete 'deregulation' between the MRA and the sector has been avoided. However, both manipulation and flexible compromise are still going on, rendering the situation highly fluid. Hence, at this moment, no 'equilibrium' or stable outcome can be predicted with accuracy.

CHAPTER 9

Expectations and Achievements:

Institutionalisation, Sustainability, and Protection of Clients

9.1 INTRODUCTION

This chapter is an ex-post aggregate listing and evaluation of a collection of rules and regulatory processes and their implementation in general. The chapter analyses the outcomes of the rules on the sector that help to fulfil the government's goal to develop a sustainable and effective institutional model to serve the poor, especially in RFM. Reaching this section of the population at an affordable price and protecting their interests are two implicit objectives of the regulation. However, a regulation may or may not always produce the desired outcome because it does not stand alone; it is formulated by a governmental body and implemented by an agency of the government. It is, therefore, constrained by the character and structure of the existing governmental system (Coglianese, 2012). These institutions have their organisational characteristics and limitations, while existing in a larger socio-political milieu.

There are diverse opinions regarding the effect of regulation on the microfinance sector. Worldwide, regulation for this sector is a new phenomenon. Very few empirical studies are available on the regulatory impact on efficiency and sustainability of microfinance institutions. Hartarska & Nadolnyak (2007) conducted a study on 114 organisations from 62 countries to analyse whether regulated MFIs could achieve better sustainability and outreach. Their observations suggest that regulatory involvement does not directly affect the performance of an MFI, though it may have an indirect benefit. Cull, Asli & Jonathan (2009) and Mersland & Strøm (2009) also failed to find any significant relationship between supervision, profitability and operational cost of an MFI in their studies.

On the contrary, Khalily, Khaleque and Badruddoza (2014) from Bangladesh have mentioned the positive contribution of regulation in reducing cost inefficiency of regulated MFIs in Bangladesh. They analysed data of 182 MFIs covering the period from the pre-regulation year (2006) to 2011 by using the Stochastic Frontier Approach (SFA). According to this study, subsidised MFIs are more inefficient than others. It also reports that NGO-MFIs affiliated to PKSF are more efficient compared

to the non-affiliated organisations. This particular finding of Kahlily et al., (2014) is mutually contradictory because the POs of PKSF are also subsidised organisations.

Hence, it appears that differences of opinions still exist concerning the direct effect of regulation on the microfinance sector, especially on their efficiency and sustainability. In this context, Coglianeses's (2012) perception regarding the existence of 'confounder' that may have other external influence on outputs and outcomes of regulation is relevant.

As mentioned in chapter two, outcomes are evaluated at two levels, the organisational level and the clients' level. At the organisational level, it is expected that;

- i) Sector is now more organised;
- ii) Monopolistic power of a few organisations has reduced significantly;
- iii) NGO-MFIs have reached self-sufficiency by improving efficiency;
- iv) Interest rate policy has been standardised for better transparency.

At the clients' level, it is expected that they are now taking informed decisions to protect their rights.

In this chapter I will evaluate how far the above-mentioned expectations have been fulfilled. The next section elaborates the evaluative criteria of the outcomes. Section three presents an analysis of the observations of the stakeholders regarding recent changes in the market, which helps in getting better views about expected outcomes. Sections four and five describe the results at organisational and client levels, respectively. The final section contains the summary.

9.2 EXPECTED OUTCOMES AND EVALUATION CRITERIA

NGO-MFIs in Bangladesh have been operating under a formal legal system for the last eight years; they must have had some impact on the sector by now. As described in the last chapter, there are three layers of operational rules, and a dedicated regulatory authority to monitor and supervise the NGO-MFIs in Bangladesh. Hence, we can expect some concrete outcomes both at organisational level and client level.

a) At the organisational level

The law has made special provisions to ensure transparency and accountability in the operations of these organisations. It desires that the market driven NGO-MFIs should be sustainable and cost-efficient in order to reduce their dependency on donor funds.

Therefore, the following outcomes are expected from these organisations after the implementation of the new law and regulation under the new regulatory authority: -

Expected outcome-1: State of institutionalisation and issue of transparency

The new rules have restricted free entry of NGOs into the market and set rules of the game that decide their boundary of operation. So, the market is now more organised and structured. An organisation has to fulfil certain criteria to get a license and it has to maintain some regulatory standards to operate as a licensed MFI. How systematically these criteria are met, and how responsively these standards are maintained are the fundamental queries that I am going to evaluate under this output. To answer these questions, I have chosen four areas of concern - licensing procedures of MRA, reporting requirement of the organisations, audit of their operations by a third party auditor, and monitoring in the field of the same by MRA . The table-9.1 presents concrete objective indicators for each sub-outcome:

Table-9.1: Objective indicators to evaluate the state of institutionalisation

Output-1: State of institutionalisation	Evaluation indicators
Sub-outcomes: 1. Licensing procedures completed successfully, 2. Reporting requirements fulfilled, 3. Audit requirements realised, 4. On-site monitoring system regularised.	1.1 MRA has brought all the existing MFIs under its licensing system within five years of operation, 1.2 All the licensed organisations meet the requirements of submission of regular statements by 2011, 1.3 All the licensed organisations are audited by registered audit firms, and they submit timely audit reports, 1.4 All the licensed MFIs, having 50 thousand or more clients ³⁸⁰ , are being inspected at head office level at least once in a year.

Outcome-2: Change in market share weakens monopolistic character

In 2004, the top 20 NGO-MFIs (among 352 reported³⁸¹) in Bangladesh covered close to 90 per cent of the market in terms of the number of clients and borrowers, and the amount of loan outstanding and savings. Just three organisations, BRAC, ASA, and

³⁸⁰ It covers more than 90 per cent of the clients

³⁸¹ 96 per cent among them were *small* organisations i.e. having less than 50 thousand borrowers. And 85 per cent *very small* MFIs i.e. having less than 10 thousand borrowers.

PROSHIKA controlled over 75 per cent of the market, of which BRAC alone had about 35 per cent share. Being the trend setters in the industry, the market was highly skewed in favour of these three large organisations. Some said (Ahmed, S. 2014; Haque, 2014; Khalily 2014) that freeing the market from this monopolistic control should be achieved by the MRA. All of them wished to see a relatively competitive microfinance market. How far has that expectation been fulfilled? The answer to this question is given under Output-2. The table-9.2 describes the objective indicators to verify this expectation.

Table-9.2: Objective indicators to evaluate change in market share

Output-2: Change in market share	Evaluation indicators
Sub-outcomes: Market share of very large MFIs has been reducing significantly.	Market share of very large organisations (four organisations each having over 1 million clients) has decreased at least to 50 per cent over the five years period after implementation of the law.

Outcome-3: Sustainability and efficiency of NGO-MFIs a prime concern

MRA reviews financial integrity, sustainability, and efficiency of an NGO while it approves an application for a license. These indicators are also considered important for monitoring a licensed organisation. So, one may expect that a licensed organisation has improved its sustainability and efficiency conditions over time under the monitoring and supervision system of MRA.

Table-9.3: Objective indicators to evaluate sustainability conditions and efficiency

Output-3: Sustainability condition and efficiency of NGO-MFIs	Evaluation indicators
Sub-outcomes: 1. Achieved operational self-sustainability, 2. Improved efficiency, 3. Less dependent on subsidy.	3.1 Organisations with over 50 thousand clients, have reached 100% operational self-sufficiency (OSS) within five years of operation as licensed MFIs, 3.2 Average operational expense ratio (OER) of the sector has decreased significantly without making any compromise on the size of the loan, 3.3 Average cost per client has also decreased with efficient operation under the law, 3.4 Decreasing trend of subsidized fund is reflected in the fund composition of the big organisations.

Since, these organisations now enjoy more access to different sources of funds, they are, therefore, also expected to be less dependent on subsidised funds. The table-9.3 shows the indicators I have used to evaluate this outcome.

Outcome-4: Standardised interest rate and transparency in pricing

The MRA has made an attempt to standardise matters related to interest rate of microcredit vide its Circular-05. This circular addresses the following issues:

- a. Loan processing fees;
- b. The minimum grace period;
- c. Minimum number of instalment of a loan;
- d. The method of calculation;
- e. Maximum nominal rates.

Most of the statements of this circular are nothing but the written formulation of the then existing practices of the market, except for the method of calculation. MRA imposes a 27 per cent cap on the interest rate of credit. This rate was fixed after negotiating with the sector, so it did not impact the market significantly. However, this circular helps in disclosing the facts related to pricing of credit. It also sends a signal to the sector to reduce the rate of credit further by increasing efficiency.

Related stakeholders have the following expectations:

- a. The new method of interest calculation, declining balance method, improves transparency in pricing,
- b. None of the organisation charges higher than the cap. The nominal interest yield is considered to be a measurement tool to get an idea on the interest on a loan, though there are differences in opinion regarding its reliability³⁸². An Annual Percentage Rate (APR) would be a more reliable measure. But, in absence of data to calculate APR I am calculating 'yield' as a proxy to get information on the interest of micro-loans. I expect the yields of top 100 NGO-MFIs to remain below 25 per cent with the presumption that the average loan loss of the sector does not exceed 2 per cent for a particular year³⁸³.

³⁸² From lenders' point of view 'interest yield' is a good measure, but from a client standpoint annual percentage rate (APR) is the best measure because APR considers timing of all cash flow in addition to loan processing fees, compulsory savings, insurance and other charges which are tagged as conditions of getting loans. MF Transparency's APRs differ by 6 percentage point from interest yield of MIX's analysis (Rosenberg, et. al. 2013).

³⁸³ Loan loss provision of the sector for the financial year 2013-14 is 1.47 per cent (as reported by the MRA in its 40th Board meeting).

One can get an approximate idea on an MFI's interest income or margin after deducting its operating expense from the yield. It provides valuable insights on how an MFI perceives its profitability and sustainability. An MFI can be profitable either by increasing yield or by decreasing expenses. So, high interest rate is not the only solution to ensure sustainability in an organisation, its expense behaviour and efficiency is equally important for sustainability. Faruqee and Khalily, (2011) have reported that OERs of the sector in Bangladesh were within the range of 16.23-17.33 per cent of the average loan outstanding during 2006-2009. Rosenberg, et. al., (2013) have found this value around 11 per cent for South Asia and 15 per cent worldwide in 2011³⁸⁴. Hence, it is expected that the top 100 Bangladeshi NGO-MFIs earn enough margin from interest to cover their costs³⁸⁵. The table 9.4 summarises the expected post regulation achievement and the ideal evaluation criteria for standardised interest rate on micro-loan.

Table-9.4: Objective indicators to evaluate standardised interest rate on loan

Outcome-4: Standardised interest rate of micro-loans	Evaluation indicators
Sub-outcome-4: 1. Instituted better method for calculating interest, 2. Regularised interest rate on micro-loan, 3. Sufficient margin ensures sustainability	4.1 New method reflects real price of credit and ensures transparency in pricing, 4.2 Yields on loan portfolio of top 100 MFIs do not exceed 25 per cent, 4.3 Top 100 MFIs earn enough margins (Yield-Operating expense) to cover costs.

b) *At the client level*

Generally, customers are not expected to be completely aware of their legal rights and responsibilities. However, they have their own understanding for making decisions to get involved in microfinance programmes of an NGO. How well informed are they about their rights and responsibilities? How much do they know about the terms and conditions related to the product and services? How do they perceive the discourse

³⁸⁴ Worldwide, both the yield and the OER show declining trends; average value of nominal interest yield has come down to 26.9 per cent in 2011 from 29.6 per cent in 2004.

³⁸⁵ Cost of fund of the sector was only 4.69 per cent in FY 2013/14 (as reported by the MRA in its 40th Board meeting), as against 3.87 per cent in 2009 (Faruqee and Khalily, 2011).

around microfinance? Is there any mechanism which can ensure that they have been taking an informed decision? These are the questions which I am going to address in this part of the chapter.

Microfinance clients are allowed to have four types of legal rights on the MFIs. They are:

- a. Right to get access to information on the terms and conditions of service;
- b. Right to get official papers on their loan and savings;
- c. Right to get back their savings if they don't have any unpaid loan, as well as right to get interest on their savings;
- d. Right to withdraw their membership from any organisation so long as they are not indebted or have any dues pending.

The law also expects some responsibilities from the clients. Clients should be aware of the terms and conditions of loans and other services beforehand, and they should confirm that loan officers enter correct information on their passbook. They should pay the loan instalments in time, and also encourage others to do so. They should attend regular '*samity*³⁸⁶' meetings and should maintain discipline to ensure cooperation among the members. Lastly, they should not borrow from many organisations at the same time if they are unable to manage loans and improve their livelihood. Therefore, the law expects that clients have been taking informed decisions about the loan.

9.3 STAKEHOLDERS' OBSERVATION ON RECENT CHANGES

At the outset, I have attempted to get clues from the relevant stakeholders on how they perceive changes in the market after the enactment of the new rules. Their perceptions and initial observations help in better understanding the expected behaviour of the market from different individual perspectives. In response to my question regarding recent changes, they have expressed a very strong common opinion in favour of the changing scenario of the market as the consequence of the regulation. They, however, believe that it happens not only for the new law but also due to combined effect of MRA's rules and related stakeholders' interacting response process towards that. They cited respective policy changes of the Bangladesh Bank and PKSF and mentioned the changes in the market in this connection. Appendix-F1 presents a list of major recent policy and strategic initiatives of the BB, MRA &

³⁸⁶ Weekly centre meeting

PKSF along with the corresponding changes in the market that have been identified by the interviewed respondents.

Each of them has emphasised the role of his or her respective organisation in changing the market. Therefore, at this stage, it is difficult to relate exactly which strategy or policy or action is directly linked to which particular change in the market. However, their observations can be classified into three broad categories:

- a. Sector's move towards commercial sources of funds;
- b. Change in loan size;
- c. Change in cost or operational efficiency.

Views of the respondents regarding the above are as follows:

a) Sector's move towards commercial sources of funds

All the respondents pointed out that, NGO-MFIs have reduced their dependency on subsidised funds significantly in recent years. They specially cited the huge investment of the banking sector in microfinance. The 10th Governor [PM-3] of Bangladesh Bank claimed that it happened due to his directional or policy bias towards the rural financial market (RFM). He encouraged the banking sector to invest in RFM via linkage with NGO-MFIs, which he considered a win-win situation for both. This linkage was actually upgrading the status of the NGO-MFIs, he emphasised. However, there are differences in opinion between the respondents regarding the direct involvement of the banking sector in microfinance. This linkage programme between banks and NGOs is considered harmful by another policy maker (PM-2). He does not support the rapid expansion of banks' investment due to its potential danger in inviting commercial investment of funds. According to him, it may ultimately push NGO-MFIs towards commercialisation and damage its social objective of poverty alleviation. In contrast to the above participants' views, RES-3 has a different view. According to him, commercial banks should not be in this market because they have a major responsibility for building other macro private sectors. Instead, he favours a separate identity of these two markets by allowing MFIs easy access to public deposits. He suggests transforming qualified NGO-MFIs into microfinance banks to link them with the main market. His idea of establishing microfinance banks gets support from many respondents. But, PM-3 thinks that this linkage programme, in fact, is an attempt in mainstreaming the MFIs since the idea of

a microfinance bank may take longer to materialise, as he considers it a long term result of a new political decision.

MRA officials [MRA-5] called attention to the volume of savings of the NGO-MFIs, which has increased a few fold in recent years, after the enactment of the law. At the same time, they pointed out illegal savings collection by some of the licensed MFIs. These organisations collect voluntary and term deposit without fulfilling the required legal criteria, which MRA considers highly risky for the depositors. MRA officials also state that many MFIs take advantage of these policies openly and without fear of punitive action.

b) Increased loan size and default rate

Many of my respondents [FA-1 &2, RES-2 &3, MRA-5, PRAC-1 &2], including sector representatives, highlighted another pertinent issue related to the size of an average micro-loan. They stated that sector has gradually been moving towards micro-enterprises and large loans. In their view, minimising cost is one of the main reasons for the move toward large and micro-enterprise loans. One respondent (RES-2) warns by saying that interest rate cap on micro-loan may push MFIs to deliver more large loans and decrease the overall cost of delivering credit. They have identified inflation adjustment and demand of the market as some other reasons for such changes in the market. They also said that PKSF's recent policy for vertical expansion of business may inspire many of its POs to introduce higher loan facility for their graduated borrowers. So, they feel that this change in the market may not happen merely because of the new rules of MRA.

Some respondents [FA-3, RES-2, PRAC-1 & 2] have expressed concern about increasing trend of loan default particularly associated with microenterprises. Two of them [FA-3 and RES-2] warned that while MFIs would be moving towards the larger loan, they would invariably face the problem of lower recovery rate since propensity of repayment was generally lower in the richer section of the population for various social reasons. They also added that larger ME loan meant for the larger portfolio at higher risk, an increase in PAR (portfolio at risk) and that ultimately would increase the cost of lending. FA-3 thinks that it is a kind of 'system check' for MFIs against moving toward the larger loan. Practitioners (PRAC-1 & 2) confirmed the problem of rising default rate. They wish to solve the problem by binding their clients under PDR

Act³⁸⁷. According to the representatives of NGO-MFIs, many of their micro-enterprise borrowers, generally male, borrow from both the banking sector and the microcredit sector at the same time, and while banks are legally privileged in taking action against them, they are not. So, they want similar privileges as the banks in collecting loans from defaulters.

c) Cost factors- A growing concern

Many of my respondents [PM-4, RES-3, MRA-4 & 5, and PRAC-1] expressed concern about recent increase in costs in NGO-MFIs operations. Their major concern was related to the administrative expenses and financial sustainability of the MFIs. One respondent [FA-2] commented after a field visit that the concept of group formation and weekly group meetings has been disappearing from the operations of the NGO-MFIs due to many reasons including cost and competition. Some of them remarked that the MFIs have become an inefficient and reckless user of funds. Representatives of the MFIs [in FGD] also acknowledged that their administrative costs have increased significantly in recent years due to salary rise, IT instalment, and other factors.

In summary, following points can be highlighted from the above statements of the stakeholders regarding changes in the market:

- Legal status has helped MFIs in moving faster for commercial and cheap sources of funds, which means new rules help NGO-MFIs to reduce their dependency on subsidised funds;
- MFIs are still trying to identify a good mix of credit portfolios (microcredit versus microenterprise loan) to minimise cost, maximise earnings and ensure their sustainability;
- Increasing operational costs despite MRA's instructions to reduce interest rates further by improving efficiency.

The above observations of the relevant stakeholders on post regulation changes in the microfinance market provide valuable inputs in analysing actual outcomes that will be addressed in the succeeding sections.

³⁸⁷ Written proposal sent to the MRA in October 2013

9.4 ACTUAL OUTCOMES: ORGANISATIONAL LEVEL

Outcome-1: State of institutionalisation

MRA (also previously MRRU) initiated the process of information collection on the sector since 2004, though the sector was not yet ready for it. Obtaining reliable data on financial matters from this huge sector was very difficult. Table-1 in Appendix-F2 presents a few vital statistics of the sector from 2004-2014 that give an idea of the size of the market. It shows that the number of reported MFIs doubled in a period of ten years. Figure-1 in the same Appendix-F2 indicates that the overall trends of the sector, regarding branch expansion, outreach, loan disbursement and savings collection fluctuated greatly till 2010. Thereafter, it exhibits a relatively stable growth. The growth rates of savings and credit remain steady at around 20 per cent since 2010. However, client outreach has not shown any growth and the number of branches have shrunk after introduction of the second layer of regulation in 2010. By June 2014, there were 678 licensed NGO-MFIs serving around 25 million clients; only about 19.42 million among them were borrowers. Till that date, these clients had saved Taka 107 billion while there was an outstanding loan of Taka 282 billion against them.

MRA received applications (for license) in two phases, first in 2006 from the existing NGOs and again in 2011 from new organisations. Accordingly, it received 4240 applications³⁸⁸ in the first phase, and 1212 applications in the second phase. Table-2 in Appendix-F2 presents the status of these applicants till 2014. Till December 2014, it provided licenses to 697 organisations from the first category and gave temporary permission to 172 organisations from the second category. It rejected applications of over 3400 from the first category and over 1000 from the second category. It still has a backlog of applications received in the first phase.

MRA needed over five years in processing applications received in the first slot; there are still some applicants from this slot waiting for a final decision. In response to a query regarding the long-time taken (over five years) in processing an application, a high official of the Authority states that MRA tries not to reject an application immediately; instead, it helps the organisation to qualify for the license. He admits that sometimes the approval takes an inordinate length of time but not because of any reason attributable to the internal functioning of the MRA. In some

³⁸⁸Many of these applicants were cooperatives who applied because there was a clause in the law that mentioned about bringing credit cooperatives under this law, which was later abrogated.

cases an applicant may appeal against MRA's decision in court, then the situation is beyond MRA's control, and the process gets delayed indefinitely. At times there are more social costs to MRA than benefits in rejecting an application if there is a public or social investment. PROSHIKA, one of the largest NGOs, is a typical example of this (see Appendix-F3 for details). So, situations like PROSHIKA can create dilemmas for MRA.

Yearly statistical publication of MRA on the sector is another step in institutionalising the sector. In depth content analysis of these publications shows how both the sector and the regulator have simultaneously matured gradually. It reveals that it has taken over five years for the MRA to systematise MFIs' financial reporting, because many of them did not maintain proper financial records. MRA provided them training, suggestions, and other support to overcome the difficulties. Initially, it was only regular operational information that MRA published. Gradually, other information such as financial information and ratios was incorporated into those publications. However, it was not before 2011 that MRA could publish the full picture of the sector. According to MRA, since 2010 over 90 per cent of the licensed NGO-MFIs now provide standardised data, and when though it recognises the fact that timely collection of valid data is still a big challenge for the Authority [Preface, Volume-7, June 2010].

External audit and field inspection are two important monitoring mechanisms for any organisation. But, both involve costs and quality. NGO-MFIs, especially the small MFIs, remained outside of proper auditing mainly due to paucity of funds. Professional auditors were also not well informed about the industry. As an emerging new sector, it required a new set of auditors and inspectors who understood the business. MRA took the initiative in preparing a list of qualified audit firms and trained auditors to conduct audits as per requirements of the authority. Usually, donor or PKSF funded MFIs are familiar with a regular audit system by external auditors, but they have to follow requirements of the funding agencies. MRA introduced a uniform set of audit requirements for all. Table-3 in Appendix-F2 illustrates a few facts on the audit reports received by the MRA.

Information presented in this table confirms increasing trends of timely submission of audit reports by the NGO-MFIs. In response to a query whether there exists a system of checks and balances both for the audit firms and the MFIs in presenting authentic information, the concerned officers of the MRA informed that

they regularly verify information in case of doubt. The same officials added that MRA was already investigating an MFI for submitting a fake report, and a CA firm had also been blacklisted for the same reason. But, MRA is not yet ready for analysing these reports to make it a useful source of information. The capability of the MRA in managing a few hundred audit reports every year also raises a serious concern regarding its meagre organisational structure with just three staff manning its Audit section.

MRA conducts regular inspections to monitor the activities of licensed MFIs, both at the office and at the field. According to MRA officials, it plans to inspect top 20 MFIs every year, mid-level MFIs once in two years and cover the rest of the MFIs once in every three years. Tables 4 & 5 in Appendix-F2 present information on the number of inspections conducted by MRA during the last five years. It is observed from the table that MRA was unable to conduct a regular and timely inspection according to its plan. The FGDs with MRA staff revealed that it has a huge backlog of work due to a shortage of human resources i.e. inspectors. There are only five approved positions (inspectors) in its organogram to inspect a few hundred MFIs and a few thousands of their branches, all over the country. MRA has attempted to resolve this difficulty by involving all the other officers in inspection programmes by rotation. This creates a chance of compromise in the quality of inspection in a bid to meet the target of inspection. MRA has guidelines for inspection, which includes inspection at head office level, branch level, and field level but it does not differentiate big MFIs from the small, especially in terms of their volume and complexities in operation. Focus group discussion with the relevant team of MRA reveals that inspectors get little formal training on inspection, and they get a little time to get insights directly from the clients.

Therefore, it appears that though the sector is now more organised and structured than it was before the enactment of the law, it is yet to attain the ultimate ideals pertaining to its goal of a fully organised and transparent sector. Monitoring of the MFIs needs further improvement, especially by way of timely quality inspections and audit.

Outcome-2: Change in market share

It has been noted earlier that over 60 per cent of the microfinance market of the NGOs has been captured by just two very large NGO-MFIs out of the approximately 700

organisations³⁸⁹. Market share of an organisation can be calculated in many ways; here I am considering it in terms of number of clients, the amount of loan outstanding, and the amount of savings. In doing so, I have divided NGO-MFIs into five categories based on the number of their clients in 2014³⁹⁰; they are termed as ‘very large’, ‘large’, ‘medium’, ‘small’ and ‘very small’. The number of MFIs under each category in different years from 2007 to 2014 is shown in table-1 in Appendix-F4. Before the enactment of the law, there were three very big organisations, BRAC, ASA, and PROSHIKA. But, only the first two were licensed by 2007, PROSHIKA received its license far later. The number of ‘very large’ organisations increased to three when BURO was included under this category in 2010, and it is now numbered four after PROSHIKA received a license in 2011. The number of ‘large’ organisations, the second category, has increased from 15 in 2007 to 21 in 2014 and number of ‘medium’ organisations has risen from 14 to 26. It is noticeable that on an average about 90 per cent of the MFIs belong to the ‘small’ and ‘very small’ category. In 2014, the average market share of ‘very large’ and ‘large’ MFIs (6 per cent of licensed NGO-MFIs), in terms of client outreach, has slightly decreased to 80 per cent from 86 in 2007.

The four ‘very large’ organisations control 60 per cent and 21 ‘large’ type control 20 per cent of the market as a whole. During the period 2007-2014, the market share of 4 ‘very large’ organisations shows a downward trend while the market share of 21 ‘large’ organisations shows an upward trend (figure-1 in Appendix-F4). In 2007, ‘very large’ organisations controlled over 68 per cent and ‘large’ approximately 18 per cent of the market, which changed to 58 and 22 per cent respectively for ‘very large’ and ‘large’ types by 2014. A kind of competition between these two groups, ‘very large’ and ‘large’ can be observed, especially after the implementation of the second tier of the rules in 2010.

In all, it can be said that the market share of ‘very large’ and ‘large’ NGO-MFIs has decreased slightly over the years from 2007 to 2014 but not as much as expected. They still retained their monopoly position in the market. Hence, no

³⁸⁹ If Grameen Bank is included then the share of the large three MFIs (BRAC, ASA and Grameen Bank) would be around 76-78 per cent of the market (in terms of loan outstanding). The NGO-MFIs are the focus of this thesis, so I am not considering Grameen Bank data in this part of the study.

³⁹⁰ This type of categorization has been used by the MRA which I have modified slightly. Instead of categorising MFIs on the basis of ‘number of total borrowers’ as done by the MRA, I have considered ‘number of total clients’ since MFIs are not only credit delivery agencies but also deposit collecting organisations at the same time.

specific conclusion can be drawn in favour of capturing market share by the small MFIs especially after the implementation of the regulation.

Outcome-3: Improving sustainability & efficiency

I have chosen three indicators viz. operational self-sufficiency (OSS), operational expense ratio (OER) and cost per client to verify whether the sector has improved its sustainability after being brought under the legal system. The financial data for the year 2007 has considered as pre-licensed data for the NGO-MFIs that were licensed in 2007 and thereafter. With the exception of PROSHIKA, all large and medium level NGO-MFIs, with over fifty thousand clients, were licensed by 2009. In my sample, there are 412 MFIs (74 from 2007, 245 from 2008 and 93 from 2009) under this category, and they represent 90 per cent of the market³⁹¹. However, after data validation, only about 50 per cent of them were considered in the final analysis. Table-9.5 displays the number of NGO-MFIs considered under each category of analysis and their related variables.

Table-9.5: Indicators, variables and number of NGO-MFIs in the analysis

Indicators ³⁹²	Number of MFIs	Variables
Operational self-sufficiency (OSS)= Financial income/ (Financial expense+ Operating expense+LLP)	Total =208 (FY 2007-2014) N=44 (2007) N=126 (2008) N=38 (2009)	Financial income, Financial, expense, operating expenses, Loan loss provision (LLP)
Operating efficiency ratio (OER) = Operating expense/ Average loan outstanding	Total =204 (FY 2007-2014) N=40(2007) N=125 (2008) N=39 (2009)	Operating expense, Loan outstanding
Cost per client= Operating expense/ number of clients	Total =228 (FY 2007-2014) N=46 (2007) N=141 (2008) N=41 (2009)	Operating expense, number of clients

³⁹¹ 92% clients, 92% loan outstanding and 97% deposits

³⁹² Indicators were chosen from CGAP, 2003

i. Operational self-sufficiency (OSS)

Organisations are rated operationally self-sufficient if OSS is equal to or greater than 1 or 100 per cent. If the value remains below 1, it is graded as non-self-sufficient this means that the organisation is not able to meet its expense from its operational income. The value of OSS largely varies with the operating efficiency and operating cost of an MFI, since the financial costs and LLP of the sector are very low. Table-1 and figure-1 in Appendix-F5 present figures on the percentage of self-sufficient NGO-MFIs and their trends respectively, for the period from 2007-2014.

It is observed from the table that only around 27, 61, and 34 per cent MFIs were self-sufficient in the years 2007, 2008 and 2009 respectively when they received the license. That means, OSS was not the single criteria in qualifying for license; there might have other considerations as well³⁹³. The table also shows that OSSs of all types of MFIs increased in 2008 from 2007. These values declined in 2009 and onwards, which suddenly have improved again in 2014. This pattern of fluctuating OSS is observed for all types of MFIs irrespective of licensing year and size of the organisation. But, generally, the increasing trend of self-sufficiency is observed in figure-1 (Appendix-F5). Figures-2 & 3 (Appendix-F5) display the trends of OSSs of the NGO-MFIs according to their licensing year and size respectively. The trends do not indicate any significant correlation between years under license with the corresponding OSS.

It is interesting to note here that the average OSS of all the large and medium NGO-MFIs, which received a license in 2007 and 2008, were above 1 in 2007 before getting the license. But, between 2008 and 2011 their values declined by 28-39 per cent, whereas the OSS of very small MFIs declined only by 0.13 per cent during the same period. The OSS of the very large organisations decreased from 1.57 in 2007 to 1.04 in 2011, whereas for very small MFIs it increased from 0.67 in 2007 to 1.03 in 2011. Therefore, the average OSSs of all types of MFIs have come close to each other in 2011 and the gap (in terms of OSS) between these two groups of MFIs has reduced drastically. The average OSS for all types of MFIs presents a far better picture in 2014; nearly 90 per cent of the licensed MFIs attained self-sufficiency in their

³⁹³ MRA had given importance to other factors like legal status (proper registration), fulfilling the requirement of appointing regular CEO, separation of management from the governing body (section 27 of the law), proper financial disclosure, etc.

operations by 2014. It seems that the self-sufficiency graph of the sector is yet to show any predictable pattern.

Regulation may not directly influence operational self-sufficiency or financial performance of MFIs (Cull et al., 2009; Ndambu, 2011). It sends a signal to the sector to be efficient and sustainable because society cannot bear the cost of inefficient and unsustainable institutions for long (Hartarska & Nadolnyak, 2007; Merslon & Strøm, 2009). The MRA has given signals to the sector at different periods in different manners. It publishes efficiency indicators of the MFIs regularly and discusses the issues at various forums. Microcredit Regulatory Authority Regulation 2010 and Circular-05 on interest rate have given instructions along the same line. However, it is difficult to identify the exact impact of those signals on the sector.

ii. Operating expense ratio (OER)

OER is the ratio of operating expense and average loan outstanding, which gives estimation on costs of operation in delivering credit. It is also an indicator of efficiency. I have chosen 204 NGO-MFIs' for this analysis. 40, 125 and 39 MFIs were licensed in 2007, 2008 and 2009 respectively. Table-2 in Appendix-F5 presents the figures on average OERs of the sample MFIs for the period 2007-2014. The average OER of the sector was on the rise till 2012, when on an average an MFI needed taka 0.24 as operating cost to maintain taka 1 as an outstanding loan. The value has fallen to Taka 0.14 in 2014, the lowest since 2007. It was slightly higher for the organisations that received license in 2009, applicable in particular to the period 2010-2014. However, no relationship is found between operating expense with the years under supervision. It is worth noting that OER has increased by 67, 53, 38, 42 and -1.82 per cent for very large, large, medium, small, and very small MFIs respectively (figure-4 in Appendix-F5), which means OER has increased at the highest percentage in case of very large organisations³⁹⁴.

In response to my query (in FGD to PRAC-1) regarding the sudden rise of OER in the sector during 2009-2013, the sector representatives attributed the rise to the pay scale revision for the employees and expansion of business by the sector. However, the argument in favour of business expansion is not supported by the available data. During this period the total number of branches of the MFIs and the

³⁹⁴ Faruquee and Khalily (2011) have also mentioned that very large NGO-MFIs in Bangladesh (clients over 500,000) were less efficient due to high expense profile.

number of clients have decreased instead (see figure-1 in Appendix-F2). I discussed the issue with the officials of the MRA as well and found that they were unaware of the sudden hike of OERs of the sector during the period 2009-13.

iii. Cost per client

There are 228 sample NGO-MFIs for analysing cost per client; among them, 46 were licensed in 2007, 141 in 2008 and 41 in 2009. Cost per client is another indicator of efficiency. Figure-5 in Appendix-F5 displays the average cost per client of the sector both in nominal and real terms (after adjusting for inflation; 2007=100). The inflation adjusted cost of the sector in a year to serve a client increased from Taka 675.33 in 2007 to Taka 1033 in 2012, maintained at Taka 1025 in 2013 and suddenly decreased to Taka 675 in 2014. Figure-6 in the same Appendix-F5 shows cost per client according to the size of the MFIs. The general pattern of this cost, irrespective of licensing year, shows upward trends for all types. Both the nominal and real costs decreased slightly in 2008 from 2007, despite a 9 per cent inflation rate in that year. The nominal values for all types increased in 2009-10 on an average by 41-58 per cent which decreased again in 2011. The nominal cost per client rose sharply in 2012 & 2013 for the whole sector on an average by 57-66 per cent from the year 2011 to 2012-13. The highest percentage of the rise is observed for the MFIs that were licensed in 2007; it rose by 68 per cent in 2012 and 96 per cent in 2013 from the year 2011. The real cost of the sector increased by 42 per cent in 2012 from 2011. It increased by 50, 17 and 62 per cent for the NGO-MFIs that were licensed in 2007, 2008 and 2009 respectively. So, no predictable pattern is observed between cost per client and year under supervision.

However, the cost per client has mostly been increased by the very large and large MFIs. Among the three very large organisations, BRAC increased it by 302 per cent, ASA by 360 per cent and BURO by 514 per cent in a year from 2011 to 2012. A lot of variation in changing values of nominal cost per client has been observed among the large organisations as well. In contrast, during the same period the costs have decreased slightly for the very small MFIs. But, we observe a sharp decrease of the cost in 2014 for all groups. Hence, the OERs of all types have come closer in 2014, though it is generally high for larger organisations. That means big NGO-MFIs in Bangladesh are yet to derive advantage of economies of scale.

iv. Funding: Less dependent on subsidy

The new regulation opens the door to commercial sources of funds for many MFIs in Bangladesh. The two important commercial sources are banks and deposit collections. Currently, above 35 per cent NGO-MFIs borrow from commercial banks that constitute over 15 per cent of their loanable funds. Investment by banks to the MFIs has recently increased immensely; the amount went up by 82 per cent in 2013 from 2008. It has increased significantly since June 2011 i.e. immediately after Bangladesh Bank's circular in May 2011 that introduced a punishment clause in the policy³⁹⁵. Since 2011, MRA has also allowed NGO-MFIs to collect term deposits from their clients. Till June 2014³⁹⁶, it had already permitted 88 organisations. Saving now constitute approximately 35 per cent of its total loanable funds, and is growing at an annual rate of 20 per cent. The contribution of direct donors' funds has now become insignificant. Two large MFIs, BRAC, and ASA stopped borrowing from PKSF since long, however, most of the other big NGO-MFIs are still borrowing from PKSF at concessional rates. Approximately 30 per cent of the organisations have loans from PKSF that constitute around 13 per cent of total loanable funds of the sector. Surplus earnings of the NGO-MFIs now constitute close to 30 per cent of the total funds. So, these facts make it clear that NGO-MFIs are now moving towards self-sufficiency and are no more dependent on grant money. But, the sector still gets subsidised funds from PKSF. A concrete measure of their reliance on subsidised and grant funds seems helpful in understanding the trends over a period.

In measuring the level of dependence of MFIs on subsidy (or more towards commercial sources), I have used a scale of 0-100 where '0' represents full dependence on grant fund, and '100' represents complete dependence on commercial sources. Annexure-F6 explains the method of calculation; it provides some hints on the NGO-MFIs position on the scale though not exact figures of subsidy dependency index (SDI) as mentioned by Yaron and Manos (2007). I have collected data for the period 2008-2013 on fund composition of 20 MFIs, two very large, and 18 large organisations. Of the 18 large organisations, 14 were partners of PKSF and one has recently been added as a PO of the PKSF; of the 3 which have never been a partner of

³⁹⁵ Bangladesh Bank ACD Circular 01 dated 16 May 2011. This circular of the Bangladesh Bank has mentioned about disbursing bank's undisbursed agricultural credit as per target via NGO-MFIs if they don't have branch network in the rural sector. Otherwise they will have to deposit that undisbursed amount to the Bangladesh Bank at 5 per cent rate annually as punishment.

³⁹⁶ Annual Report, 2014, MRA

the PKSF, one has been mainly dependent on bank finance and two are still in receipt of a considerable amount of grant funds. So, there are different combinations of the loanable fund for various MFIs in this sample. Table-3 in Appendix-F5 presents descriptive statistics on the aforesaid “dependency scale” of the sample NGO-MFIs for the period 2008-2013.

It is observed from the above table that the average value on the scale has changed from 0.73 in 2008 to 0.81 in 2013, which shows that the sector has been moving towards commercial sources of funds. Minimum and maximum values indicate that none of the organisation is either fully dependent on the grant (0) or fully on commercial sources (100). The minimum value was 0.38 in 2008 that increased to 0.60 in 2013 with the increase in the volume of deposit and bank loans. It is also evident from the data that many of the POs of PKSF, who were highly dependent on its subsidised funds earlier, have started borrowing from the banks at a commercial rate. The sector representatives explained³⁹⁷ that this was due to the fact that they have greater flexibility in operation with banks than with PKSF.

In summary, regarding output-3 related to sustainability and efficiency, it can be said that only about 75.67 per cent of the NGO-MFIs in Bangladesh have reached self-sufficiency in operation (OSS) within five years of receiving a license. But, the overall picture still does not show any predictable trend. They are now less dependent on subsidy and grant, though they have not yet reached 100 per cent self-sufficiency. The major concern is the operating expense ratio (OER) of the sector that is fluctuating considerably with time. NGO-MFIs’ cost of credit to a client is also on the rise, though it should decline with the increasing amount of average loan size. Furthermore, large NGO-MFIs incur more costs compared to the same of the small MFIs. So, the sector is yet to reap the benefits of economies of scale.

Outcome-4: Standardisation of interest rate, issue of transparent pricing

Bangladeshi NGO-MFIs used to charge around 15 per cent interest on micro-loan at flat rate till 2011³⁹⁸; the effective rate would be around 30 per cent. This calculation, however, does not include the initial charge on loan, compulsory savings and insurance tagged in loan products. A number of ambiguities exist in calculating the

³⁹⁷ During FGD with the MFIs in March 2014

³⁹⁸ A report prepared by the MRRU/ Bangladesh Bank in 2003 has mentioned that 79 per cent of the MFIs in Bangladesh used to charge 15 per cent flat rates on the loans.

so-called cost covering ‘balanced or responsible pricing’³⁹⁹ due to inadequate disclosure of information. The following analysis will cast some light on the issue and will substantiate whether there remains any reason to believe that the MRA’s circular on interest rate helps in solving problems of ambiguity in this respect.

a) Method of calculation: Flat versus Declining

The flat method of interest rate calculation is not a standardised practice in the financial sector because it does not consider the time value of money and declining balance of principal amount. Thus, it does not reflect the actual value of interest (annualised interest rate) imposed on credit. However, it is relatively easier to calculate, and it shows a lower value of a rate artificially. The microfinance sector in Bangladesh favoured flat method of calculation instead of declining balance method. The main argument: the latter method is complicated and difficult to implement. Other arguments are that field officers are not familiar with this method and that borrowers may face difficulty in understanding the rates. Despite resistance, MRA implemented the declining method and provided the necessary support to ensure proper implementation.

I have verified whether this new method of calculation has been actually practiced in the field and how it has been done. Initially, I checked borrowers’ passbooks and talked to them about interest rate policies of the government. I found the borrowers completely unaware of the government rates and its method of calculation. They usually know how much they are paying every week, but are unaware of what constitutes that “how much”. For example, a client (PATU_BAU-GOA_06) in Patuakhali district mentioned that she received Taka 5000 as loan from an NGO-MFI and would be repaying Taka 5725 in total in 46 weekly instalments with a weekly instalment of Taka 175 (taka 125 loan as instalment for 45 weeks and Taka 100 in the last week, taka 40 as compulsory savings, and Taka 10 as loan insurance⁴⁰⁰). She paid Taka 50 for the passbook and received taka 26 as interest on her savings of Taka 711. In this case, considering only the repayment of loan, her interest rate would be approximately 27 per cent by the declining balance method. But, if payment for insurance is considered then the borrower has paid Taka 6185

³⁹⁹ Meaning balance between MFI’s own sustainability and poor people’s sustainability (Waterfield, July 2015)

⁴⁰⁰ In absence of any policy guidelines on micro-insurance, paying certain amount for insurance purpose has become a compulsory phenomenon as an unwritten loan contract.

(taka $10 \times 46 = 460$ as insurance + 725 as interest on loan = 1185 as insurance and interest + 5000 as principal) instead of Taka 5725. This means she has actually paid Taka 1185 in addition to the principal for holding the average amount of Taka 2500 [(First balance of loan + Last balance of the loan)/2] for a year. A straightforward calculation reveals that she has actually paid interest at a rate of 47.40 per cent if payment for compulsory insurance is taken into consideration. If compulsory savings and other charges are considered, then it would be even higher. Payment for micro-insurance is not based on risk or any other factors as it is in regular cases. It is a kind of added fund for the MFIs which do not follow any particular rules. Uddin's survey (2003) of 10 MFIs points out that on an average 18 per cent insurance is refunded every year as a claim to the borrowers and the balance of the amount remains with the MFIs. So, re-fixing the calculation method is not sufficient; which components of a loan should be taken into consideration or imputed in calculating interest rates need to be identified. Otherwise, chances of manipulation will always remain high in the environment where information asymmetry is also high.

I discussed my observations with the MRA officials both at the collective level in FGD and individual level with the high officials. They were least aware of the facts on compulsory insurance payment with a loan. One of the senior officials mentioned that insurance and loan are two separate products, so I should not mix them up in calculating the interest rate. However, international practices (Rosenberg, 2013 & Water field, 2015) stipulate that all the compulsory payments need to be counted during interest rate calculation in order to get the real picture. I asked inspectors, who regularly visit fields for inspection purposes, that how do they know that MFIs have been calculating interest at declining balance method and how much do they charge actually? I was informed that they check MFI's amortisation schedule or passbook at client level to verify the rate and method. They do not count whether there is any compulsory payment tagged with a loan contract or not. One of the inspectors commented that it was actually a practice of paperwork instead of investigation at field level. MRA only monitors whether any MFI violates rules of "maximum rate 27 per cent" using the declining balance method. In recent years, the issue of 'truth in lending' has been gaining importance in the market⁴⁰¹. Reserve Bank of India has

⁴⁰¹<http://www.mftransparency.org/regulation/>

introduced necessary disclosure policies in its new rules for the NBFC-MFIs in India, where it has stated:

The law requires NBFC-MFIs to provide the borrower a copy of a standard loan agreement form with the loan term and conditions, including the annualized interest rate and method of application. To assist the borrower in conducting a meaningful comparison of terms and conditions among different NBFC-MFIs, each loan application must include the information that affects the borrower.

Following the conclusion of the loan, each borrower must receive a summary loan card reflecting “the effective rate of interest charged,” all other terms and conditions attached to the loan, information which adequately identifies the borrower and acknowledgments by the NBFC-MFI of all repayments⁴⁰².

In Bangladesh, there is no such requirement that reflects all the terms and conditions attached to a loan including an effective rate of interest from where stakeholders may get an idea about a loan contract of MFIs. Neither client passbooks nor MFIs websites⁴⁰³ in Bangladesh provide any such information regarding the real price of a loan.

b) Cap on interest rate

Interest yield is the ratio of interest income and average loan outstanding that gives an idea about real rates of interest. Its value for a particular year cannot be more than the nominal interest rate. Exact value depends on income loss due to loan default. So, if an MFI does not charge more than 27 per cent on loans for a year then its interest yield will never exceed 27 per cent. Sector’s average loan loss generally varies from 1.52 to 2.46 per cent of the loan outstanding. So, the expected yield would be around 25 per cent. I have collected data on service charge income of 512 licensed MFIs for the period 2007-2014 to calculate their yield on loan portfolios. Finally I chose the top 100 MFIs after scrutiny. Table-1 and figure-1 in Appendix-F7 present average interest yield of the sample MFIs both in terms of value and trends respectively for the period 2007-2014.

It is observed from this table that the interest yield of the sector varies from a low of 22.34 per cent in 2007 to a high of 27.53 per cent in 2009 and has been declining since then. The average yield of these sample MFIs was 25 per cent in 2014 when they incurred an average loan loss of 1.55 per cent. So, apparently from the

⁴⁰² (<http://www.mftransparency.org/pricing-regulation/india/>, accessed in September 2015)

⁴⁰³ ASA mentioned on its website that it used to charge 27 per cent at declining balance method.

lenders point of view, it remains within the cap fixed by the authority and is, therefore, in full compliance with rules. However, the figure on interest yield is not adequate to draw a conclusion on whether this rate is sufficient or not to cover the lender's cost. We need more information for that. Is this a justifiable or affordable rate from the borrower's point of view? Further, how much return a borrower is needed from his or her investment to cover this cost? It is not possible to answer these questions here due to non-availability of data from any source.

c) Yield and expenditure that decide sustainability of an MFI

The difference between yield and operational cost, i.e. figure on margin, indicates whether an MFI makes enough money to cover its other costs such as cost of funds and loan loss. In the previous sections, I discussed about increasing trends in the average operational costs of the sector. Table-2 in Appendix-F7 shows a comparative picture on average yield, expenditure and margin of the top 100 MFIs in Bangladesh over the period 2007-2014. The figures for the years 2007, 2009, 2012, and 2014 reveal important information on the sector. It shows that, in 2007 these sample NGO-MFIs earned less and spent less, but still had some margin to cover other costs. In 2009, they had the highest yield and despite high expenditures, still had a reasonable margin. In 2012, they earned enough (within the limit of the cap on interest), but they did not have enough margins to cover other costs due to high operating expenses (highest in the periods). But, the NGO-MFIs experienced the highest margin in 2014, even after earning less compared to 2012, due to less expenses (lowest) in that particular year. In a relatively steady scenario of other costs (such as costs of funds, and costs for loan losses) and price, fluctuating nature of sector's operating costs seems crucial for its sustainability.

The year 2009 was particularly crucial for the sector since it was the year when a considerable amount of discussions and arguments took place between the MRA and the sector, regarding formulation of second layer of regulation and the circular on interest rate that were important for reshaping the industry. The MRA gathered the first round information on cost factors in 2008 (for the year 2007) and the second round in 2010 (for the year 2009) to standardise cost of operation and interest rate. Before issuing the circular, there were a few rounds of data collection and discussions on the issues. It needs to be pointed out here that in 2009, MRA proposed to keep the maximum cost of operation within 12 per cent of the loan

outstanding and minimum margin at 8 per cent, which NGO-MFIs opposed. Thereafter, a rising trend of operational costs is observed in Bangladesh, over 20 per cent for the period 2009-2013. As mentioned earlier that the average cost was found to be only 11 per cent in South Asia and 15 per cent worldwide in 2011 (Rosenberg, 2013). Bangladesh was incurring higher operational costs than the others. This rate suddenly decreased from 24 per cent in 2012 to 14 per cent in 2014, which is puzzling.

In summary, MRA's circular on interest rate improves pricing transparency of the sector. However, in the absence of clearly defined disclosure policies, chances of manipulation by the lenders remain. Its cap on interest rate reflects a prevailing market rate that reinforces lender's interest only. There remains further scope to address the issues regarding NGO-MFI's 'operating cost' to improve their transparency in operation.

9.5 ACTUAL OUTCOMES: CLIENT LEVEL

Clients' profile

Clients of MFIs are generally poor people. There are 120 clients under the survey of this research, 112 (93%) female, and 8 (7%) male⁴⁰⁴. Of these, 35.83 per cent are from Kurigram, 25 per cent from Tangail, 22.50 per cent from Patuakhali, and 16.67 from Dhaka district. They are mostly below the age of forty. 47.50 per cent belong to the age group 18-30, and 31.67 per cent are between 30 to 40 years. Nearly half (49%) of these clients are uneducated, 31 per cent went primary school, 17 per cent completed high school, and 13 per cent have a college level degree. All the uneducated clients (59) are female. At the aggregate level, 63.33 per cent of them have electricity at home, 39.17 per cent have sanitary latrine (*paka* toilet) facilities, and 95 per cent have access to safe drinking water (tube well). Male clients are found to be in a better socio-economic condition in all aspects regarding education, electricity, and sanitary latrine. Six male clients out of 8 have bank accounts in conventional banks as opposed to only 15 female clients out of 112.

Table 1, 2 and 3 in Appendix-F8 provide a summary of clients' profiles. Table-1 shows that most of the young clients are from Kurigram, Tangail, and Dhaka districts. Tangail has the highest percentage of uneducated clients and Patuakhali the lowest, as shown in Table-2. Kurigram district remains backward in all respects, as

⁴⁰⁴ Generally 10 per cent clients of MFIs are male (Source: MRA-MIS)

presented in Table-3. Among the three socio-economic indicators viz. access to safe drinking water, access to a sanitary latrine, and access to electricity, sample clients are on the higher side of the national average that prevails for poor people in Bangladesh. It indicates that these customers do not belong to the poorest section of the population.

Specific observation from the field

In all these areas a few clients are either former clients of the Grameen Bank or current clients who are continuing membership both with Grameen Bank and NGO-MFIs simultaneously. The clients in the Bozra Union of Ulipur are badly affected by the river erosion, and they are the new settlers in that area. So, they are relatively in a poorer condition compared to the clients in other areas. In Tangail, most of the clients are from a definite professional group, involved in that particular profession from generation after generation and in some of the cases, their parents were first generation microcredit borrowers of Grameen Bank during the mid-80s. Characteristics of two slums of Dhaka city are very different; one was relatively in a better economic condition compared to the other. Clients from the better area are mostly involved in various kinds of small business activities. In the better slum, clients live in the rooms made of concrete walls; some of them even have refrigerators and televisions at home. Many NGO-MFIs are active in this place, so clients of this area usually borrow from multiple MFIs, and they have larger loan size compared to the other slum of Dhaka city. Most of the clients in the poor slum in Dhaka city are daily labourers; they used to borrow from various unauthorized organisations due to the absence of a sufficient number of authorised MFIs accessible by them.

Problems faced

Getting information on an individual client is one of the major problems in the field. In a group scenario, especially in the context of a village, information even of personal nature is known to everyone. Most of the time, it is the group leader who answers, even when a particular question may have been posed to a particular client. Sometimes if a person remains silent or feels shy in talking, another vocal or assertive person provides information for that shy person. Besides, sometimes all the clients respond together when a question is thrown to a single individual. I have faced all these problems during the client survey. Separating individuals from the group would

have created suspicion among clients as they might not feel comfortable in answering the question in an isolated environment, so that also was not feasible, had to be avoided. This problem was minimal in case of male clients.

Another problem that I faced during data collection in the field was related to the husbands of some of the female clients, who actually had been operating the accounts in favour of their wives. So, female customers of this type were not able to answer questions properly. Sometimes I talked to both of them; in three cases I had to speak to the husbands only in the absence of their wives. However, there was no case where the wife had to talk on behalf of a husband.

The third problem was related to terminology. Among all type of clients, MFIs are synonymous with all authorised or unauthorised organisations including Grameen Bank, NGO-MFIs, cooperatives, multipurpose savings & credit organisations, and insurance agencies. ‘*Samity*’ is the popular word that is used extensively to mean any of these organisations. The problem of terminology in differentiating one type of organisation from the others has created confusion in collecting data on NGO-MFIs’ rules. Besides, I realised that the foreign words ‘Microcredit Regulatory Authority’ sounded very unfamiliar to the village folk when I asked them about the rules and the MRA. This particular term sometimes created a barrier against candid conversation with the clients.

Clients’ involvement in microcredit

The matters related to clients’ involvement with multiple organisations, their year of attachment with these MFIs and the size of their current loan(s) (the extent of their debt) have been considered to understand the depth of their participation in the programme. Figure-1 in Appendix-F8 presents summarised information on sample clients in all districts in percentage form.

a) Involvement with multiple MFIs

How many MFIs is a client attached to? This was the question to the sample clients to get an answer about their involvement with multiple MFIs and multiple loans; here MFI meant Grameen Bank and the NGO-MFIs. Their responses indicated that they were uncomfortable in answering this question. They were found to be involved with multiple MFIs in a number of ways. Sometimes they have borrowed from one MFI but have remained as members with others just to save money. Informal conversations

with them revealed the fact that they wanted to retain their membership with as many organisations as possible to increase their opportunities to get easy access to money in the event of an emergency. Sometimes they borrowed from multiple organisations to meet urgent needs like medical treatment, fees for children exams, and paying back instalment to other MFIs, and other reasons, or at times just to meet the demand for additional cash to run a business.

40 per cent of them were involved with more than one organisation at an aggregate level; male clients were more involved with multiple organisations than female. Six male clients out of 8 were attached to more than two MFIs. If cooperatives and other unauthorised organisations are considered under the category of MFI, then the percentage of clients' involvement with multiple organisations will further increase. Figure-2 of Appendix-F8 shows that clients from Dhaka district are more involved in multiple borrowing compared to the other districts, Tangail is the next. Clients from Kurigram are the least involved with multiple organisations.

Hossain (2014) thinks that multiple borrowing by microfinance clients may happen due to many reasons; one of the reasons could be competition among the MFIs. Now more and more MFIs are pursuing a single client that was just the opposite initially, he states. According to him, if borrowers can use these loans productively then it might not be any problem for them to pay back the loan. However, it could create serious problems of indebtedness if borrowers failed to utilise it productively, he added. Globally over-indebtedness has surfaced as one of the most serious problems of microfinance in recent years [EAYM, 2015]. Borrowing from multiple agencies at a time just out of the simple need for business may not always be the case. At times urgent family needs or pressure by MFI agents might influence them to get involved with multiple loans without any business consideration. This runs the risk of dragging them down into problematic situations though the law stipulates that the MFIs should avoid this kind of risk as part of their responsibility. The law says that it is not only just the clients' responsibility but also that of the MFIs'. Before sanctioning new loans⁴⁰⁵ the latter should consider borrower's ability to pay back a loan and his or her indebtedness with other organisations and individuals to ensure proper utilisation of the loan. Prevention of over-indebtedness is one of the essential components of Client Protection Principles

⁴⁰⁵ Section 13(8) MRA Regulation, 2010

(CPPs) implemented by the SMART Campaign group which has been supported by many network organisations of MFIs and donor communities (Rozas, 2011). So, this remains an issue of concern.

b) Duration of involvement

How many years have they been members of an MFI? This was the next question to the clients to understand the length of their participation and their familiarity with the programme. It was expected that the more experienced borrowers would be better informed on the terms and conditions compared to the less experienced clients. Data reveals that only 38 clients were attached with MFIs for 1 to 5 years, 45 for 5 to 10 years, and 25 for over ten years. All the 25 clients in the last category were female, of which 7 were involved for 20-plus years. Five male clients out of 8 have experience between 1-5 years. The average duration of association of all the clients was around eight years. Figure-3 in Appendix-F8 shows that clients from Tangail have the longest duration of involvement with the microfinance services at an average of 10.23 years, for both Kurigram and Patuakhali it is an average of seven years while it is lowest in Dhaka district at around five years.

c) Loan size

In this survey, nine clients did not have any loan outstanding during the period of survey, so only 111 clients had a loan with the MFIs. The average size of the loan was found Taka 37990, but it might not be from a single MFI. The average amount of loan to a female client was Taka 30291 and Taka 136125 to a male client. The lowest loan size was Taka 3000, and the highest, Taka 600000. This highest amount was given to a male client by two MFIs, one had given Taka 500000 and the other one Taka 100000 as micro-enterprise loan. Table-4 in Appendix-F8 shows the number of borrowers for each category of loan size (also shown in figure-1 in percentage form). So, table-4 shows that more than half of the clients belong to the loan size of Taka 10 to 30 thousand.

d) Source of information and decision making

How do they make decisions in taking a loan and in choosing a lender organisation? Is that the clients' own decision, or it is influenced by some other external individuals or agencies or factors? Where do they get information on the MFIs? Information

regarding clients' decision-making process and their sources of knowledge are two important factors to understand their perceptions towards microfinance and related rules. It is also so because microfinance is a different kind of financial service especially designed for poor people who generally belong to backward socio-economic condition and do not have easy access to related information. In the surveyed questionnaire they were given a few options to choose regarding their decision making process. Data shows that 35 per cent of 120 clients have chosen 'request from family members', which included their husbands in case of female clients. Figure-4 in Appendix-F8 also indicates that family members and neighbours have a major role in making a loan decision. Joining as a member or a borrower with an MFI is rather a joint decision instead of a pure individual decision. This is especially true for a female member. In most cases 'family member' meant husband to the female clients. In their own words, they decided to take a loan on '*paribarar anurodhe*' which means 'request from family (husband)'.

On the other hand, the decision-making process in choosing an MFI is greatly influenced by the MFI's physical closeness to the clients and the facilities they offer to the clients such as the facility to open a DPS account, allowing savings to adjust loan, and other factors, as shown in figure-5 in Appendix-F8. Other options like suggestions from others, and recommendations from the MFIs also play a significant role in choosing an organisation from where they would be borrowing. To the clients, informal discussion with existing clients is the primary source of information for making decisions in the absence of any formal sources.

Degree of awareness: Legal rights and responsibilities

Clients were asked the following eight questions to ascertain whether they make informed decisions, and to understand their level of knowledge about the legal rights and responsibilities that are mentioned in the law:

- 1) Whether they know that an MFI needs a license, from the government, to run microfinance operation;
- 2) Whether they check beforehand how much interest they have to pay for a loan;
- 3) Whether they know the interest rate policy of the government and the cap it has fixed;
- 4) Whether they compare the interest rates with others;
- 5) Whether they get their savings back in time;

- 6) Whether they get interest on savings;
- 7) Whether they know about government policy on savings;
- 8) Whether they have seen the poster that the MRA distributed to make clients aware of these government policies?

The above questions have incorporated two important pricing policies of the government viz. interest rate on a loan and savings, which actually have direct and tangible effects on the clients' livelihood. Figure-6 in Appendix-F8 presents the summary of their responses to the above questions. It is seen from this figure that over 92.50 per cent of the clients knew nothing about licensing requirements of an MFI. The other 7.50 per cent, who claimed that they knew about it, were vague in their answers when requested to clarify their statements.

It is also seen that 42.50 per cent of the clients generally asked field officers about the interest rate on a loan before borrowing. But, 99 per cent of them knew nothing about the government policy on that. A few of them (29 per cent) mentioned that they compared the interest rates of a loan with others before borrowing. Field survey confirms that 100 per cent of the borrowers have not seen the poster that the MRA circulated for borrowers' awareness although MRA staff claimed that it circulated this policy in poster form to publicise the content of the government policy via NGO-MFIs' network. Since none of them knew about the 27% interest cap announced by the government, they were simply asked to reveal what interest rate was followed in their transactions. And, what was revealed to them in answer to their question to the field officers of the lending agencies when they asked them about a rate? In response, the general answer from the borrowers was, "Sirs say that you will have to pay Taka...in amount for every Taka 1000 as loan". So, clients are used to compare the price of the loan on the basis of 'Taka' in an amount that they have to pay instead of any rate in percentage. Many of them mentioned that it was not only interest on the loan that they considered before taking a decision from which organisation(s) they would borrow. There are many other factors for consideration in taking a decision on a loan from a particular MFI, which are-- the urgency of loan, knowledge sharing from peer groups, the nearness of an MFI to the locality, behaviour of field officers, the influence of other family members, other interlinked facilities associated with a loan, and other factors. All these factors combined usually

affect the choice of a borrower; although urgency of the loan is definitely one of the most important factors.

This survey has revealed the information from borrowers' passbook that they are paying extra charges unduly for insurance, in addition to a regular one-time payment. They are also paying insurance instalments for covering the risk of the loan even when there is actually no outstanding loan. This fact has also been partially confirmed by the MRA officials who visit the field regularly. This is like hidden transaction costs of service that can further manipulate interest rate calculation. The EVC, MRA has also pointed out the issues like unclear pricing policies of the MFIs, and clients' lack of knowledge of the terms and conditions of a loan in a few meetings with the clients arranged by the Institute of Microfinance (InM)⁴⁰⁶.

The response of clients, related to the questions on savings, provide better-informed answers. 85 per cent of them mentioned that they usually got savings back in time if there was no outstanding loan with an MFI. 77 per cent clients informed that they received interest on savings. However, most of them had vague knowledge on the rate of interest on savings and they were totally ill-informed about the government policy on minimum rate.

There is no correlation, however, between the borrowers' level of education, duration of association with the MFIs and the degree of awareness about their rights and responsibilities at any level. Same level of understanding regarding legal statements is generally observed across the clients irrespective of the district and years of involvement with the MFIs. They are usually highly dependent on field officers for information; their conversations indicate that they relied a lot on them. Only 27 clients out of 120 reported that field officers sometimes discussed rules in their meetings. The scope of discussions usually remained limited to the best utilisation of loan and the necessity of regular repayment of loan. No one mentioned that field officers had ever discussed recent government policies with them. Sharing information with the clients, providing them sufficient and timely information in a manner and language that clients can understand to make an informed decision is a part of 'responsible pricing' and 'transparency' of Client Protection Principles (CPPs) under SMART

⁴⁰⁶ Meetings with local NGO-MFIs, and clients in Chittagong on 8 May 2014, in Jessore on 19 June 2014, and in Rangpur on 14 August 2014 where he was the Chief Guest.

Campaign that Bangladeshi NGO-MFIs have recently agreed upon⁴⁰⁷. However, field survey does not indicate that the MFIs are abiding by that commitment.

Repaying regular instalment of loan- a tough reality

Paying regular instalment of a loan in time is one of the important legal responsibilities for a microcredit client. 'Kisthi' is the popular word used by the microcredit borrowers to convey the instalment of a loan. This word has become a synonym of microcredit, and it occupies a significant part in their daily conversation. All microcredit borrowers have to deal with this issue of 'Kisthi' at least once in a week. Some of them may have more than one weekly 'Kisthi' depending on the number of loans. They have to arrange or manage money to repay 'Kisthi' that comprises their weekly instalment, weekly compulsory savings, other savings, and sometimes weekly payment for insurance. Those who do not have regular income or cash inflow have to manage it somehow; there is no other alternative. One client in Kurigram stated-

we all know that we will have to pay it anyhow, it does not matter what happens in our life. So, we keep the money to pay 'kisthi' aside before spending money for other purposes. They (*field officers*⁴⁰⁸) will not leave the place without that. If our parents die, they will help us in digging the grave, if needed. They would participate in crying with the relatives, but they would not leave the place unless we pay the 'kisthi'. [Kuri_UI_M_04]

Similar sentiments have echoed in the voices of the other clients as well. An old Hindu lady in Kurigram mentioned that-

this is (instalment) *Ma Kali's*⁴⁰⁹ money, so we have to keep it separate. [Kuri_UI_A_10]

Another lady in Patuakhali has cited the punishment mechanism for not paying an instalment in time. According to her-

if we do not pay it timely, we may not get access to any credit in future, they may drop us out. [Patu_Bau_Goa_04]

⁴⁰⁷ BRAC arranged the first workshop in July 2014 and the second workshop on 3-5 February 2015 (jointly hosted with CDF and SMART Campaign) in Dhaka as part of endorsement of CPPs policies.

⁴⁰⁸ Italics inserted by researcher

⁴⁰⁹The Hindu Goddess Kali.

All the statements mentioned above indicate that borrowers obey their duty religiously in paying instalments on a regular basis. However, some of them fail, as noted in the survey. 43 per cent mentioned different kinds of problems that they were facing in paying instalment. Of this 43 per cent or 52 clients, 27 admitted borrowing money from others to repay regular instalment of credit. Three of them said that they had to sell other assets like a duck, rice, or goat to manage cash for paying 'kisthi'. Some clients from Patuakhali and Dhaka City reported about some mal-practices in regularising their loan by deducting unpaid amount from other borrowers' loan. They also confirmed the fact that they sometimes borrowed from other MFI to pay for another loan.

Samity shava (centre meeting)- 'Point of sale'

"Abide by law and order of the samity and spontaneously cooperate with the Microcredit Organisations by attending the meetings of the samity.." is one of the duties of a client as per section 17(ga) of the rules⁴¹⁰. In the early stage of microcredit, attending 'samity shava' was mandatory. . It was considered a kind of social gathering of poor people to mobilise and train them. This meeting of 'group members' is a part of the microcredit model developed in Bangladesh though there are many other settings in other places of the world (Wright, 2000). Field survey signifies that the concept of conventional 'samity shava' and 'group' have gradually become obsolete for various reasons from both the clients' side as well as organisations' side. Now it is not always necessary for all the clients to attend group meeting or repay loan individually. Any representative of a borrower can take that responsibility for others. This system helps both the borrowers and the MFIs in saving time. During the survey, some of the borrowers displayed a reluctant attitude towards attending every group meeting.

However, Grameen Bank still maintains the rule of mandatory presence in the meeting of each member. This was criticized by some of the clients. An ex-member of Grameen in Patuakhali stated that her family did not like her attending a meeting outside the home and sitting there with other poorer women. So, she had to leave Grameen Bank and joined another NGO where that requirement of joining group meeting is not mandatory. Now her husband maintains the necessary communication with the field officer, keeps the passbook with him and pays back the loan. She only

⁴¹⁰ Microcredit Regulatory Authority Rules, 2010

signs on the paper when and where it is required and the field officer visits her home if needed. 'Samity shava' or centre meeting now acts as a 'point of sale' where field officer generally comes once a week to collect instalments on the loans and receive new applications, which is mostly true for NGO-MFIs. This place either can be the client's home or a shop in a local market. Dr Mahbub Hossain, the former ED of BRAC, has recognised this fact during an interview while he mentioned that now opportunity costs of time for borrowers have become high due to wage rise in the rural areas and in that consideration they are not interested in spending time in meetings.

Gap in understanding

It is clear that there is a gap between the practices in everyday life and the written policy statements. The story in Appendix-F9 discloses a few shocking facts about a female client [Patu_Bau_Goa_03] that may not be true in every case, but it is not unlikely. It shows how sometimes female clients are in vulnerable condition in making a loan decision. I met this client twice. In the first sitting she told me her tragic story regarding taking credit for the second time, which she was forced because of pressure from her husband. Her husband squandered the money and she faced severe difficulties in repaying the loan. She again visited me and brought her husband along with other in-laws in the hope that I would intervene to help her.

I believe that this story would help to explore some other social dimensions of microfinance that demands further research to dig the issue for future policy intervention in protecting the interest of clients. Microfinance clients are socially more vulnerable compared to the clients of the banks. The issue of clients' protection has recently become a serious concern worldwide [EAYM, 2015]. However, MRA has yet to set up a system to establish regular and direct interaction or communication with the clients except field visits by the MRA staff as part of their regular onsite supervision. When this matter was pointed out to the officials of the MRA during the interview and FGD, they mentioned that they talked to some selected clients and checked their passbooks during field visits to verify information supplied by the MFIs, which was the main source of their information about clients. They also added that any aggrieved person can submit a written complaint to MRA.

Clients are generally reluctant to complain; more than 80 per cent of surveyed clients do not have any complaint to mention. 88 out of 120 clients even do not have

any suggestion of what kind of policy will be useful to improve the existing conditions. 92 per cent of them did not make any additional comment when asked them to make free comments on the kind of microfinance services they were getting. Some of them noted that any complaint would not change the situation. When they previously needed money urgently to cater for emergencies, they had to borrow from moneylenders, and now they borrow from MFIs at better terms and conditions. They think that now they have better access to money. However, there are three major types of complaints from some brave clients. These are:

- a. Pressure for repaying loan during hard times;
- b. High-interest rate on loans;
- c. Pressure to borrow when there is no necessity for a loan.

9.6 CONCLUSION

In this chapter, I tried to examine the post-law effect on the market. In doing so, I have identified some expected outcomes both at organisational level and clients' level. The effective implementation of the rules might have improved transparency of the sector in terms of its disclosure of information, efficiency in operations, and in setting 'balanced' pricing. The rules expect responsible behaviour and informed decision on the part of clients as well. I interviewed some important stakeholders to get their observations and comments on the expected outcomes. Their views provided valuable insights in understanding recent important changes in the market. They think that the recent changes in the market are the combined results of actions and counteractions of many players though government's recent rules have played the dominant role in influencing the final outcomes.

Recent data analysis shows that MRA has brought all the major NGO-MFIs under its regulatory system though it took time more than expected. There are some areas of concern that pose challenges for MRA to reduce the gap between expected level of institutionalisation and actual achievements. MRA's monitoring system is such an area. Improvement in its field inspection and audit system might bring better results. Collecting timely and reliable data on the sector, ensuring the quality of inspection and translating audit reports into useful information still demand special attention to fulfil the objectives of rules.

It is still tough to break the monopoly of the few NGO-MFIs on the sector, though some mid-level organisations are on the rise to compete with them. Financial

data on the sector indicates NGO-MFIs are taking strides towards commercial sources of funds rather than depending on subsidy and grant. However, their sustainability is still a concern due to high costs associated with their operations, which is higher than average figure in other Asian countries. This cost is not only showing increasing trends, but also is fluctuating a lot and yet to show any stable pattern. No reasonable explanation was found for the rising trend of operating costs of the sector. Sector's cost per client is also on the rise though it is expected to decline with the rising trend of average loan size. This cost has increased at a much higher rate for large NGO-MFIs compared to the same of the smaller organisations. So, it appears that Bangladeshi NGO-MFIs fail to exploit the opportunity of economies of scale.

MRA's rule on interest rate ensures better disclosure of pricing information. However, loop holes remain that hinder the expected outcome of full transparency in pricing of microcredit. It has not defined which components of a loan contract should be taken into consideration in calculating an effective rate. The cap, MRA has imposed on the interest on a micro-loan, reflects the prevailing market rate that mostly protects interests of the lender. Little attention was paid to the borrowers' perspective in deciding this so called 'reasonable' cap on interest. So, the lender has adequate scope to earn a reasonable income within the boundary of rules and remain sustainable. There remains scope to reduce interest rate further by reducing operational cost of NGO-MFIs.

On the other hand, practical efforts in protecting clients' rights remain an area of concern. Clients were found to be highly unaware about their rights and responsibilities, and they were also completely unaware of the existence of government rules in this respect. No formal attempt was observed to educate or to inform clients about their rights and responsibilities; neither by MRA nor by the MFIs. So, the degree of awareness of the clients regarding government rules is very sketchy. Their knowledge on interest rate of credit was found not only poor but also vague.

Over 40 per cent of them were found borrowing from multiple organisations, which might not always be driven by the sheer need of business expansion. Many of them were found borrowing from others to repay instalments of another loan. Close to 31 per cent clients have stated that timely repayment of instalments is one of their main difficulties associated with micro-loans. Other issues such as compulsive borrowing by female members against their will, under pressure from family members

to get more loans from the MFIs, forcing of clients to pay back loan during periods of economic hardship and deduction of loan instalment of one borrower from another also emerged during the field survey.

This chapter can be concluded by saying that the microfinance sector in Bangladesh has progressed a long way towards institutionalisation; it is now a better-organised market than before. However, there are still some challenges to reduce gaps between expected outcomes and actual achievements. High operational costs to serve a client, monopolistic nature of the market, and transparency in the operations of the NGO-MFIs are some areas of concern prevailing in the market. Installing a proper mechanism to protect clients' rights is another area that needs special attention from the policy makers. MRA will not be able to handle all these issues without enhancing its human resource capacity.

CHAPTER 10

Conclusions and Recommendations

10.1 INTRODUCTION

The rural financial market of Bangladesh is now largely dominated by microfinance institutions and has changed dramatically in the last three decades. In 1983, the Bangladesh government provided regulatory support to Grameen Bank, the first microfinance bank in the country. In 2006, twenty-three years after its first response to Grameen, the government responded to another regulatory demand, this time concerning NGO microfinance activities (NGO-MFIs). These two sets of regulations, their follow-up amendments, and other supplementary rules have had an immense impact on institutionalising microfinance in Bangladesh.

This paper attempts to understand the regulatory role of the government, its background and purpose, evolving characteristics, implementation procedures, and the role of state agencies like Bangladesh Bank, the central bank of Bangladesh, and the new regulatory authority for NGO-MFIs, the MRA. In doing so, this paper takes an institutional approach and uses a basic IAD (Institutional Analysis and Development) framework to analyse data. This framework is based on game theory that helps identify an action arena, the players, their interaction pattern, and finally the outcome that evolves from commonly accepted strategies and moves of the players.

Its data set includes the institutional memory preserved in Bangladesh Bank, the MRA, and other organisations in the form of published and unpublished documents. A set of primary data was also collected in the form of interviews, focus group discussions, and client surveys. It also uses balance sheet information and operational statements of NGO-MFIs.

This concluding chapter is divided into six sections including introduction. Other sections include a summary of major findings, the general conclusions, the policy implications of these findings, the scope for future research, and finally, concluding remarks.

10.2 SUMMARY OF MAIN FINDINGS

10.2.1 *State's response to Grameen Bank regulation*

The first regulatory attempt of the government adopted for Grameen Bank, was a spontaneous reaction dedicated to controlling a single organisation. No one thought of considering it as a general regulatory framework for microfinance. So it remained a stand-alone policy response of the government, particularly for Grameen Bank.

Grameen Bank evolved during a period of shifting national policy from nationalisation to privatisation, towards a market-led approach. It adopted many features from earlier experiments. It was neither a version of the old subsidised credit system, nor an entirely commercial venture. It followed a partly cooperative model, but its major focus was individual business.

Though many participants were involved in the initial phase of its development, the final regulatory game was played between the government and GB management. The government responded to GB management's demand for an independent identity, ignoring opinions of other participants. The non-elected Army government took the side of the organisation in the 80s when it provided regulatory support to GB to keep it outside the purview of any external oversight and monitoring.

Grameen Bank's contribution to society lies in its novel ownership structure. Though not well defined, it is legally an organisation of poor people. It is one of the factors that helped GB gain popularity far and wide, despite its focus on individual efforts and higher interest rate loans compared to mainstream banking sector rates. So this first set of regulations for Grameen Bank helped in building the public confidence and image of an emerging microfinance institution.

In the early stages of the formation of MFIs, i.e. during the early 80s, the state was in a position to bargain and was somehow successful in establishing its control or rights over Grameen Bank, at least partially, in the form of ownership and through direct governance. Under the law of 1983, GB eventually became involved in a complementary and conflicting relationship with the government on the issue of control and ownership. The regulatory responses to GB went through many amendments that largely varied with the type of government in power. It was mostly favoured by the non-elected government. But no significant amendments were brought by successive elected governments in power, either to establish a proper monitoring mechanism for GB, or to define the property rights of its members.

10.2.2 *State's response to NGO-MFI regulation*

Twenty three years later the government had to meet another set of needs of the same nature. This set of regulations for the NGO sector emerged from market demand, where self-employed private management bodies of NGOs had a significant role in influencing market dynamics, since they had full control of the social and economic capital of the organisations. This time, the government did not claim any ownership of the 'social capital' that had been largely built up with the help of donors, government, and the poor. The governing and management bodies of these NGOs had more freedom in behaving like private owners of 'social capital' in the more liberalised market at this phase of development.

They developed long term bonds with the grass roots population while building these organisations, had more internal information than the government, and they emerged as a strongly organised force. Besides, these organisations meanwhile had also created some social values, so a strong feeling of apprehension remained, that dismantling them might create more social costs than gain. They only needed legal support to uphold their social position and improve their personal and corporate economic benefits further, alongside sharing some of the benefits with their clients.

Over time, they gained more bargaining power over the government since they emerged as the third sector in development (quasi-public, quasi-private) supported by dominant national and international political trends, and mainstream economic views. So, the demand for a regulatory system based on lender requests was more powerful than for client or demand based regulations, which would have to consider client views and interests to a far greater degree. The NGO-MFIs and the government bargained with each other on the nature of regulation needed, and an appropriate regulatory agency.

The government responded to this market demand with a set of separate rules and regulatory authority, fulfilling the expectations of all parties concerned. This set of rules took a very simplistic approach to regulating NGO-MFIs, which gave the sector a broader sanction of legal rights. At its core, a 'microcredit organisation' is not a separate legal entity. It belongs to its parent organisation that may or may not have other functions. Inevitably there are problems of rules overlapping with other legal agencies, and full compliance with rules to ensure transparency is further complicated. Under this law, the sector was given broader access to public deposits by adapting its previous practice of naming a 'client' as 'member'. Most importantly, the

poverty alleviation function of an NGO-MFI, sanctioned by the law, granted unlimited scope to include as many functions as they wished under this basket.

A separate regulatory authority, the MRA, was created outside the Bangladesh Bank system. It emerged from a compromise between a private interest view of the sector and the public interest view of the government. Hence, the effective application of the law depended on a proper balance of these two views. Though the MRA was given broad legal authority over a few hundred NGO-MFIs operating all over the country, its physical and financial capacities were very limited. It could do little to bring significant change to the sector.

However, the MRA made an effort to balance between NGO-MFI demand and public need by drawing up supplementary rules later, which was a tough battle. The MRA engaged in all sorts of negotiation and compromise. On the one hand, the government wanted votes and popularity, so they were keen on low interest rates. On the other hand, they needed support from development agencies (national and international) to accomplish their poverty alleviation objectives, so they had to fulfil development agency demands for the interest rate to be fixed at sustainable market rates. This kind of dilemma and fluctuating decisions were reflected in the implementation process of rules and in the follow-up formulation of MRA policies.

Though these regulatory attempts for the NGO-MFIs were undertaken by an elected government, it too did not take the public point of view into account before formulating rules. It largely neglected the issue of client protection and their rights.

10.2.3 *Post law outcomes*

The new rules endorsed the microfinance activities of NGOs as a kind of legally permitted act that was pending for long. Thus, legal recognition of the sector at a certain level was the first great outcome of the new set of regulations. This single outcome helped the sector regain its image from the blame of illegal practice or operation.

This legal setup brought the sector under an organised system that was absent in the past. There are three major areas in the rules that most affected the microfinance operations of NGOs. First of all, rules related to governance issues attempted to replace the predominant power of a few individuals, with a well-functioning corporate governing body in an organisation. Secondly, though the rules allowed NGO-MFIs deposit collection, the MRA attempted to enforce some

restrictive clauses to ensure protection against mismanagement of deposits. Last but not least, the MRA's interest rate policy stopped MFIs from practicing non-standard interest rate calculation methods and replaced them with a standard method. In addition, the MRA fixed a ceiling on the rates. But the sector's compliance with MRA rules concerning governance and deposit collection is yet to be fully realised. Furthermore, the interest rate policy also needs to be reviewed again. There is still scope for malpractice and manipulation due to gaps in the rules. The cap it imposed largely reflects lender views.

Contrary to expectations, the market is still dominated by a few large organisations. Only four NGO-MFIs control near about 58 per cent of the total market covered by NGOs. GB alone serves 20 per cent of the total microfinance market in Bangladesh. Monopolistic market characteristics still exist, though a group of medium sized organisations is showing a rising trend. In spite of enormous grant and subsidy support over a long period, NGO-MFIs have yet to reach a stable level of full self-sufficiency in their operations. Many of them still seek subsidised funds from different sources.

There is no significant improvement in the operational efficiencies of NGO-MFIs. Rather, the efficiency of large NGO-MFIs has declined. Operational self-sufficiency (OSS) of the sector fluctuated a lot from 2007 to 2014. In 2007, only around 40 per cent organisations were self-sufficient in operation. This figure jumped to 90 per cent in 2014 from 42 per cent in 2013. However, the average OSS value of three large NGO-MFIs decreased from 1.57 in 2007, to 1.04 in 2014. The major concern is that the sector's operational expense is on the rise. The average operational expense ratio of the sector increased from 0.17 in 2007 to 0.24 in 2012, which remained as high as 0.20 till 2013, with a sudden decline to 0.14 in 2014. It was no wonder that the average annual inflation adjusted cost to the sector of serving a client, increased from Taka 675.33 in 2007 to Taka 1033 in 2012, which suddenly went down to Taka 675 again in 2014, from Taka 1025 in 2013. This cost went up by more than 300 per cent for three very large organisations between 2007 and 2012.

There was no direct regulatory attempt to improve the sector's efficiency that might have helped reduce the cost of providing services and thereby lead to a reduction in the interest charges. Bangladeshi NGO-MFIs' cost of operations is much higher than that of MFIs in other countries.

Clients of MFIs remained uninformed about their rights and responsibilities; no formal or informal arrangement is there to inform them. The concept of 'informed decision' on the part of clients, as mentioned in the law, is completely absent in practice. Thus, major information asymmetry still prevails in the market.

10.3 GENERAL CONCLUSIONS

Two sets of regulations for institutionalising microfinance were supplied by the government of Bangladesh; one for GB and one for NGO-MFIs, from two different socio-political perspectives to achieve two different goals. Though the general objective of these two sets of rules was to create an appropriate institutional environment to provide financial support to the poor, they differed in many ways.

The Grameen Bank Ordinance has specific focus for the poor, there is no ambiguity in its legal structure, and it has a clear focus on finance. Grameen Bank charges lower interest rates compared to NGO-MFIs, while NGO-MFIs are still struggling to find a clear balance between sustainability and serviceability, and their legal structure is ambiguous. They are experimenting with multiple functions, where microfinance is one of their major income generating activities to support other programmes. The client is treated as customer by NGO-MFIs as is the case for any business, but in Grameen Bank's case, clients are owners or part of the organisation. GB is run by its Board without being monitored by anyone and is allowed to collect public deposits, while NGO-MFIs are under MRA control and they have restricted access to public deposits. However, both are kept outside the purview of Bangladesh Bank and banking rules.

The initial regulatory response to GB was a one-shot game. In the case of NGO-MFIs, the process was more complex and the decision was taken at multiple phases under a repeated game model. The state behaved more reactively in providing regulations along the lines of greater compromise in later phases. Till now, that compromise generally continues in favour of the more powerful NGOs, at the client's expense, the weakest player in the game, namely the poor. The phenomena of moving regulation away from the public interest sometimes manifested at later phases, through a tendency towards regulatory capture, which cannot be ignored.

It is evident from the above findings of this paper that Bangladesh Bank, responsible for managing the credit system of the country to foster inclusive growth and pro poor development, remained mostly indifferent to the credit needs of the

poor. It failed to recognise the potentials of the market, especially the rural non-farm sector, and the market was left to be served either by the informal sector, or by others who would naturally emerge in response to demand. But considering the many delicate issues associated with this particular segment of the market, many risks remain if it is left to be served wholly by the private sector, following a pure market led approach.

As a state agency, Bangladesh Bank in this case has a definite role in ensuring social return over the economic return of individual lenders. So its silence regarding Grameen Bank and NGO-MFI issues is not beyond question. Most of the time, it engaged in these matters either due to a request from the Government or through the accidental personal interest of an individual from inside. Interestingly enough, some top level policy makers of Bangladesh Bank expressed views in favour of an option to transform some of the NGO-MFIs into specialised microfinance banks. But, these views have no reflection in any policy suggestions coming from Bangladesh Bank. The contribution of Bangladesh Bank to the evolution of the microfinance sector is thus largely unplanned, ad-hoc, and sporadic in nature.

The reactive regulatory response of the government and government nominated agencies, such as Bangladesh Bank and the MRA, can be explained by drawing together three important findings of this study. First, the government's willingness to recognise Bangladesh Bank's contribution and comments, regarding GB, was essential. Second, proper acknowledgment of the MRA as an independent body to monitor NGO-MFIs activities was absent. Finally, the government largely neglected the beneficiary's point of view.

Given the above, why did the government attempt to create regulatory agencies and bring the MFI sector under a legal system? Theoretically, the objective of any government regulatory response is to improve conditions for the people and organisations who are affected by it. Yet, analysis of the conditions under which these rules were supplied, and their consequences, demonstrates that other objectives predominated. The regulatory response of the state was mainly determined by investor demand and the sector's need to protect its own interests. Thus, appeasement of the powerful MFI sector, not improvement of the lot of the poor, was the main objective of the government when it provided regulations to institutionalise the microfinance sector in Bangladesh. The regulatory environment was largely driven by the dominant

political views of the government and the government's stated objectives were not evidenced by their actions.

This modern day model of microfinance in serving the rural poor might be one step ahead from its previous historical status, mainly dominated by moneylenders, and supporting a feudal culture of keeping women inside the home, if we view it from the perspective of institutionalisation of formal credit opportunity for the poor and marginal. However, past and present governments could have taken far better action in favour of target groups (the poor and the marginal) in order to raise their benefits and ensure their rights, by designing a more inclusive model of rural finance for them. This thesis proves clearly that this was, and still is, a real possibility if the state could respond proactively in a coherent manner at critical junctures.

10.4 POLICY RECOMMENDATION

There is still scope within the framework of existing law, to improve the legal environment conditions of microfinance by addressing the following issues:

- a. Effective monitoring of Grameen Bank by an external monitoring agency;
- b. Clearly define property rights of Grameen Bank shareholder-members to include issuance of share certificates, distribution of dividends, assessment of share value, transfer mechanism of shares to others, member voting rights, and an election mechanism to elect shareholder-member representatives to the Board of GB.
- c. Clarify the definition of a 'client' and a 'member' to remove ambiguities in the operation of NGO-MFIs.
- d. Define the boundaries of the new law applicable to NGO-MFIs. Clarify whether an NGO-MFI is a separate legal entity or not. If not, then how to ensure effective implementation of laws for an overlapping legal entity like an NGO-MFI will have to be discovered.
- e. Develop necessary and sufficient mechanisms to protect public savings collected by NGO-MFIs.
- f. Accurately define and identify the components to be counted in calculating the effective rate of interest for a loan.
- g. Address the issue of client protection and develop a system to effectively inform them of their rights and the rules governing them.

Regulation, a set of legal rules prescribed by the government, is a very powerful tool for reshaping institutions with long-term impact on the regulated organisations as well as on the public whose livelihoods are affected by the regulation. Regulated organisations always try to influence regulation to protect their corporate or individual interests while the government is supposed to protect the public interest. The stakeholders of regulation interact with each other on the basis of their particular interests and ultimately it is a balance of power that decides the outcome. Hence, regulation may lose its focus and direction if the state behaves reactively. Effective regulation demands clarity and commitment from the regulatory authority in everything regulation addresses. Regulation also requires thoughtful guidance and needs future direction for the overall public good.

The public body or state that is in a position to define and provide regulation should take appropriate measures in sanctioning legal power and authority, both to the agency and to beneficiaries. Without stating a specific monitoring mechanism and the enforcement of clear punishment clauses, the implementation of regulation remains ineffective. Regulation should be backed by other appropriate support from the state; mere good legislation is not sufficient. Finally, the state should take special care if regulation touches the lives of a vulnerable segment of the population. The state should concentrate on enhancing the awareness and capacity of the vulnerable to react when regulations are broken and their rights violated.

10.5 DIRECTION FOR FUTURE RESEARCH

This research only touches upon a few points concerning the regulatory role of the state and state agencies in the historical evolution of microfinance in Bangladesh. It uses an IAD framework to understand how regulation evolved over time to institutionalise the MFI sector in the evolving socio-political and economic circumstances of the early 70s to 2014. It attempts to analyse how some players interacted and influenced regulation in a certain direction to fulfil their goals that might not always ensure equity and justice for all. However, this is not an in-depth analysis of regulatory impact either on the organisations, nor their clients, or the market as a whole. It does not examine the economic implications of each and every regulation, nor does it try to analyse laws from a legal perspective.

Therefore, there is ample scope for future research to address the subject from different perspectives, using multiple techniques and models. Future researchers may

pay attention to these relatively less treated factors to understand the role of the state in formulating regulation for the greater public good in this field of microfinance. They may try to suggest new sets of rules on the basis of which new games may emerge with the possibility of better outcomes in this arena.

Although this research tries to explain the role of state regulation in the evolution of microfinance in Bangladesh, similar studies can be conducted in other countries as well, to gain better insight from other contexts.

10.6 CONCLUDING REMARKS

The research shows that the regulatory response of the state is primarily driven by the government's political views, and regulating agencies have little role in the evolution of microfinance institutions in Bangladesh. The government provided regulatory support, not to protect the public interest, but to protect the private interests of regulated organisations.

The various regulatory attempts of the government of Bangladesh play an important role in framing the basic concept of 'microfinance' in the public domain though they do little to change market dynamics. They could have played a far better role in reshaping the market to achieve greater social gain with a proactive response from the beginning. The government's regulatory attempts do not provide any direction to how the efficiency of NGO-MFIs can be improved to ensure their sustainability and protect client rights simultaneously.

At this point, we can only wait to see a more coherent and well-planned regulatory response from the state in the matter of 'microfinance', since by now, it has accumulated a long and richly varied experience in this field.

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APPENDICES

APPENDIX-A1

List of official documents

Table-1: Bangladesh Bank

Sl. No.	File No.	File name
1.	ACD(Proj)526/79-Vol-I	Grameen Bank Project
2.	RCPD(GBD)537(P)82-Vol-II	Grameen Bank Project Division
3.	ACPD(GBD)537(P)/83-Vol-III	Policy Permanent Record
4.	ACPD(GBD)537(31)/82-Vol-IX	Proposal for Grameen Bank Limited (GBL)
5.	RCPD(GBD)537(P)/85-Vol-V	Policy file
6.	RCPD(GBD)537(P)84/85-Vol-IV	Grameen Bank Division
7.	BRPD/613/14/2012	Grameen Bank (misc)
8.	ACD (Poli)72/96-98 (2 nd Part)	PKSF, Poverty alleviation, and NGO related
9.	ACD(Poli)95/2000	MRRU related (file transfer to Financial institution department from ACD)
10.	ACD(Poli)76/96 (2 nd Part)	Micro-finance project- Poverty Alleviation Micro-credit Project
11.	ACD (Poli)76/97-99 (5 th and 6 th part)	Micro-finance project- Poverty Alleviation Micro-credit Project
12.	ACD (Poli)76/2000 (7 th Part)	Poverty Alleviation Micro Finance Project
13.	ACD (Poli)95/99	Micro Finance
14.	ACD (micro)95/2000	MRRU related
15.	ACD(RES/AID)407A/77	Rural Finance Experimental Project
16.	ACD(RFEP)407/16	Rural Finance Experimental Project- Consultants Invoice
17.	ACD(RFEP)407/II	Rural Finance Experimental Project- Meeting with the consultants/ Bankers
18.	ACD(RFEP)407/7	Rural Finance Experimental Project- Agrani Bank
19.	ACD(RFP)407/14/83	Rural Finance Project
20.	ACD (Poly)153/83 Vol-I	Recovery of Loan disbursed under TK 100 Crore SACP through PDR Act
21.	Review Committee Report, Grameen Bank, 25 th April 2011	
22.	Grameen Bank Inspection and its implementation as of 31/12/1999	

Table-2: Microcredit Regulatory Authority

Sl. No.	File No.	Name
1.	FID(P)1078/1-2000*	Poverty Alleviation Micro Finance Project
2.	FID(P)1077/1-2000*	Microfinance Research and Reference Unit (MRRU)
3.	FID(P)1076/1/2001*	Microfinance Research and Reference Unit (MRRU), Vol-2
4.	FID(P)/1076(c)/1/2002*	MRRU (Misc)
5.	FID(P)1076/1-2000*	MRRU
6.	ACSPD-Poli (Micro)1/2003, Vol-2*	MRRU Steering Committee
7.	ACSPD-Poli (Micro)3/2003, Vol-1*	MRRU (Misc)
8.	ACD-Poli (Micro)1/2002*	MRRU-Steering Committee, Vol-5
9.	ACSPD-Poli(Micro)3/2004*	MRRU (Misc)
10.	MRRU/Intl.yr-2005/12/2004-2006	UN Year of Microcredit-2005
11.	MRRU/S.C/ Meeting-01/2004 (Vol-1)	Steering Committee Meeting
12.	MRRU/S.C/ Meeting-02/2006 (Vol-2)	Steering Committee Meeting
13.	MRRU/S.C/Meeting-02/(02)/2004-2006	Steering Committee Meeting (Misc)
14.	SARCFINANCE Governor's Symposium on Microcredit (02 nd February 2006)	
15.	MRA's other files related to draft law and regulation (from 20004 to 2010)	

*File transferred from Bangladesh Bank to Microcredit Regulatory Authority (Previous MRRU)

Notes on interviews and short profiles of participants

I have conducted 15 personal interviews. Among the participants, four were policy makers from the Bangladesh Bank, five representatives from financing organisations which included PKSf and the donors, four researchers, two high officials from the MRA, and the former MD, Grameen Bank. All the recorded interviews have been preserved electronically, a complete written transcription (in original language) of which has also been prepared as a separate document. The following table contains a detailed list of interviewees along with their short profiles.

Date of Interview	Name of Participant	Short profile
Telephone Interview on 31 March 2014	Dr Fakhruddin Ahmed	Dr Fakhruddin Ahmed took the charge as Chief Adviser (Prime Minister) to the Caretaker Government of the People's Republic of Bangladesh on 12 January 2007 and continued in this position till January 2009. Before this appointment, Dr Ahmed worked as Managing Director of Palli Karma-Sahayak Foundation (PKSF), the apex funding agency of microcredit operations in Bangladesh, from June 2005 to January 2007. From October 2001 to April 2005, he served as the 8 th Governor of Bangladesh Bank, the central bank of the country. Previously, Dr Ahmed served for over twenty years at the World Bank. Prior to joining the World Bank, he served for over fifteen years in the erstwhile Civil Service of Pakistan and after independence in the Government of Bangladesh. Dr Ahmed began his professional career as a Lecturer in Economics at Dhaka University. He took the lead in formulating a regulatory framework for microfinance sector as the governor of the BB & the chief of the National Steering Committee formed by the government for this purpose. He expedited the work. Currently, he lives outside the country.
Face to face interview on 25 & 27 February & 4 March 2014	Dr Salehuddin Ahmed	Dr Salehuddin Ahmed joined as the 9 th Governor of Bangladesh Bank (Central Bank) on 02 May 2005 and completed his four-year tenure on 30 April 2009. Before joining Bangladesh Bank, he was the Managing Director of Palli Karma-Sahayak Foundation (PKSF), the apex funding agency of microcredit operations in Bangladesh from late 1996 to April 2005. He started his career with a short period in the Planning Department of the Government of East Pakistan and then joined as a teacher of Economics at Dhaka University and joined the civil service of the government in

		<p>the erstwhile Civil Service of Pakistan (CSP) cadre. He served in various capacities in the field of administration in the Government of Bangladesh. He worked at the Centre on Integrated Rural Development for Asia and the Pacific (CIRDAP), a regional inter-governmental organisation with its headquarters in Dhaka. He was the Director General of Bangladesh Academy for Rural Development (BARD), Comilla. He worked as the Director General of the NGO Affairs Bureau (NGOAB) under the Office of the Prime Minister. He was one of the important members, as the MD of PKSF, in the National Steering Committee for formulating a regulatory framework for microfinance. He was the first Chair of the MRA Board as the governor of BB.</p> <p>He has recently joined as a faculty member at BRAC University.</p>
Face to face interview on 15 June 2014	Dr Atiur Rahman	<p>Dr Atiur Rahman was appointed as the 10th Governor of the Bangladesh Bank, the central bank of the country, on May 1, 2009. He was Professor of Economics in the Department of Development Studies (2006-2009), University of Dhaka, and Chairman of the Board of Trustees of Shamunnay, a centre for excellence in development research in Bangladesh. His previous roles also include Director of Sonali Bank, the largest commercial bank in Bangladesh, Chairman of the Board of Directors of Janata Bank, the second largest commercial bank in the country and a long tenure as a Senior Research Fellow at the Bangladesh Institute of Development Studies (BIDS). For many years, Dr Rahman also steered the Credit Development Forum (CDF), a network organisation of NGO-MFIs in Bangladesh as Chairman. His contribution in popularizing financial inclusion program under central bank system has been recognized both at home and abroad.</p> <p>He resigned from Bangladesh Bank on 15 March 2016.</p>
Face to face interview on 25 March & 12 May 2014	Khandakar Muzharul Haque	<p>Khandakar Muzharul Haque was the Executive Vice-Chairman (EVC) of the Microcredit Regulatory Authority from its inception till March 2015. He acted as the Member Secretary of the National Steering Committee since he was the Executive Director in Charge of Agricultural Credit and Special Programs Department of the Bangladesh Bank. He started his career as Assistant Director of Bangladesh Bank in 1976 and served in the position of Executive Director during the period 2004-2009.</p>
Face to face interviews on 13 March 2014	Md. Fazlul Kader	<p>Md. Fazlul Kader is the Deputy Managing Director (DMD) of Palli Karma Sahayak Foundation (PKSF). He joined PKSF on 1st October 1990 as Management Executive. He has made a significant contribution in formulating rules and regulation for the microfinance sector during pre and post MRA.</p>
Face to face interview on 16 April 2014	Dr Reazul Islam	<p>Dr Reazul Islam was a senior economist at the World Bank Dhaka Office during the 90s. Currently, he works as an International team leader in a DFID funded program (PROSPER).</p>
Face to face interview on 10	Dr Hasan Zaman	<p>The Senior Adviser in the South Asia Region of the World Bank. Dr Hasan Zaman was Chief Economist of Bangladesh</p>

March 2014		Bank (Central Bank), prior to which he was a Lead Economist at the World Bank. Earlier in his career, he worked for BRAC in Bangladesh.
Face to face interview on 16 April 2014	Dr Qazi Kholiquzzaman Ahmad	Dr Qazi Kholiquzzaman Ahmad has been the Chairman of the PKSF since November 2009. He is also the Chairman of the governing council of Dhaka School of Economics. Dr Ahmad spent 23 years in a research career at Bangladesh Institute of Development Studies (BIDS) and its predecessor Pakistan Institute of Development Economics (PIDE).
Face to face interview on 15 April 2014.	Dr Rushidan Islam Rahman	Dr Rushidan Islam Rahman is a Research Director at BIDS. She has published a large number of articles, books, and monographs on agriculture, rural development, labour market, poverty and microfinance. She was one of the members of the first Board of the MRA.
Face to face interview on 11 June 2014	Dr Mahbub Hossain	Dr Mahbub Hossain was (he passed away in January 2016) an internationally renowned development economist. He was an advisor to the interim executive director of research activities in BRAC and BRAC International and responsible for the agriculture and food security program. Before joining BRAC as the executive director in 2007, Dr Hossain was the head of the social sciences division at International Rice Research Institute (IRRI), Philippines. From 1989 to 1992, before joining IRRI, he worked as the Director General (DG) of Bangladesh Institute of Development Studies (BIDS). Dr Hossain was a member of technical review committee of the Global Fund for Agricultural and Food Security, project advisory council of the HarvestPlus Challenge Programme of CGIAR, and rice advisory board for Syngenta Asia Pacific Pte Ltd. He was awarded the first gold medal from the Bangladesh Agricultural Economist Association in 1985 in recognition of his outstanding contribution to understanding the operation of the rural economy in Bangladesh. He was president-elect of the Asian Society of Agricultural Economics for the period 2011-2014.
Face to face interview on 10 & 23 March 2014	Professor Baqui Khalily	Professor M.A. Baqui Khalily was the Executive Director (currently an advisor) of Institute of Microfinance (InM), Bangladesh. He retired as a professor from the Department of Finance, University of Dhaka in September 2012 after working there for 37 years. He is keenly interested in corporate governance and is the current Chairman of the 'Center for Corporate Governance and Finance Studies' at the University of Dhaka. He was the visiting scholar in the Department of Agricultural Economics and Rural Sociology of the Ohio State University during December 1993-January 1994. He is renowned nationally and internationally for his expertise and knowledge in rural finance, particularly in microfinance.
Face to face interview on 22 April 2014	Sajjad Hossoin	Mr Sajjad Hossoin is currently acting as a Director at MRA; he is in charge of supervision of NGO-MFIs. As a central banker, he has been deputed to the MRA since its inception. He joined Bangladesh Bank in 1993 as an Assistant Director

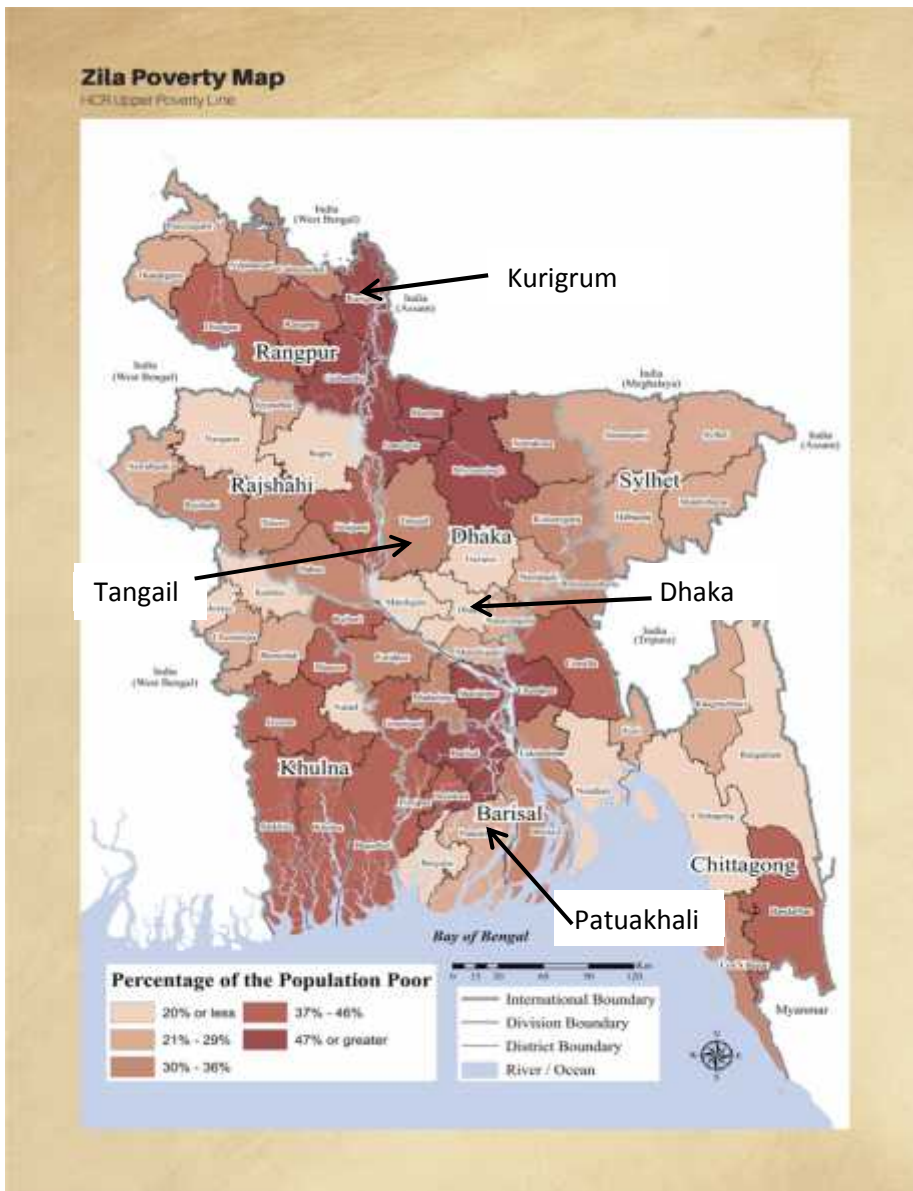
		and promoted to a Deputy General Manager. He was also involved with the MRRU that was created in Bangladesh Bank by the government in 2000.
Face to face interview on 23 April 2014	Fauzia Zafrin	Ms Fauzia Zafrin was a Director at MRA; she was in charge of Research division of the MRA. She was from government administration and seconded to MRA for a couple of years.
Face to face interview on 31 March 2014	Professor Muhammad Yunus	Professor Muhammad Yunus is the founder and first Managing Director of Grameen Bank. He received his Ph.D. in economics from Vanderbilt in 1969 and the following year became an assistant professor of economics at Middle Tennessee State University. Returning to Bangladesh, Muhammad Yunus headed the economics department at Chittagong University. He, jointly with the Grameen Bank, received the Noble Peace Prize in 2006. He was one of the members of the National Steering Committee under MRRU.
Face to face interview on 14 March 2014	Professor Muazzam Husain	He is a former professor of Bangladesh Agricultural University (BAU), Mymensingh. He was the Chairman, Sub-project Implementation Committee, ASARRD Project on 'Small Farmers and Landless Laborers Development' in 1976 at Bangladesh Agricultural University, Mymensingh initiated by FAO/UNDP.

Focus group discussions with the MFI representatives and the MRA officials

Date	Participant	Key areas of discussion
FGD: NGO-MFIs		
19 February 2014	Discussion with 19 representatives of 13 NGO-MFIs at Branch office level.	New rules and the MRA: <ol style="list-style-type: none"> 1. Impact of central bank's policy on MFIs, 2. New rules, its implication, effect on the MFIs, 3. Benefits and problems of the new rules, 4. Comments on the MRA, 5. Interest rate issues, 6. Savings collection, 7. Field experiences.
17 March 2014	Discussion with 20 representatives of 20 NGO-MFIs at Head office level.	New rules and the MRA: <ol style="list-style-type: none"> 1. Impact of central bank's policy on MFIs, 2. New rules, its implication, effect on the MFIs, 3. Benefits and problems of the new rules, 4. Comments on the MRA, 5. Interest rate issues, 6. Savings collection, 7. Field experiences and changes in the market, 8. Future of the sector.
FGD: MRA		
23 April 2014	10 mid and entry level officers of the MRA working in HR, Admin, Finance & Account sections	Organisational Capacity: <ol style="list-style-type: none"> 1. Criteria for appointing staffs, 2. Training for staffs, 3. Operational plan of MRA, 4. Staff promotion/incentive policy, 5. Staff support by the BB and GoB, 6. Budget from the government, 7. DFID project, 8. Problems.
27 April 2014	10 mid and entry level officers of the MRA working in License, Regulation, & Research sections	Regulation and License: <ol style="list-style-type: none"> 1. Views towards microfinance & MFIs, 2. Perception towards Law and related regulation, 3. Impact of regulation on the MFIs, 4. Impact of regulation on the market, 5. Governance issues, 6. Savings collection by the NGO-MFIs, 7. Interest rate issues, 8. Criteria for getting license, 9. Cancellation of license, 10. Problematic issues, 11. Future direction.
30 April 2014	14 mid and entry level officers of the	Monitoring & Supervision: <ol style="list-style-type: none"> 1. General procedures and guidelines,

	<p>MRA working in with off-site & on-site Supervision, Audit & MIS sections</p>	<ol style="list-style-type: none"> 2. Classification of supervision, 3. Criteria for supervision, 4. Reporting requirements, 5. Report analysis mechanism, 6. Implementation process, 7. Requirements of Audit, 8. Capacity of the MRA, 9. Depth of monitoring, 10. Problems, 11. Client survey.
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District Poverty Map- Bangladesh⁴¹²



⁴¹² Source: Poverty Maps of Bangladesh 2010, Bangladesh Bureau of Statistics and The World Food Programme

Survey questionnaire

Client Survey-Microfinance**District:****Upazila:****Village:****Date: 00 /00/14****Serial no.:**

A) General information	
1) Name:	
2) Gender:	Female Male Others
3) Age (rough estimation)	Below12 12-18 18-30 30-40 40-50 over 50
4) Education (institutional):	None Primary High School College
5) Main profession:	
6) Marital status:	Unmarried Married Divorced Widow
7) Profession of head of the family:	
8) Education of head of the family:	None Primary High School College
9) No. of family member:	Below 5 5-10 above 10
10) No. of earning members:	
11) Have electricity at home?:	Yes No
12) Have sanitary latrine at home?:	Yes No
13) Have access to safe drinking water?:	Yes No
14) Do children above 5 years old go to school?:	Not applicable Yes No

B) Bank and microcredit related	
1) Have any bank account?:	Yes No
2) Have taken loan from any bank?:	Yes No
3) Are you a member of any MFI?:	Yes No
4) If yes, then how many MFIs you are attached to?:	
5) When you first became member of an MFI?:	
6) Amount of current total loan (in Taka) from all MFIs:	
7) Where have you invested your current loan?:	
8) Is any other member of your family attached to any MFI?:	Yes No
9) If yes, how many of them are attached to how many MFIs?:	
10) Do you or any of your family member have any loan from money lender/:	Yes No

C) Main questions	
1) How did you make decision on borrowing?:	<div style="display: flex; flex-wrap: wrap; gap: 10px;"> <div style="border: 1px solid black; padding: 5px; width: 150px;">Self</div> <div style="border: 1px solid black; padding: 5px; width: 150px;">Suggestions from family members</div> <div style="border: 1px solid black; padding: 5px; width: 150px;">Suggestions from neighbours</div> <div style="border: 1px solid black; padding: 5px; width: 150px;">Suggestions by MFIs</div> <div style="border: 1px solid black; padding: 5px; width: 100px;">Other (specify)</div> </div>
2) How do you choose MFI?:	<div style="display: flex; flex-wrap: wrap; gap: 10px;"> <div style="border: 1px solid black; padding: 5px; width: 150px;">Reputation of</div> <div style="border: 1px solid black; padding: 5px; width: 150px;">Close to house</div> <div style="border: 1px solid black; padding: 5px; width: 150px;">Suggestions from MFIs</div> <div style="border: 1px solid black; padding: 5px; width: 150px;">Suggestions from others</div> </div>
3) What features of an MFI are considered as important to become a member? :	1) 2) 3) 4) 5)
4) What features of an MFI you do not like?:	1) 2) 3) 4) 5)
5) What are the features you like most?:	1) 2) 3) 4) 5)
6) Do you know that MFIs are not permitted to work without having license from the government?:	Yes No
7) Have you ever asked about interest rate on loan when you borrow?:	Yes No
8) Do you know about government's cap on interest rate?:	Yes No
9) Do you compare interest rate with other MFIs before borrowing?:	Yes No
10) Do you get your savings back when needed?	Yes No
11) Do you get interest on savings?:	Yes No
12) Do you know about government's announced rate of interest on savings?:	Yes No
13) Do field officers discuss government policies?:	Yes No
14) Have you ever seen this awareness poster (shown poster) circulated by the MRA?:	Yes No
15) If yes, do you know what are written in it?:	Yes No
16) Is there any improvement in your family after taking microcredit?: If yes, please specify (maximum 3)--	Yes No 1) 2)

	3)
17) Have you ever faced any problem after borrowing? If yes, please specify (maximum 3) :	Yes No 1) 2) 3)
18) Have you noticed any changes in the operations of microfinance in last five/ six years? If yes, please specify--	Yes No 1) 2) 3) 4) 5)
19) Do you have any complaint? If yes, please specify:	Yes No 1) 2) 3)
20) Do you have any suggestion to improve the service? If yes, please specify:	Yes No 1) 2) 3)
21) Do you have anything to mention?:	

Thanks for spending your valuable time and for your kind cooperation.

Signature of the client:

Table-1: Variables and models under RFEP⁴¹³

Sl.no.	Features	Ranges
1.	Interest rates on loan	12% to 36%
2.	Interest rates on savings	11% to 15%
3	Collateral/ Security requirements	None to cosigner to crop hypothecation to mortgage variations
4.	Mode of repayment	In kind, cash, in combination of both
5.	Extend of loan supervision	No supervision to complete supervision
6.	Mode of loan disbursement	In kind, cash, current account deposit
7.	Risk management	Insurance against crop failure (multi-year/ multi-trench lending)
8.	Loan application requirement	Written forms vs. oral agreement (simplified version)
9.	Individual vs. group lending	
10.	Instalment and Recovery technique	One instalment from the sale proceeds, Lawsuit, Jail, appropriation of the mortgage, supervision of assets, etc.
11.	Role of local organisations	Lending directly to borrowers or through local organisations
12.	Role of bankers	From pure financing institutions to agents of development

⁴¹³ Compilation by the researcher from various official documents of the Bangladesh Bank (RFEP/ S2)

Table-2: Major features of the eight models under RFEP⁴¹⁴

Participating Institution	Model and its basic features	Interest rates	Comments
Bangladesh Krishi Bank No. of outlets: 16	A budget line of credit model was designed to address a family's annual budget to determine the cash needs during the year that included production, consumption and other needs like medical expenses. The Bank attempted to build a permanent relationship with the borrowers. Applications were taken in the field or office. The maximum loan amount was Taka 4000 depending on borrower's repayment capacity.	Interest on loan:12% - 30%, Interest on savings: 11% to 14%	Did not focus much on savings
Sonali Bank No. of outlets: 10	Opened village based Krishi Shakha or agricultural sub-branch within 7-mile radius of the regular branch office. These branches remained open for cash transactions on local market days. However, staffs worked daily for selecting borrowers from the fields and approving loans. The borrower had to open an account to get a loan. Maximum loan size was Taka 5000.	Interest on loan:12% - 30%, Interest on savings: 11% to 14%	Introduced two savings concepts
Janata Bank No. of outlets: 11	Area development approach- it adopted comprehensive area development model to accommodate comprehensive credit need of the community irrespective of target group eligibility. No fixed limit on loan size. Loan applications were received in the branches,	Interest on loan:12% - 36%, Interest on savings: 11% to 15%	No fixed limit on the size of loan
Agrani Bank No. of outlets: 11	Small farmer service centre- This model provided credit facilities and attempted to arrange the supply of production inputs to borrowers through local dealers. The maximum	Interest on loan:12% - 36%, Interest on savings: 11% to 15%	The original plan of establishing input supply centre was

⁴¹⁴ Compiled by the researcher from various project documents collected from the Bangladesh Bank

	size of the loan was Taka 5000. Savings account was not required but encouraged.		dropped later due to implementation difficulties
Pubali Bank No. of outlets: 4	Banker as ombudsman-trained lending officers to serve not only as credit officer but also as referral agents to arrange services from local other related agencies like Agricultural extension agent, rural health centre, etc. Loans were based on a family budget. Each borrower was required to open a savings account when a loan was approved.	Interest on loan:12% - 36%, Interest on savings: 11% to 15%	The model concept had changed radically during the implementation period; ombudsman approach was later dropped as impractical and replaced by technical assistance approach.
Rupali Bank No. of outlets: 7	Village agent model- commission villagers as agents to identify farmers and refer them to the bank for loan processing. It attempted to bridge the gap between branches and target group borrowers by appointing villagers. Total loan limit was Taka 5000.	Interest on loan:18% - 36%, Interest on savings: 12% to 15%	
Uttara Bank No. of outlets: 5	Village level group model- extending loans to individual members of voluntarily formed groups under joint guaranteed by all members. The loan application can be made either in the field or the branches. The leader was considered as a de-facto liaison for the group and the bank. Maximum loan size for an individual was Taka 5000.	Interest on loan:18% - 36%, Interest on savings: 12% to 15%	Group guarantee system had not been properly applied
IRDP and BSBL No. of outlets- IRDP:13 BSBL: 19	Co-operatives for landless, sharecroppers and women. Practices existing two-level approaches of cooperatives. Loan size depends on activities.	Interest on loan:18% - 30%, Interest on savings: 12%	Practiced two-level approaches of cooperatives from TCCAs to KSSs.

Table-3: A few facts of individual participating organisations under the RFEP

Descriptions	BKB	Sonali	Janata	Agrani	Pubali	Rupali	Uttara	IRDP	BSBL
% of savings to loans outstanding	8.8	13.3	27.7	32.7	3.8	34.1	8.9	12.4	2.6
% of administrative costs to total loan disbursed	4.2	3.0	9.8	4.9	8.0	7.9	25.8	3.2	3.0
Administrative costs per loan disbursed (Tk)	72.2	57.0	173.9	60.3	113.5	112.8	293.6	32.5	62.7
% of principal overdue to total due	10.4	13.4	17.1	5.8	20.8	6.1	16.3	4.4	36.4
Salaries and allowances as % of total operating costs, less reserve	33.0	20.0	40.4	32.6	37.9	50.2	60.3	21.1	10.9
Reserve for bad debts as % of total operating expenses	13.1	23.2	10.1	18.0	31.2	6.1	22.4	8.2	34.3
Interest rate needed to cover total operating expenses	14.6	15.6	23.7	23.7	31.3	24.4	51.8	14.5	32.2
Interest rate needed to cover total operating expenses, less reserve	12.7	12.0	21.3	19.4	21.5	22.9	40.2	13.3	21.1
Net profit (loss) (Tk in 000)	957	264	(91)	(2)	(261)	28	(134)	237	(248)

APPENDIX-C1

Initial thoughts about Ownership and Management structure of Grameen Bank by different participants before the enactment of the law.

Participants	Date & reference	Proposal/ Opinion regarding proposed GBP/GB
Project Management/ Prof Yunus	30 March 1982, in a letter to the Governor on the 'Proposal for Restructuring the Organisational Arrangement of Grameen Bank Project' ⁴¹⁵	<ol style="list-style-type: none"> 1) <u>An autonomous project; participation by all NCBs, BKB and Bangladesh Bank.</u> 2) Management of project would be vested on a Project Governing Board which would be constituted with all the <u>Managing Directors of the participating banks, the PD (member—Secretary), and the Governor of Bangladesh Bank as the Chair.</u> 3) Bangladesh Bank would bear the project cost and participating banks would provide the development fund. 4) GBP units would operate independently in the field. 5) GBP units would allow accepting deposits from anybody, but would provide credit only to the target people. 6) GBP might turn into an independent bank if it proved to be successful. 7) All funds from donors and Bangladesh Bank would directly transfer to the project.
Project Management/ Prof Yunus	20 August 1982, in another letter to the Governor on 'Project Proposal for Setting up of a Specialized Financial Institution for Financing the Rural Poor' ⁴¹⁶	<ol style="list-style-type: none"> 1) The new institution might be called as Grameen Bank Limited (GBL). 2) Initially, it might be sponsored by a <u>wholly owned financial institution of the Bangladesh Bank</u> with an authorized capital of Taka 20 crores, and paid up capital of Taka 50 lakh. There should be a provision in the Article of Memorandum <u>to allow the group members to buy gradually up to 60% of the shares,</u> leaving the remaining 40% for Bangladesh Bank and other commercial banks. 3) GBL would have a Board of Directors where <u>Managing Director will be the Chief Executive and also the ex-officio Chairman of the Board.</u> 4) The present PD (Prof Yunus) would be the first Managing Director for first five years. 5) Would accept all kinds of deposits from anybody, but would provide loans and advances only to the group members; 6) Donors fund could be used as loan funds.
Bangladesh Bank	6 th September 1982, in a letter to the PD of GBP in response to Yunus' proposal sent on 20 th August 1982 ⁴¹⁷	<ol style="list-style-type: none"> 1) It would be an <u>independent entity entirely owned by the Government/ Bangladesh Bank.</u> 2) <u>Legal status would be company instead of a statutory body.</u> 3) There should be a <u>provision to issue shares to</u>

⁴¹⁵ Bangladesh Bank, File no. R.C.P.D (GBD)537(P)82 ; Sum 29

⁴¹⁶ Bangladesh Bank, File no. ACPD(GBD)537(31)/82-Vol IX; Sum 32

⁴¹⁷ Bangladesh Bank, File no. ACPD(GBD)537(31)/82-Vol IX; Sum 32; Sum 33

		<p><u>the public.</u></p> <p>4) Or as alternative, it could be a wholly owned subsidiary/ independent and self-contained wing of existing big bank to build up public confidence since it would collect public deposit.</p>
Project Management/ Prof Yunus	8 th November 1982 in a draft Memorandum of Association (MoA) and /Article of Association (AoA) of the proposed GBL prepared by the PD of GBP in response to a letter sent by the Bangladesh Bank on 6 th September 1982 ⁴¹⁸	<p>1) The proposed <u>GBL would be a banking company</u> under the Companies Act, 1913 for the purpose of Banking Companies Ordinance, 1945; Banking Companies Act, 1948; and Bangladesh Bank Order, 1972.</p> <p>2) Its capital would be Taka 20 crores, which would be divided into 20 lakh equity shares of Taka 100 each.</p> <p>3) Total shares would be divided into two categories; <u>60% of 'A' category reserved for weaker section</u> of the society who could establish satisfactory business relationship with the proposed GBL and remaining <u>40% under 'B' category for the Bangladesh Bank, NCBs, and BKB.</u></p> <p>4) 50% shares under 'A' category would be reserved for women.</p> <p>5) 'A' class shares would not be transferable to any other persons other than people belong to 'A' class, and women's shares were not transferable to men.</p> <p>6) Directors would be nominated on the basis of percentage of share (type A and B). The first directors would be appointed by the Bangladesh Bank. Directors from 'A' class would be nominated in General Meeting⁴¹⁹.</p> <p>7) <u>The Managing Director, who would be the Chairman of the Board, would be appointed by the Bangladesh Bank.</u></p>
Bangladesh Bank	29 th November 1982, In a memo sent to the Ministry of Finance from the Bangladesh Bank ⁴²⁰	<p>1) It would be a <u>public limited company instead of a full-fledged bank</u>, at the beginning.</p> <p>2) It may act <u>as a non-bank financial institution</u> as per Bangladesh Bank Order under the name "Grameen Rin Sangstha".</p> <p>3) Authorize capital would be Taka 20 crore and paid-up capital Taka 50 lakh, <u>of which BB (and or other NCBs and BKB) could provide 50% (Taka 25 lakhs) and rest 50% could be raised from rural poor as shareholders.</u></p>
Participating banks	29 th November 1982 in a Bankers' meeting	Generally, <u>not in favor of establishing a separate banking institution, especially before completing the</u>

⁴¹⁸ Bangladesh Bank, File no. ACPD(GBD)537(31)/82-Vol IX; Sum 32;Sum 35

⁴¹⁹ This part however is not very clear in the draft. It mentioned that there would be General Meeting once in a year, at least.

⁴²⁰ This memo was prepared on the basis of a meeting on the Draft MoA with the bankers where Finance Minister and Prof Yunus were present. Finance Minister's presence in the meeting was also confirmed by Prof Yunus in his interview on 31st March 2014. (Bangladesh Bank, File no. ACPD(GBD)537(31)/82-Vol IX; Sum 36 & 38)

	arranged by the Bangladesh Bank ⁴²¹	<u>project period</u> . Expressed apprehension regarding the sustainability of this program considering its costs and nature of operation.
Government/ MoF	19 December 1982, in a working paper of a meeting on the issue. ⁴²²	Establishing <u>a bank</u> , with restricted function, would be <u>more attractive to the potential donors</u> .
Bangladesh Bank	26 December 1982, in the meeting arranged by the MoF on the issue ⁴²³ .	Mentioned that, in response to government's proposal to keep this proposed bank outside the purview of Bank Companies Ordinance, keeping this outside of banking rules would create problems for the Bangladesh Bank.
Participating Banks	26 December 1982 in the meeting arranged by the MoF ⁴²⁴	Generally, <u>not in favor of establishing a separate banking institution, especially before completing the project period</u> . Expressed apprehension regarding the sustainability of this program considering its costs and nature of operation.
Government/ MoF	26 th December 1982, decision was taken in a meeting of MoF with the bankers ⁴²⁵ .	At the beginning, the Minister made it clear to everybody that views would be expressed in this meeting might not necessarily influence the final decision to be taken at highest level. Meeting minutes concluded by saying that: <ol style="list-style-type: none"> 1) <u>A separate bank could be established under a separate Ordinance, which would remain outside the purview of Bank Companies Ordinance,</u> 2) <u>It could operate as a subsidiary either of BB/ NCBs/ BKB. Alternatively, it could be an independent body;</u> 3) <u>Majority of the shares would remain with the government, and the rest would be for landless members;</u>
Government/ MoF	6 th April 1983, in a letter sent to the BB ⁴²⁶ .	<ol style="list-style-type: none"> 1) <u>Grameen bank would be established under a separate Ordinance, and it would remain outside the purview of the Bank Companies Ordinance.</u> 2) <u>60% share of the bank would be held by the government (or its nominated organisations) and 40% for beneficiaries/ borrowers/ members.</u> 3) <u>Initially, it would work for five years in some specified areas.</u> 4) <u>It would be permitted to collect deposits from anybody. However, its lending activities should be limited to the landless people who would have less than or equal to 0.5 acres of cultivated land.</u> 5) <u>It would not be permitted to provide service in urban areas.</u> 6) <u>This proposed bank would not be permitted</u>

⁴²¹ Bankers' meeting at Bangladesh Bank in presence of the Finance Minister and Prof Yunus (Bangladesh Bank, File no. ACPD(GBD)537(31)/82-Vol IX; Sum 36 & 38)

⁴²² Bangladesh Bank, File no. ACPD(GBD)537(31)/82-Vol IX; Sum 39

⁴²³ Meeting was held in Ministry of Finance (Bangladesh Bank, File no. ACPD(GBD)537(31)/82-Vol IX; Sum 40)

⁴²⁴ Meeting was held in Ministry of Finance (Bangladesh Bank, File no. ACPD(GBD)537(31)/82-Vol IX; Sum 40)

⁴²⁵ Meeting held at Ministry of Finance with the bankers, it was chaired by the Finance Minister (Bangladesh Bank, File no. ACPD (GBD) 537(31)/82-Vol IX; Sum 40).

⁴²⁶ Bangladesh Bank, File no. ACPD(GBD)537(31)/82-Vol IX; Sum 42

		to do any business related to foreign exchange.
Project Management/ Prof Yunus	2nd May 1983 in the draft law prepared by the PD of GBP as per instruction of the government (via BB), which submitted to the BB ⁴²⁷ .	<ol style="list-style-type: none"> 1) <u>Provision of Bank Companies Ordinance, 1962 and Bangladesh Bank Order, 1972 should not be applicable to this proposed Grameen Bank.</u> 2) <u>It would act for public interest.</u> 3) The clauses related to the Authorize capital and distribution of share between government and the landless people remained, however, undetermined in the draft. 4) <u>The government would hold 100% share initially for five years</u>⁴²⁸. 5) <u>The government should offer 40% of share to the borrowers</u> after the end of initial period. 6) Transferring of borrowers' share would not be permitted outside the borrowers, but transferring of shares would be possible to the heirs of the shareholders. 7) The Board of the proposed bank would be responsible for all functions. 8) <u>Until the first Board is appointed, the MD would exercise all the powers of the Board.</u> 9) <u>Ten Directors, including MD, would be appointed by the government. However, when 40% share would be handed over to the borrowers then four directors would be elected by them.</u> 10) <u>MD would be acting as the Chair for first five years</u>, after that, the Chairman would be appointed by the Government. 11) Auditors would be appointed by the government, and they would report to the government as per instruction given. 12) Bank should submit audited report to the government. 13) The government should publish it (the law) in a gazette and place it in the parliament.
Project Management/ Prof Yunus	16 th May 1983, revised draft law submitted to the BB ⁴²⁹ ,	Submitted revised draft after some changes related to shareholding (60% by government and 40% by the borrowers) as advised by the Governor of the BB.
Government/ MoF	4 th September 1983, in the enacted Ordinance ⁴³⁰	<ol style="list-style-type: none"> 1) Government established <u>Grameen Bank (GB) under a separate Ordinance.</u> 2) GB would remain outside the purview of Bank Companies Ordinance, 1962. 3) Branch could be opened with the prior approval of the Bangladesh Bank. 4) Authorized capital would be Taka 10 crores

⁴²⁷ Draft Ordinance prepared with the help of a renowned lawyer of the country and forwarded to the BB in response to its letter dated 11th April 1983 (Bangladesh Bank, File no. ACPD(GBD)537(31)/82-Vol IX; Sum 43 & 44)

⁴²⁸ It mentioned about 100% share by the government considering practical difficulties which might be faced in the initial stages of floating the shares (Bangladesh Bank, File no. ACPD(GBD)537(31)/82-Vol IX; Sum 45)

⁴²⁹ Draft revised by Prof Yunus as advised by the Governor in a discussion with Prof Yunus on 8th May 1983. Bangladesh Bank submitted this draft to the government on 18th May 1983 (Bangladesh Bank, File no. ACPD(GBD)537(31)/82-Vol IX; Sum 45 & 46)

⁴³⁰ The law (Grameen Bank Ordinance, 1983) enacted by the government

		<p>which would be divided into 10 lakh ordinary shares of Taka 100 each.</p> <ol style="list-style-type: none"> 5) Paid-up capital would be Taka 3 crores, of which <u>60% would be subscribed by the government or any other body of the government and 40% by borrowers (20% preferably for women borrowers).</u> 6) Shares held by a borrower could be transferred to another borrower of the same class. 7) <u>The bank should act for public interests.</u> 8) <u>Out of total 12 Directors of the Board 4 would be elected from the borrower-shareholders and remaining 8, including Chairman and the MD, would be appointed by the government.</u> 9) <u>The government kept all the powers in changing any policy, in appointing auditors, and in issuing any directions.</u>
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APPENDIX-C2

The important features of the Grameen Bank Ordinance, 1983

Sl. No.	Feature (Clause)	Description
1	Aim [Preamble]	To provide credit facilities and other services to landless persons in the rural areas
2	Outside the purview of Bank Companies Ordinance [4]	The Banking Companies Ordinance, 1962 (was applicable during that time), and any other law relating to banking companies not applicable in the case of GB. However, the government reserves the right to apply any clause(s) of any law at any time.
3	Authorized capital [6]	Taka ten crores, which would be divided into ten lakh ordinary shares of Taka one hundred each. It can be increased with the prior approval of the government.
4	Paid-up share capital [7]	Taka three crores, of which 60% by the government (or by any organisation or body set up, managed or controlled by the government) and 40% by borrowers (20% preferably by women borrowers). The government may increase it, and the borrower may transfer the share to another borrower of the same class.
5	General direction and superintendence [8]	Entrusted to a Board of Directors, who should run the bank to serve the public interest. However, the government reserves all the rights on questions of policy matters and is the sole judge to decide whether a question is a question of policy or not.
6	Composition of Board and related matters [9, 10 & 14]	Total 12 directors (8 persons or 67% to be appointed by the government and 4 persons or 33% to be elected by the borrower-shareholders) as follows: <ul style="list-style-type: none"> a) The Chairman to be appointed by the government, b) The Managing Director to be appointed by the government, c) 3 other persons, of which 2 would be from the government, to be appointed by the government, d) 1 woman (having experience in working with landless) to be appointed by the government, e) 2 Managing Directors of NCBs and BKB to be appointed by the government, f) 4 (preferably 2 women) to be elected by the borrower-shareholders.
7	Accounts, Audit and submitting reports [22, 23 & 24]	Accounts should be maintained as per general directions given by the government and Bangladesh Bank. The accounts will be audited by at least 2 auditors who would be appointed by the government. The auditors should report to the government and the government reserves the right to issue directions to take measures for the protection of the interests of the government and the creditors. The Bank should submit reports to the government which should be published in the official Gazette and be laid down before Parliament.
8	Reserve fund and disposal of profit [25 & 26]	Should maintain a reserve fund as per the decision taken by the Board. The Board has been given the power to decide how to utilize remaining profit after meeting the provisions of the reserve fund.
9	Exemption from taxes [33]	Exempted from income-tax, super-tax and business profit tax for the period to be stipulated by the government.
10	Liquidation [34]	The government reserves the right to wind up operations at its discretion; no other law will be applicable here.

Major changes in the Ordinance, 1983 mainly to empower Grameen Bank's Board and Management

Section No.	Contents of Original Ordinance	Proposal for amendments by GB	Bangladesh Bank's response	Amended contents
1. Amendments published in the Gazette on 8th July 1986 during HM Ershad Period under Martial Law				
Section 7 and 9	-Paid-up capital was Taka 3 crores; -60% share holds by the government and 40% by borrower-shareholders -8 Board directors, including Chairman and MD, would be nominated by the government and 4 would be elected by the borrower-shareholders	-Transfer all the shares to the landless borrowers since shares already given under the name of this group (40% of Taka 3 crores, each taka 100) had been sold out, and more people are waiting to buy shares. -Make the bank independent and bring it out of government's control for efficient decision making and new experiments ⁴³¹	Grameen Bank should not be allowed to work without any supervision either by the government or by the BB though BB had been kept outside. However, there must be some sort of oversight. A financial institution of any nature cannot work in this way anywhere in the world. ⁴³²	-Paid-up capital increased by Taka 7.20 crore; -25% holds by the government and 75% ⁴³³ by the borrower-shareholders; -3 persons, including Chairman and MD, would be appointed by the government and 9 persons would be elected by the borrower-shareholders.
<p><u>GB sent another set of proposal on 6th January 1987, major arguments were:</u> The government retained the power to appoint both Chairman and MD, it had the power to apply any clause of any law on GB, and it kept huge power in its hand to exercise when needed. These things were hindering GB's development to grow and undermining its transformation to be an <u>independent private organisation</u>. It had been creating confusion of dual administration, uncertainties in GB, and lingering its decision-making process. <u>Bangladesh Bank's comments on this, in response to government's request, were as follows:</u> the Bangladesh Bank repeated the same previous comments given earlier in 1986 while added the following lines at the beginning of the letter sent to the government:</p>				

⁴³¹ This proposal sent on 11th May 1985

⁴³² Full comments were: “ ..such divesture would not mean that the Bank (*Grameen Bank*) should be allowed to function utterly independent of Government or Bangladesh Bank's supervision, because no financial institution, irrespective of its specialized nature can function in that way either here or anywhere in the world . The reasons are obvious. Government can not addit its responsibility with regards to an institution which deals with people's savings/ money. It is more so in this case where substantial amount of IFAD fund, where Government is the borrower, is involved. Bangladesh Bank's responsibility for supervision and control has already been taken away by excepting (*exempting*) the Grameen Bank from the purview of Bank Companies Ordinance. So, some supervision or control must be there, even if the bank becomes a 100% private institution. One way of exercising that supervision and control is to bring the Grameen Bank under the purview of the Banking Companies Ordinance with some exception there and allow it to function just like any other existing private banking institution....”
[Reply sent by the Bangladesh Bank to the Ministry of Finance on 25th August 1985 in response to its request (Bangladesh Bank, File no. ACPD(GBD)537(P)/83-Vol-III; Sum 62]

⁴³³ Government still had the same amount of paid-up capital (taka 1.80 crore which was 60% of Taka 3 crore earlier), but borrowers' share had been raised into taka 5.40 crore from Taka 1.20 crore.

<p>“.. while we wish to see the Grameen Bank march forward with the spirit and ideas of highly efficient management to achieve its goal with full flexibility, adaptability, and relative freedom from hindering interferences from other administrations, it is also desirable that its desperate pursuit not jeopardizes public interest and depositors’ money.”⁴³⁴</p> <p>However, no amendments in the law were made after this request</p>				
<p>2. Amendments published in Gazette on 31st July 1990 just before H M Ershad, the then President of the Country, was pushed to step down from the power under public pressure on 6th December 1990.</p>				
Section 8	The bank should work for public interest and shall be guided solely by the government for policy matters in question.	No official document related to any request from the GB was found in the files of BB	No official records were found in the files of BB ⁴³⁵	The line which mentioned that the government had sole authority to make a decision on policy matters had been omitted.
Section 9	Composition of Board			Composition remained same. MD’s voting rights had been curtailed.
Section 10	Government could nominate anybody as Chairman amongst the Directors except MD			Government could nominate anybody as Chairman amongst the appointed Directors (<i>but not the elected Directors</i> ⁴³⁶)
Section 14	MD would be appointed by the government			MD would be appointed by the Board with the prior approval of the Bangladesh Bank under the conditions as prescribed by regulations.
Section 16	All the directors including MD would submit resignation letter to the government			All the directors would submit a resignation letter to the government, except MD. MD’s letter would be given to the Chairman.
Section 19	List of functions those were permitted by GB. Some clauses contained that some functions were permitted with the approval			Deleted all the lines under ‘with the approval of the Government’ and added two more clauses which permitted GB to undertake the

⁴³⁴ Letter sent by the Bangladesh Bank to the Ministry of Finance on 4th February 1987 (Bangladesh Bank, File no. ACPD(GBD)537(P)/83-Vol-III; Sum 64)

⁴³⁵ It seems that these amendments in 1990s were brought as follow up requests of 1987 without any consultation with the BB.

⁴³⁶ Italics inserted by the researcher.

	of the government			management, control and supervision of any rural organisation/ enterprise/scheme and income-generating projects for the benefit of landless persons.
Section 22	Accounts should be prepared along the line of general directions issued by the government and the Bangladesh Bank			Directions issued by the government omitted.
Section 23	Auditors should be appointed by the government, and they should be reported to the government, and they would work as per direction given by the government to protect government's interest.			Auditors should be appointed by the Board; they would be reported to the Board, and they would work as per directions given by the Board to protect the interest of the shareholders. Government's power curtailed
.Section 24	GB should submit all kinds of reports/ returns to the government. Annual and audit reports should be submitted to the parliament and published in the official gazette by the government.			Requirements for submitting an audit and annual reports to the parliament and published in the official gazette by the government omitted.
Section 35	The government had the power to make any rules.			Government's power in making rules had been limited to a single clause of holding elections of the directors.
Section 36	The Board was given the power to make regulations with the previous approval of the government.			The requirement of government approval omitted. The board was given absolute power to make regulations.
<p>The MD of GB again sent another proposal to the government on 28th August 1990, main contents of which were as follows: Shares allocated in favor of borrower-shareholders were sold out; many landless people were</p>				

interested in buying shares, so authorized capital could be increased to Taka 25 crores from Taka 10 crores and paid-up capital could be increased from Taka 7.20 crore to Taka 15 crores. The increased amount of paid-up shares could be sold out to the landless people⁴³⁷.

The BB gave comments in response to government request:

The only increase in the number of borrowers/ members and their interest to purchase shares could not be the argument in favour of raising capital; the government should consider other things like its necessity, business expansion requirements, etc. BB also informed the government that its percentage of share in total would be further cut down (from 25% to 12%) if the amendments related to increasing capital were made as per Grameen's proposal, and BB thought that it would be the case like other private banks where government had only 5% share⁴³⁸.

However, the government increased authorized share into Taka 25 crores and paid-up capital into Taka 15 crores on 02nd March 1991 by a Gazette notification instead of amending the Law.

3. The Government applied Section 44 of Bank Companies Act, 1991 on GB in October 1998 to empower BB to inspect GB and Section 45 of the same Act in June 2003 to empower BB further to give directives to the GB.

4. Amendments made by the Care taker government (backed by Army) on 24th February 2008, which were not approved by the Parliament later as per constitution and, therefore, they were not part of the legal framework of GB.

Section 1 & 2	It was permitted to work only in the rural areas.	No record was found.	No document was found in BB's file.	GB was given permission to work in the urban areas which included Cantonment Board and City Corporation
Section 7	Originally 60% share was for government and 40% for borrowers (which changed to 25% and 75% respectively in 1986)			Decreased government share into 15% and kept rest 85% for the borrowers.
Section 9	8 directors, including Chairman and MD, out of 12 would be appointed by the government (it changed into 3 in 1990)			2 directors would be appointed by the government.
Section 10	Chairman should be appointed by the government. According to Section 11, Chairman should hold office for 3 years.			Chairman should be appointed by the Board and hold the office of 2 years. Both Chairman and MD should submit resignation letters to the Board. Only appointed directors should submit the same to the government.

⁴³⁷Bangladesh Bank, File no. ACPD(GBD)537(P)/83-Vol-III; Sum 66

⁴³⁸Bangladesh Bank, File no. ACPD(GBD)537(P)/83-Vol-III; Sum 66

Section 21	GB was permitted to issue bonds and debentures with the prior approval of the government.			Instead of 'government', GB should seek permission from the Securities and Exchange Commission to issue bonds and debentures.
5. Amendments made on 24th September 2012⁴³⁹				
Section 14	MD would be appointed by the government (it changed into 'by the Board with the prior approval of the Bangladesh Bank ' in 1990)		No official comment was found in BB's file.	The Chairman was authorized to form a selection committee who would form a panel of three. The board was permitted to select any of them after getting clearance from the Bangladesh Bank.
<p>6. New Act (Grameen Bank Act, 2013⁴⁴⁰) has been passed on 10th November 2013. All the activities under Grameen Bank Ordinance, 1983 and after that amendments have been ceased by this new Act. Most of the amendments till the 1990s have been accommodated under this new Act except a few. New changes are as follows:</p> <ul style="list-style-type: none"> -Authorized capital increased into Taka one thousand crores which would be divided into 10 crore shares of Taka 100 value and paid-up capital increased into Taka 300 crores. <u>The government would hold 25% of share and rest 75% by the borrowers.</u> -<u>MD would be appointed by the Board with the prior approval of the BB just like amendments made in 2012, only added that MD's age limit would be maximum 60.</u> -Accounts would be maintained as per direction given by the BB. -Return and all other reports including <u>audit report and annual report should be submitted to the Bangladesh Bank.</u> -Audit report and annual report should be placed before the Parliament and published in official gazette by the government. -Omitted the lines which had given GB to remain out of Banking Companies Ordinance/Act, instead added that the government would hold the right to apply any clause of any Act including Banking Companies Act, 1991. 				

⁴³⁹ Ordinance no. 42 of 2012

⁴⁴⁰ Ordinance no, 56 of 2013

APPENDIX-D

Table-1: Legal setup to form an NGO and associated features

Title of the Laws	Nature of organisation	Enforcing agency	Last amended
1) The Societies Registration Act, 1860	To form Society, charitable organisation	RJSC under Ministry of Commerce	1978
2) The Trust Act, 1882	To form Trust, Foundation	Sub-registrar offices under Ministry of Law	1973
3) The Voluntary Social Welfare Agencies (Registration & Control) Ordinance, 1961	To form Voluntary organisation	DSS under Ministry of Social Welfare	1973
4) The Companies Act, 1913/ 1994	To form non-profit company, Foundation	Ministry of Commerce	1994

Table-2: Number of NGOs (4241 NGOs, applied for license from the MRA) registered under different laws in Bangladesh⁴⁴¹

Sl no.	Registration Authority and related laws	No. of NGOs
1	Only from the DSS, Ministry of Social Welfare under The Voluntary Social Welfare Agencies Ordinance, 1961	274
2	DSS + Others (with multiple agencies)	129
3	Only from the RJSC of Ministry of Commerce under the Societies Registration Act, 1860	68
4	RJSC + Others (with multiple agencies)	83
5	One from the Sub-Registrar Office under the Trust Act, 1882	7
6	Non-reported NGOs	3740

⁴⁴¹ Source: MRA Database. Compiled and arranged by the researcher.

Important features of the Microcredit Regulatory Authority Act, 2006

Chapter	Section no. & heading	Summary of content
Preamble	Purpose of the Law	This law has been passed to create a regulatory authority to ensure transparency and accountability in the operations of Microcredit organisations in Bangladesh.
First	2: Definition	It defines: Financing organisation, Deposit, Depositor, Client, Member, Poor, Assetless & landless, License, Service charge, Microcredit, Microcredit organisation, etc.
Second	4: Establishment of an Authority (MRA) 6: Formation of Board of the MRA 9: Activities & responsibility of the MRA 10: Appointment of Chief Executive (EVC) of the MRA	An authority namely 'Microcredit Regulatory Authority' will be established to fulfil the objective of this law. This authority will be a statutory body, and the responsibility of its operation will be given to a Board where the governor of the Bangladesh will be acting as the Chair by designation. Other seven members including the Executive Vice Chairman (EVC, the chief executive) will be appointed by the government. Providing license to the Microcredit organisations with the objective of poverty alleviation and welfare of the poor people is the main duty of the authority.
Third	12: Fund of the MRA 14: Accounts & Audit of MRA	MRA may create a fund with the grant given by the government, license fees & annual fee from the MFIs, and/or grant given by any foreign government/ organisation with the prior approval of the Bangladesh government. Office of the Auditor General of Bangladesh shall conduct an audit of the MRA and submit audit report both to the MRA and the government.
Fourth	15: License 16: Procedure of license 17: Condition of license 18: License fee and annual fee	No MFI will be allowed to provide microcredit service in Bangladesh without having a license from the MRA. Existing MFIs (before enactment of the law) should apply for a license within six months of the enactment of the law, and they are permitted to continue operations until a final decision on their applications is taken by the MRA. Conditions of the license will be as per rules of the MRA. Every licensed MFI shall be bounded to provide license fee, annual fee, and other fees as decided by the Authority.
Fifth	19: Depositors' protection fund	MRA shall create a fund to provide protection to the depositors.

	<p>20: Change in constitution (of MFIs) 22: Accounts & budget of MFIs 23: Protecting interest of financing organisations 24: Power & activities of MFIs 27, 28 & 29: CEO & governing body members of MFIs, their eligibility criteria, and removal 30: Requirement of reserve fund by MFIs 31: Profit distribution 32: Deposit collection by MFIs</p>	<p>) No MFI is permitted to change its constitution without prior approval of the MRA.) MFIs should prepare and submit their Balance sheet and profit-loss accounts to the MRA within three months after the end of each year.) Every MFI should cooperate with its financing organisation in utilizing fund, preparing reports as well as in maintaining accounts.) Providing microcredit and related other services to the clients are the main duties of licensed MFIs.) CEO of an MFI will be appointed by its governing body, who will also act as the member-secretary of the governing body of an organisation. No other salaried person is allowed to be a member of a governing body of an MFI.) MRA has the power to remove any member of the governing body to protect the interest of the clients and the depositors of any organisation.) Every licensed MFI should maintain a reserve fund.) No MFI is permitted to distribute dividend without having permission from the MRA. However, none of the MFIs, who are getting tax rebate facilities or any financial benefit from the government, is not allowed to distribute a dividend for any reason.) No MFI is allowed to collect deposit from the general public other than its members/ clients.</p>
Sixth	35-43: Offence & penalty	This chapter describes the activities that will be considered as an offence and it mentions about the penalty for the particular offence. Offence under this Act is considered as non-cognizable and bailable, and it is treated under the code of criminal procedures.
Seventh	44: MFI unable to pay liability 45: Annual report of the MRA 50-51: Power to make rules	<p>) If any MFI is unable to pay liability it should inform the matter to the MRA and MRA shall provide necessary guidelines.) MRA shall submit its annual report to the government to present it to the Parliament.) MRA has the power to make rules on related matters as described in the law upon prior approval of the government.</p>

APPENDIX-E2

Table- 1: Staff strength of the MRA (As of December 2014)

	2007	2008	2009	2010	2011	2012	2013	2014
Under government budget								
a) Sanctioned		87						
b) Joined			18	59	3	6	9	3
c) Resigned				6	7	4	4	1
Project								
a) Joined		5	31	2	13	5	11	5
b) Resigned	-	-	4	17	8	4	4	6
Bangladesh Bank								
c) Joined	14	6	3		2	1		2
d) Left			8	12	1			2
Others					1			

Data Source: MRA

Table- 2: Budget allocation for the MRA

Year (Financial)	Government budget (in million taka)	Year (calendar)	Project-DFID/PROSPER (in million taka)
2008-2009	7.67 ⁴⁴²	2007	16.63
2009-2010	20.00	2008	35.61
2010-2011	35.00	2009	45.61
2011-2012	60.00	2010	30.45
2012-2013	59.95	2011	171.60 ⁴⁴³
2013-2014	72.50	2012	58.66
2014-2015	78.50	2013	62.96
	-	2014	16.75
Total	333.62		438.27

Data Source: MRA

⁴⁴² Reimbursed Bangladesh Bank's expenditure⁴⁴³ MRA has purchased own office space

A brief summary of the MRA Regulations, 2010

Section no.& heading	Summary of content
3: Issuing license	An NGO should apply for a license on the prescribed form supplied by the MRA. These prescribed forms require full disclosure of information by an NGO.
8: Formation of governing body and its function	Number of governing body members remain restricted to 5-10. Governing body members will be appointed from the General Body for three years, and no one is permitted to serve more than 3 consecutive terms. The chairperson will be elected from the governing body members and she/ he will also act as the chair of the general body.
9: Chief Executive Officer	There will be a full-time Chief Executive Officer in any MFI. She will be a salaried person under the specific pay-structure of the organisation. CEO should not be a member of the governing body which means that this person does not have any voting rights.
10. Regarding Chair and the CEO	The Chair and the CEO should not be family members. They should not be joint signatories of the bank account of an MFI.
11. Management and organisational structure	Every MFI should have an approved organisational structure and written policy for appointing staff. The policy must specify pay-scale and written terms and conditions for hiring staff.
13. Maintenance of accounts and other procedures	<ul style="list-style-type: none"> - MFIs should not finance long-term assets by short-term liability, - At any point in time, there must have at least 70% borrowers among total clients, - Depositors should get first preference in case of closure of operations, - MFIs should consider the ability of clients to pay back the loan and their liabilities with other MFIs, before sanctioning credit to them.
18. Sources of funds	<p>Sources of MFI funds could be:</p> <ul style="list-style-type: none"> -donation, - deposit from clients, -loan from local legal, financial institutions, -foreign loan subject to approval by the related government agencies, -securitization subject to approval of the MRA, -capital market subject to approval of the MRA, -loan from individuals as per contract (not as a commercial business investment).
19, 20 & 21: Utilization of Fund, Reserve Fund, and Surplus Fund	Every MFI should create a reserve fund by using 10% of its yearly surplus fund (accumulated surplus or profits). This reserve fund should not be used for any purpose without approval of the MRA. Balance of the surplus fund can be used for microcredit operations and other poverty alleviation activities upon prior approval of the Authority.
24 (3): Disbursement of microcredit	At any point in time, the total amount of credit for micro-enterprise (other than regular microcredit) should not exceed 50% of the total credit portfolio. No credit can be sanctioned for any general body or governing body member of an MFI.
26: Service charge on loan	<ul style="list-style-type: none"> -MFIs should follow MRA policy directives in the matter of rate of interest on credit and its method of calculation, -Clients should be clearly informed about the declared rate, - Rebate should be given to the clients if loans are paid before the due date.
27-35: Terms and conditions of Deposit collection, its use and other related matters	<p>-Following three types of deposit can be collected by MFIs from their clients depending on fulfilling other related terms of conditions mentioned in this regulation:</p> <ol style="list-style-type: none"> a) Compulsory deposit- equal amount for each member of a <i>Samity</i>; b) Voluntary deposit- at a uniform rate in open meetings depending on the nature of <i>Samity</i>. MFI needs to have 5 years of experience in operating

	<p>microcredit and must have records of profitable operations for last 3 years in addition to cumulative loan recovery rate over 95% for last 5 years. The total amount of this deposit should not exceed 25% of total capital⁴⁴⁴.</p> <p>c) Term deposit- under written contract for a specified period. MFI needs to have 10 years of experience in operating microcredit and must have records of profitable operations for last 5 years in addition to cumulative loan recovery rate over 95% for last 10 years. The total amount of this deposit should not exceed 25% of total capital.</p> <p>However, the total amount of savings will never exceed 80% of total loan outstanding.</p> <p>-An MFI should stop taking any voluntary and term deposit if it is in loss continuously for 3 years and if it breaks the conditions mentioned above.</p> <p>-Clients have the right to get back their entire amount of deposits after paying back all dues or loans.</p> <p>-The rate of interest payable on deposits should be consistent with the service charge on loan, and there must be a proper disclosure of the same.</p> <p>-Records of deposit should be maintained as per the rules mentioned and should be recorded in clients' passbooks as well.</p> <p>-15% of total deposited amount should be kept as liquid (5% in cash and 10% in fixed deposit).</p> <p>-This fund cannot be used to purchase any fixed asset.</p>
38: Inspection	MRA reserves the right of conducting an inspection of any organisation at any time.
40-43: Maintenance of financial records	MFIs should maintain financial records as per the rules and provide financial information to the MRA on uniform formats.
44: Loan Loss Provision	Loans have been classified into five categories depending on the periods of overdue and certain percentages have to be kept as provisions for loss. 1 per cent of principal loan needs to be kept as a provision for the regular loan.
47: External Audit	MFIs should arrange external audit by enlisted audit firms and should submit reports to the MRA within three months of the end of the financial year.
48: Submission of reports	All MFIs should submit the required reports on the prescribed formats biannually to the MRA.

⁴⁴⁴Capital means own fund of an MFI on which there is no claim by any internal or external person, project or organisation [section 1(7) of MRA Regulation, 2010]

Negotiations on the issue of Interest rate

1. In 2008, MRA sent a proposal to the government suggesting a 26 per cent cap on the interest rate of credit. It was based on the actual average cost of the fund (6%) + cost of operations (12%) + other expenses (8%) including loan loss provision.
2. The Sector did not agree with the proposal.
3. The government called a meeting on 4th April 2009 at the Ministry of Finance under the chairmanship of the Finance Minister to discuss certain regulatory issues including the interest rate. After the meeting, it was decided that an international agency/ expert be engaged to review/ re-examine the issue and to recommend future action. Till then, 15 per cent flat or 30 per cent effective rate would prevail.
4. Microfinance Transparency (MFT), an international consulting firm, was invited for this purpose in August 2009. MFT failed to propose any concrete suggestion due to non-availability of standardized data. It recommended standardizing of the procedure, such as calculation method, loan contract and others. It also suggested that information be disclosed properly.
5. A committee was formed for this purpose. Members were drawn from the MRA, InM, PKSF and the Bangladesh Bank. The MD, PKSF was the Chair and the researcher was the coordinator of this committee. This committee analysed operational data of 50 organisations and reported that the average operational cost of the sector had increased a few fold without convincing reasons. It added that this could be attributed due to the inefficiency of the MFIs, mismanagement of funds, and unplanned business expansion. So, it arranged a meeting with the sector on 2nd July 2010 to share the findings with them.
6. The Committee arranged a Workshop⁴⁴⁵ on 4th August 2010. The Governor of the Bangladesh Bank chaired the session in which the findings of the Committee were discussed publicly. It proposed a lending band/ cap, suggested that a standardized method of interest rate calculation be defined, and that a standardized loan contract along with a loan repayment schedule be developed. The NGO-MFIs had a serious disagreement with the findings of the Committee. Finally, the Workshop ended with the decision that the Committee would collect more information directly from the field and would present its results to another meeting.

⁴⁴⁵ Researcher presented the paper.

7. Accordingly, the Committee conducted a survey in six major regions of the country during August-September 2010 and collected information from 292 borrowers of 26 MFIs.
8. Another meeting, under the leadership of Chairman PKSf, was arranged on 16th October 2010 to share its field level findings with selected representatives of the sector and other relevant stakeholders. Major findings were:
 - a) various hidden costs associated with the loan contract still remained;
 - b) borrowers had limited bargaining power due to their dependence on the MFIs for various interlinked/interlocked services;
 - c) non-existence of competition in the market;
 - d) inadequate knowledge of the borrowers about terms and conditions of the loans, etc.

Hence, the Committee recommended proper disclosure of information by changing the flat method of calculation to the declining balance method to reflect the real rate and emphasized on standardizing the loan contract. It also proposed a rate (25/26 per cent) as an initial cap along with other proposals such as allowing a certain grace period to a client for repaying a loan. The sector's initial response in the meeting was positive so it was perceived as their agreement with the proposal.

9. However, the following day, they requested for another meeting with the Committee at least on the issue of the cap proposed by the committee.
10. So, the Committee arranged another meeting on 28th October 2010 at PKSf. Chairman, PKSf presided over the meeting. At the outset itself, the Chairman mentioned that it would be the last meeting of that type, and that members should take their final decision on that day. The sector's proposal on interest rate cap was 29 per cent whereas, the Chairman proposed to fix the rate at 25 per cent. However, the sector representatives steadfastly opposed the proposal and the meeting ended without any consensus on the issue; both parties left the meeting room. After a while, the sector representative returned with a revised proposal of 27 per cent. So, finally, the Committee accepted their proposal with a condition that this rate would be reviewed in a year, and the sector should attempt to reduce it further with a gradual increase in efficiency.

List of important circulars of the MRA

Circular no.	Issue date	Subject	Core content
Circular letter no- Regu-05	10 November 2010 ⁴⁴⁶	Interest rate of microcredit	<ul style="list-style-type: none">) All fees (admission+Application+Passbook) should not be more than Taka-15;) Grace period of loan should be at least 15 days;) Number of instalment will be at least 50 weeks;) No deduction from loan during disbursement;) Interest on savings should be minimum 6%, and should be announced earlier;) Interest rate should be calculated on declining balance method instead of flat method;) Interest rate on loan should not be more than 27%, and MFIs should try to decrease this rate by increasing efficiency.
Circular letter no. 8 (amendment of Circular 5)	08 June 2011	Grace period and instalment of loan	<ul style="list-style-type: none">) Minimum grace period of 15 days is applicable for regular microcredit for one year,) Minimum number of instalment will be 46 instead of 50, mentioned earlier.
Circular letter no. Regu-13	30 April 2012	Activities other than microcredit	Warning for unauthorized use of surplus funds for commercial use and other purposes. Requested to seek prior approval from the Authority as per the provision of the Law.
Circular letter no. Regu-14	07 May 2012	Loan classification and provisioning	Defines 'Overdue loan' and circulated formats to classify loan as mentioned in the rules.
Circular	08 May	Definition of	Clarify the definition (Capital) given in

⁴⁴⁶ This circular has been issued after sending draft regulation (Regulation, 2010) to the government. The Government passed the regulation later after completing regular formalities.

letter no. Regu-17	2013	Capital	the rules: it includes reserve fund, capital grant, donation given by any members of general body or by anybody and provisions kept against regular loan .
Circular letter no. Regu-21	16 January 2014	Loan write-off policy	Detail instruction for writing off bad loans. Also supplied formats to calculate the amount of bad loans.
Circular letter no. Regu-23 (amendment of Circular 5)	04 May 2014	Revised fees	All fees (admission+Application+Passbook) should not be more than Taka-25 (it was Taka 15 according to the circular 5)
Circular letter no. Regu-25	05 June 2014	Investment facility by large MFIs to small MFIs	<ul style="list-style-type: none">) Big MFIs can lend funds to small MFIs to solve small MFIs' funds crisis;) Interest rate of which will not be more than 10%;) This investment will be for one year.
Circular letter no. Regu-27	19 August 2014	Maintaining reserve fund	Warning to maintain appropriate percentage of reserve fund as per the Law.
Circular letter no. Regu-28	08 September 2014	Help clients affected by flood	<p>Given instruction to</p> <ul style="list-style-type: none">) stop receiving regular repayment from flood affected borrowers;) reschedule their loans;) provide them savings withdrawal facility;) use surplus fund to help affected people.

Summarized response of three Governors along with their brief personal antecedents

1. Dr Fakhruddin Ahmed (Ahmed, F., 2014)

As mentioned earlier in Appendix A2, Dr Fakhruddin Ahmed was the 8th governor of the Bangladesh Ban. He took the active initiative in speeding up the work, given to the National Steering Committee by the government, in formulating rules and a legal framework for the microfinance sector. I had to conduct a telephonic interview with him as he lives abroad, so the interview was not as spontaneous as the other interviews.

He is of the view that there was an urgent need of regulation for the sector considering the sector's size and number of people associated with it. According to him, the main challenge was ensuring sector's development (not stifled) while formulating and implementing rules. Sustainability of institutions was an important area that was accorded particular attention while he was preparing rules. He recalled that the committee under his leadership was concerned about developing the sector as a financial system and wished to link it with the macro-financial sector so that it could contribute to the real economy. They recommended establishing or transforming some selective organisations into microfinance banks that could ultimately help the sector to be sustainable. Microfinance banks would also help in providing services to the rural sector where traditional banks did not reach, and people would benefit from that, he commented. He wished to adopt the institutional set up of these NGO-MFIs that had already been developed and operating, not only as a tool to alleviate poverty but also as a part of the overall financial market especially to serve rural sector.

According to him, the Bangladesh Bank, as the central bank, did not have any active and direct role in this process of institutionalizing MFIs in Bangladesh; it did not have any experience in this field. The committee worked in close collaboration with the PKSF since it had experience in working with the sector, he added. He believed that microfinance organisations should not be operated by family members or relatives. However, there could be debate regarding the involvement of experienced governing body members with the organisations, he supplemented. According to him, the interest rate on loan should be within a reasonable limit, but

imposing a cap on the rate might have different implications. He thinks that there are other instruments which can be used instead of directly enforcing a cap on interest.

2. Dr Salehuddin Ahmed (Ahmed, S., 2014)

Dr Salehuddin Ahmed assumed the position of Governor immediately after Dr Fakhruddin Ahmed; they actually exchanged chairs. Bangladesh Bank's attention towards microcredit was boosted at least to a certain level during the governorship of Dr Salehuddin Ahmed. Coordination between the Bangladesh Bank and the PKSf on issues of microcredit also improved during his tenure.

He had vast experience in working both with the rural organisations and NGOs. He was one of the prominent members of the National Steering Committee, who under the guidance of the National Committee, chaired the Technical Committee which actually conducted initial research and formulated preliminary rules for the sector. The National Committee had already submitted the draft law to the government when he took the charge as Governor. He took special interest in ensuring that the government passed the law before its tenure ended in October 2006. He was the first Chair of the Board of the MRA after the law was passed and actively participated in the initial implementation process of the law. Formulation of the second layer of rules also took shape under his supervision.

Dr S. Ahmed talked about his vast experience in rural development with organisations like CIRDAP (Center on Integrated Rural Development for Asia and the Pacific, a regional inter-governmental organisation with its headquarters in Dhaka), BARD, NGO Affairs Bureau, PKSf and Bangladesh Bank. His experience in working with the PKSf was the dominant part of the conversation during the interview. He blamed the Bangladesh Bank for not being proactive about the rural financial market with a positive approach. According to him, the bank treated the market mechanically and shut down loss-incurring rural bank branches under the reform program instead of linking them with the private sector like NGOs, which he thinks would have been very useful in building an inclusive financial market a long time back.

He, however, is not in favour of commercial investment in microcredit. He also criticized government's attempt to address regulatory issues of microcredit from the perspective of controlling NGOs. He mentioned that he played a positive role in convincing the government to allow microcredit and savings operations for NGOs as well as in influencing government to get a tax rebate on NGOs' income. Dr Ahmed

considered governance as a failure in case of NGO-MFIs, which was one of the tough issues for them to address in rules and to implement. He recalled, that while formulating policies, issues like fixed period term for governing body members, and limiting their access to remuneration from the organisations were vehemently opposed by the sector.

He also pointed out some technical problems related to the translation of business into legal rules. According to him, there was a knowledge gap between legal experts and microfinance experts; they were not able to understand each other's language and terminology and therefore, the committee had difficulty in translating the business requirements into legal forms.

He recognized the fact that the draft law needed more public discussion before passing it as law. In his view, the law has some weaknesses, but the major problem was related to the implementing agency, the MRA, and with its implementation. He drew attention to MRA's problems of human resource, budget, and the overall visionary and dynamic leadership of the organisation. At the same time, he mentioned the absence of proactive support of the government for the MRA to enable it to function properly. He stated, "their (government) objective is not backed by their action". Dr Ahmed wished that the MRA would be able to break existing monopolistic structure of the market, and provide appropriate support to small and useful local level MFIs.

He also had laid emphasis in ensuring transparency and accountability in the operations of MFIs; special importance was given to fund transfer and appropriate use of fund by MFIs. According to him, the idea of creating a microfinance bank, which was suggested by the committee, would have been very useful if it could be implemented. Microfinance bank would work on a shareholding basis like Grameen Bank where people would have their ownership rights, and they would have their own bank for getting both savings and credit facilities, he added. He believes that the microfinance sector has the potential to stand alone as a different financial sector like other sectors as it is contributing to the economy just like other businesses, which politicians, policy makers and academicians need to recognize.

Though he thinks that supervision of microfinance banks could be given to the central bank, he does not see any reason for involving Bangladesh Bank directly with the issue of supervising Grameen Bank. He prefers the cooperative type of ownership structure in the organisations rather than the NGO type where nobody has ownership

or a direct stake in the organisation. He, however, does not have any significant opinion on the interest rate cap imposed by the MRA.

3. Dr Atiur Rahman (Rahman, A. 2014)

Dr Atiur Rahman is the 10th Governor of Bangladesh Bank. Immediately before joining the Bank, Dr Rahman also acted as the chair of the governing body of CDF (a private network of microcredit organisations). He has a number of published research papers on microfinance and has a much friendlier image to the sector compared to the previous governors.

Dr Rahman introduced the idea of inclusive finance in the Bangladesh Bank. He opines that financial inclusion was the broader umbrella under which microfinance existed as the first pillar. He has diluted the term ‘microfinance’ by popularizing the new term ‘financial inclusion’ which probably would help in reducing/ neutralizing the antipathy of the current government (AL) towards the term ‘microcredit’ (*khudroreen*). He cited his initiatives (‘directional bias’) for accelerating agricultural finance through the banking system, broadening the coverage of agriculture by redefining the area and linking banks with the NGOs to provide financial services to more people. According to him, this situation would be win-win both for the banks and the NGOs, because banks were unable to reach this group of people though they have funds for investment. While, NGOs were suffering from liquidity problems though they have a good record of reaching poor people. He considers the current regulatory environment as a ‘light touch regulation’, which helps NGO-MFIs to reach the un-bank population.

He focuses more importance to getting easy access to funds by the NGO-MFIs than other issues of the sector. So, he has been trying to open different windows of the Bangladesh Bank for NGOs from where they may get access to funds. During his tenure BRAC, the largest NGO in Bangladesh, has received a few million Taka directly from the Bangladesh Bank to disburse to share-croppers; considered by many as a very unlikely policy of the Bangladesh Bank. He mentioned this special program with BRAC as an experiment and considered it to be very successful so far.

He thinks that transforming NGO-MFIs into microfinance banks is a political decision and the environment is not yet ready to consider any such recommendation. The government is yet to recognize the contribution of microcredit to the national economy and growth, he added. During the interview he did not make any specific comment on the issue of interest rate prevailing in the market. He seems frustrated

about the government's financial support towards the MRA, and also about the operational limitations of the MRA. He is concern about government's criticism related to microcredit, especially about interest rate of microcredit. He is in favor of changing the current method of calculation into the previous flat method.

He is not interested to be involved in the Grameen Bank's running debate on the issue of removal of Professor Yunus from his previous position as MD; he considers this an issue which should be handled by the concerned ministry of the government. He thinks that Bangladesh Bank should not go beyond the limit on the issue of Grameen Bank that has been set legally. However, he does not support the idea of holding any post by anybody in any organisation for life-long.

Table-1: Recapitulation of opinions of the Governors' regarding the sector and the rules

Description/Issue	F. Ahmed	S. Ahmed	A. Rahman
Tenure	November 2001- April 2005	May 2005-April 2009	May 2009-15 March 2016
Major job (previous) experiences	The World Bank	CIRDAP, BARD, NGOAB, PKSF	BIDS, Dhaka University, CDF as Chair
Major role	Active initiative in speeding up the work of Steering Committee in formulating rules	Bangladesh Bank's attention towards microcredit had boosted up during his tenure. He took special interest in speeding up in passing the law by the government, and he was the first Chair of the MRA. He actively participated in the initial implementation process of the law and took the lead in formulating regulation at the second phase of rules.	Has introduced the idea of 'inclusive finance', which has diluted the term 'microfinance'. It helps in neutralizing current government's (AL) antipathy towards the vocabulary 'microfinance' by popularizing the new term 'financial inclusion'. He holds the much friendlier image with the sector.
Focus	NGO-MFIs sustainability and linking them with	Improve governance and financial management of the	Accelerate rural finance with the help of NGOs

	the macro-financial sector	NGO-MFIs	
Challenged faced	Not to stifle innovation of the sector	Addressing governance issue and ensuring appropriate use of funds	Government's antipathy towards microfinance
Special attention	Transform selective organisation into Microfinance Bank	Creating Microfinance Bank at some level	Solve liquidity problems of the NGOs
Reflecting Bangladesh Bank	Did not have any active and direct role in the process as it had no experience in the sector	Blamed Bangladesh Bank for not being proactive about rural financial market with positive approach	Bangladesh Bank has opened different windows to get funds by the NGOs
Comments on governance issue	MFIs should not operate by family members, however, the involvement of experienced governing body members cannot be ignored.	Considers governance as a failure in case of NGO-MFIs	No specific comments, however, he does not support the idea of holding any post by anybody for life-long
Comments on interest rate issue	The interest rate should be within a reasonable limit, but imposing cap might have other implications. Other instruments can be used instead of directly enforcing a cap on interest.	No significant opinion, however, he believes that the rate should be within a reasonable limit.	No specific comment, however, he thinks that flat method of calculating interest rate is easier than the current declining balance method, and he, therefore, favours changing the method.

The rules on governance issues that are facing problems of implementation

Rule no.	Content of rule	Implementing problems	Participants' Comments
Section 27, Act 2006	A CEO of an organisation is appointed by its governing body who also acts as a secretary of the governing body. As a salaried person, CEO is not a member of the governing body and has no voting right.	<ul style="list-style-type: none"> ○ In practice, generally, the founder of an NGO acts as the CEO. Current founders usually do not want to leave this position to outside professionals. They also wished to get voting rights [PRAC-1]. ○ As per Voluntary Social Welfare Act, 1961 CEO is a member secretary and has voting right which MRA Act does not permit [MRA-3/ FGD/ P-400] 	<ul style="list-style-type: none"> ○ The issue of setting fixed terms for all the governing body members might be questioned on the consideration of their experiences and contribution in developing the organisations [PM-1/Intvw/P-12] ○ (NGO) has founder syndrome. Once the founders become chairpersons, they do not want to leave [PM-2/Intvw/P-55] ○ Do not see any problem in the limited term. If they (<i>governing body members</i>) are interested in staying forever, then they will create the same problem like GB. They can remain as advisors [PM-3/Intvw/P-127]
Section 8(5), Regulation 2010	Governing body members are nominated for 3-years term, and they are not able to continue more than 3 terms	The disagreement has grown within the sector regarding fixed tenure of a governing body member. All the members, including the Chair have to leave the organisation after completing the fixed tenure. This clause affects all the first generation founders.	<ul style="list-style-type: none"> ○ It is an important ('<i>marattak</i>') intervention (<i>by the rules</i>) which will be difficult to implement. [PM-4/Intvw/P-144] ○ Board members should be removed after fixed term [RES-2/Intvw/P-329] ○ The law does not recognize founders' role in building MFIs; they have dedicated their labour and professionalism to build up organisation. However, these organisations cannot be under their family members just on this ground; this nature should be changed phase by phase. CEO should have voting right (RES-3/Intvw/P-355-357) ○ These organisations have been established with the initiatives of some entrepreneurs, many of them think that they are the owners. Founders act like chairman, CEO and they are everything. NGO has its governing body but most of the
Section 10, Regulation 2010	Chairperson of the governing body and the CEO should not be family members, and they should not be the joint signatory in operating bank accounts	Other than Chairperson and CEO, there are other members who are either directly family member or they are relatives who jointly dominate the organisation as a family through their majority voting share in the board. However, MRA is not able to take any action in this case because of legal limitation [MRA-4/FGD/P-403]	

<p>Section 29, Act 2006</p>	<p>MRA has the power to remove any board member or CEO to protect clients' or public interest</p>	<p>The problem especially arises when MRA needs to remove CEO. It has the authority to remove but does not have the power to appoint any administrator to replace that particular CEO. So, there is a chance of selecting another harmful person by the same Board [MRA-1 & 4/Intvw& FGD/ P-374 & 402]</p>	<p>cases it remain ineffective. Both the policy making body and the operational body are functioning under the directions of a single person, the founder, which the law does not permit (MRA-1/Intvw/P-372-373).</p> <ul style="list-style-type: none"> ○ Law sees the CEO as part of operational body, not a member of policy making body. So, there remain implementation problems of law. MRA informed the matter to the government and requested to amend the clause 27 (Act 2006) in favour of CEO's voting right to consider this person as member-secretary instead of only as a secretary on its governing body (MRA-1/Intvw/P-372-373). ○ But assigning the power of replacing CEO upon MRA may again have conflicts with the primary registration Authority Acts and with other programs of NGOs since all the other programs are running under a single legal umbrella where such a power is not allowed [MRA-1/Intvw / P-374]
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APPENDIX-F1

Major areas affected due to policy changes by some important stakeholders

Stakeholders	Recent policy initiatives	Observations of the respondents
Bangladesh Bank [as mentioned by the 10th governor of the Bangladesh Bank]	<ul style="list-style-type: none">) Incorporates MFIs in various programs as part of the financial inclusion programme;) Emphasizes on bank-MFIs linkage in disbursing agricultural and rural credit;) Creates favourable environment for MFIs to get funds from the banking sector under various schemes;) Provides preferential treatment to BRAC in getting funds directly from the BB by making an exception to the regular practices; 	<ol style="list-style-type: none"> 1. Increased commercial sources of funds from the banking channel [PM-3 & PM-4] 2. MFIs' expectations from the BB has inspired NGO-MFIs further for getting more funds at cheaper rate from formal sector like banks [PRAC 1 & 2] 3. Volume of deposit has increased [MRA-5] 4. Moving away from microcredit to micro-enterprise loans [FA-1, FA-2, RES-2, RES-3, MRA-5, PRAC-1]
Microcredit Regulatory Authority [Discussions with the high officials and FGD with mid & entry level officers, MRA]	<ul style="list-style-type: none">) Favourable savings policy that allows MFIs to collect various types of voluntary and term deposits from their clients;) Introduces interest rate cap on micro-loans;) Credit policy that allows micro-enterprise loan up to 50 per cent of total credit portfolio;) Policies that push organisations to be sustainable;) Specific policy guidelines for utilizing surplus funds; 	<ol style="list-style-type: none"> 5. Average loan size has increased [FA-1, RES-2, RES-3, MRA-5] 6. Poorer section of population are deprived from getting credit [RES-2, RES-3, MRA-4] 7. Increased loan facilities for men due to increasing ME loan and Agri-loan [FA-1] 8. Default rate is getting high due to ME loan [FA-3, RES-2, PRAC-1]
PKSF [as mentioned by the current chairman and a high official of the PKSF during interview]	<ul style="list-style-type: none">) Promoting vertical expansion in favor of micro-enterprise and large loan;) Financing agricultural sector;) Introduces integrated approach (healthcare facility, education, and other services along with credit) by replacing previous minimalist approach of singular focus on finance;) Focusing on value chain intervention, market development, and business development programmes. 	<ol style="list-style-type: none"> 9. Cost of operation has increased [MRA-4, MRA-5] 10. Idea of group meeting/ discussion is vanishing [FA-2, MRA-5] 11. Financial sustainability has been getting more focus than the social objective [FA-2];

APPENDIX-F2

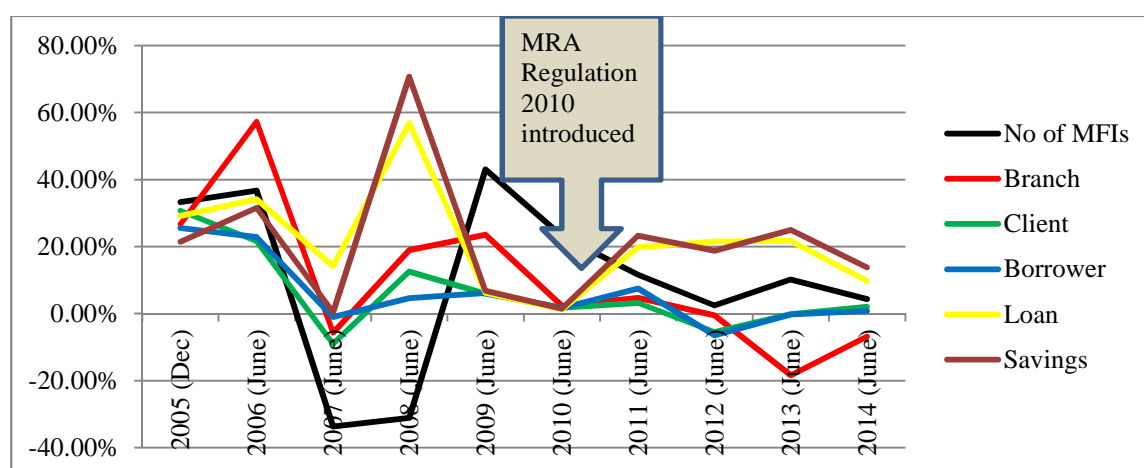
Table-1: Number of reported NGO-MFIs and a few facts about the sector: 2004-2014*

Year**	No. of reported NGO-MFIs ⁴⁴⁷	Total no. of branches	Total no. of clients (in mil)	Total no. of borrowers (in mil)	Outstanding loan (taka in million)	Savings (taka in million)
2004 (Dec)	352	6106	14.40	11.14	43406.36	17293.71
2005 (Dec)	469	7733	18.82	13.98	56058.80	21005.35
2006 (June)	641	12156	22.89	17.18	75198.71	27636.12
2007 (June)	425	11461	20.83	17.01	85872.94	27759.38
2008 (June)	293	13636	23.45	17.79	134680.96	47386.19
2009 (June)	419	16851	24.85	18.89	143134.03	50610.04
2010 (June)	516	17252	25.28	19.21	145022.66	51352.93
2011 (June)	576	18066	26.08	20.65	173797.60	63304.44
2012 (June)	590	17977	24.64	19.31	211210.00	75200.00
2013 (June)	650	14674	24.60	19.27	257010.00	93990.00
2014 (June)	678	13668	25.11	19.42	282200.00	106990.00

*Source: MRA-MIS database, collected in May 2015

** MFIs from 2008-2014 in the table are licensed organisations

Figure-1: Year to year percentage change in numbers of various factors, 2004-2014



⁴⁴⁷ This number of MFIs reported to a particular year may not match fully with the number of MFIs mentioned in the MRA's Statistical publications since they are based on available data till the time of publication.

Table-2: Number of application received, license provided, application rejected and license cancelled by the MRA

Year	No. of application received	No. of license approved from the first category of existing MFIs ⁴⁴⁸	Cumulative no. of License (existing MFIs)	No. of application rejected	No. of MFIs given temporary permission from the second category of new MFIs ⁴⁴⁹	No. of license cancelled ⁴⁵⁰
By 26 th February 2007	4240 (existing MFIs before enactment of the law)	-	0		-	-
2007 (Dec)	-	76	76		-	-
2008 (Dec)	-	255	331	604 (till Dec 2008) ⁴⁵¹	-	-
2009 (Dec)	-	92	423	1722 (till 27 October, 2009) ⁴⁵²	-	-
2010 (Dec)	-	66	489	2872 (till 24 October, 2010) ⁴⁵³	-	-
2011 (Dec)	1212 (new MFIs)	57	546	3020 (till June 2011) ⁴⁵⁴	-	4
2012 (Dec)	-	72	618	Not available	-	17 (total=21)
2013 (Dec)	-	56	674	Not available	30	19(total =40)
2014 (Dec)	-	23	697	3467 ⁴⁵⁵	142	16(total=56)

⁴⁴⁸ List published on MRA's website (accessed on 30 April 2015). This figures differ with the some other internal documents of the MRA

⁴⁴⁹ List published on MRA's (website accessed on 30 April 2015). 1053 applications have been rejected

⁴⁵⁰ List published on MRA's (website accessed on 30 April 2015).

⁴⁵¹ Source: NGO-MFIs in Bangladesh, Volume IV, June 2007, MRA

⁴⁵² Source: NGO-MFIs in Bangladesh, Volume-5, June 2008, MRA

⁴⁵³ Source: NGO-MFIs in Bangladesh, Volume-6, June 2009, MRA

⁴⁵⁴ Source: NGO-MFIs in Bangladesh, Volume-7, June 2010, MRA

⁴⁵⁵ Source: MRA-MIS database, received in May 2015

Table-3: Observations on audit reports received by the MRA from the licensed MFIs

Financial year (July-June)	No. of licensed MFIs submitted timely audit report	No. of licensed MFIs submitted delayed audit report	How many of them failed to submit reports?	How many of them completed audit by enlisted audit firms	How many of these reports have been analysed by the MRA
2007	NA	NA	NA		
2008	NA	NA	NA		
2009	NA	NA	NA		
2010	150	254	18	404	Not done
2011	187	310	22	497	Not done
2012	227	342	12	569	398
2013	276	336	32	612	612
2014	322	326	16	648	648

Source: Audit section, MRA. 'NA' indicates non-availability of data

Table-4: Number of large NGO-MFIs inspected in last five years, 2010-2014

Type of MFIs (based on no. of Clients in June 2014)	No. of MFIs	No. of large organisations inspected in the year				
		2010	2011	2012	2013	2014
Very large: Over 1 million	3	1	3	0	3	3
Large: Over 100 thousand but less than 1 million	22	13	16*	4	13	17

*3 MFIs were inspected twice in a year, Source: Inspection section, MRA

Table-5: Number of NGO-MFIs inspected in each year, 2007-2014

Calendar year	No. of organisation inspected	No. of Branch visited	No. of special/surprise visit
2007	46	46	0
2008	75	75	0
2009	127	127	0
2010*	195	195	0
2011	268	268	8
2012	297	297	13
2013	273	273	3
2014	216	216	6

*Regular inspection started since 2010. Source: MRA

Proshika Manabik Unnayan Kendro (License no-0152-03135-00600)

Proshika Manabik Unnayan Kendro (Proshika), an NGO, has been working in Bangladesh since 1976. It is registered under the Joint Stock Companies under the Societies Act. Proshika was one of the three largest NGOs in Bangladesh that received considerable attention from foreign donors in the eighties and nineties. In addition to microcredit, it had various types of program interventions for poor people. It became a partner organisation of PKSf in the mid-nineties and received an enormous amount of government fund. However, the organisation started facing problems from the beginning of this century when its Chairman, Qazi Faruque Ahmed, got involved in national politics. The then government (BNP) had denied its request of getting permission from NGOB for receiving foreign funds.

Proshika applied for a license to the MRA on 25th February 2007, which was approved only on 10th October 2011. MRA Board had decided to reject its application since it did not comply with the criteria of getting license, which included lack of proper financial disclosure, financial insolvency that puts clients' savings at risk, more external liabilities than assets, conflict among general and governing body members (appointed two CEOs by two groups), and many others. PKSf alone had an overdue loan of Taka 941.20 (principal) million, and it incurred a cumulative loss of Taka 2030 million by June 2008 while it had Taka 2160 million clients' savings, that was at risk. PKSf tried to help it in getting a license by rescheduling overdue loan, but Proshika failed to utilize that privilege due to internal conflict.

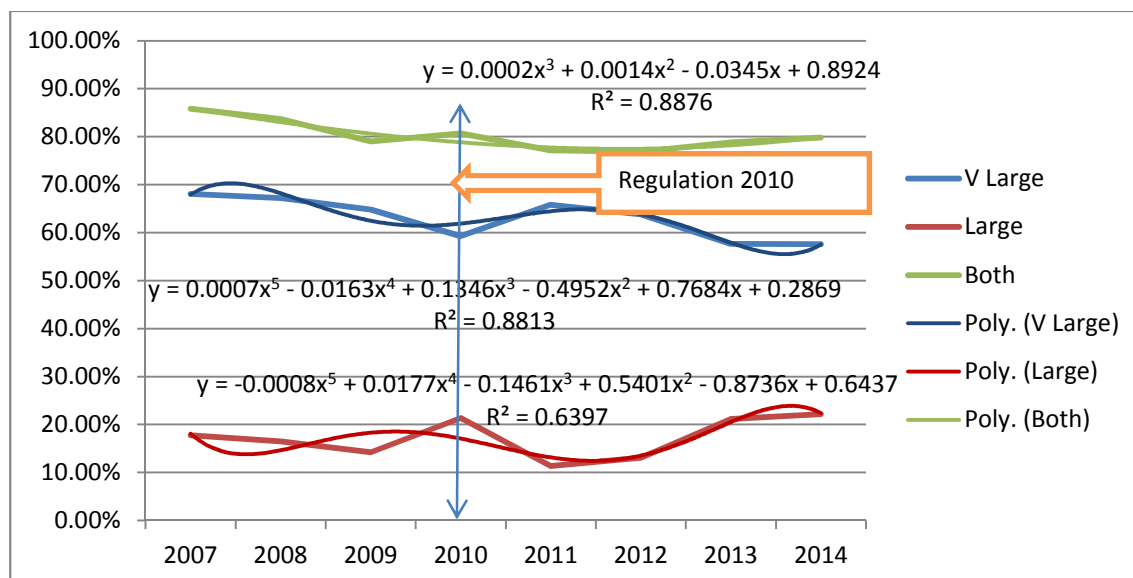
In the middle of a discussion on how to regain its strength, Qazi Faruque Ahmed was removed from the position of Chairman on 24 May 2009 by a group of members of the governing body. He filed a case in the Court against this decision of the governing body. After that, governing body members got divided publicly into two groups and started fighting with each other both in court and in the office premises. The situation went beyond the control of the MRA, or any other government body. After getting High Court's stay order on the situation, which mentioned Mr Ahmed as an 'Ex-chairman', MRA started communicating with the group that had control over the organisation and finally approved license in October 2011 while it appointed an observer at the governing body meeting as well.

However, the situation became hostile once more in early 2012 when the group under Mr Ahmed took control of the organisation again after breaking High Court's stay order. Since then no significant progress has been observed in stabilizing the condition despite several attempts of the MRA.

Table-1: Number of organisations under different category from 2007-2014

Type of MFIs (based on total number of clients in 2014)	Number of MFIs							
	2007	2008	2009	2010	2011	2012	2013	2014
Very large: Over 1 million	2	2	2	3	4	4	4	4
Large: Over 100 thousand but less than 1 million	15	14	18	20	17	19	19	21
Medium: Over 50 thousand but less than 100 thousand	14	15	22	24	28	27	25	26
Small: Over 10 thousand but less than 50 thousand	73	82	111	111	107	112	120	119
Very small: less than 10 thousand	178	176	316	348	396	422	482	462
Total	282	289	469	506	552	584	650	632 ⁴⁵⁶

Figure-1: Average market share of very large and large NGO-MFIs



⁴⁵⁶ Data collected from the MRA database during May 2014 varies with the data collected from the MRA website

APPENDIX-F5

Table-1: Percentage of self-sufficient NGO-MFIs, 2007-2014

License year	2007	2008	2009	2010	2011	2012	2013	2014
2007 (N=44)	0.27	0.73	0.32	0.41	0.55	0.43	0.43	0.93
2008 (N=126)	0.50	0.61	0.44	0.56	0.55	0.48	0.48	0.90
2009 (N=38)	0.32	0.55	0.34	0.42	0.53	0.42	0.39	0.87

Figure-1: Self-sufficient and non-self-sufficient NGO-MFIs (in % of total), 2007-2014

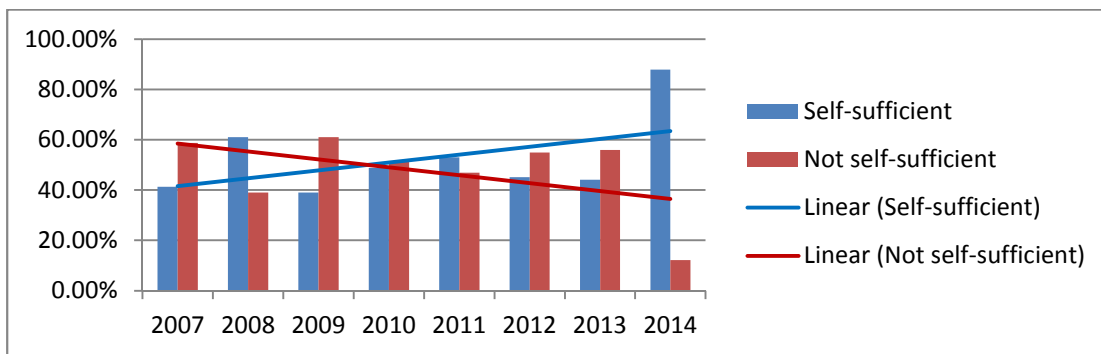


Figure-2: Mean OSS of 208 NGO-MFIs according to licensing year, 2007-2014

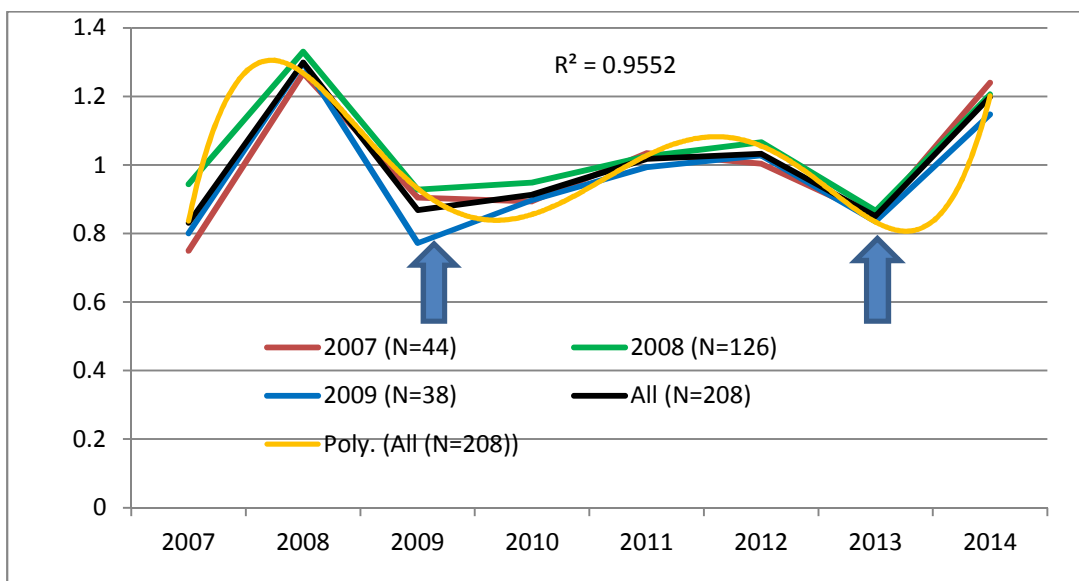


Figure-3: Mean OSS of 208 NGO-MFIs according to size of the MFIs, 2007-2008

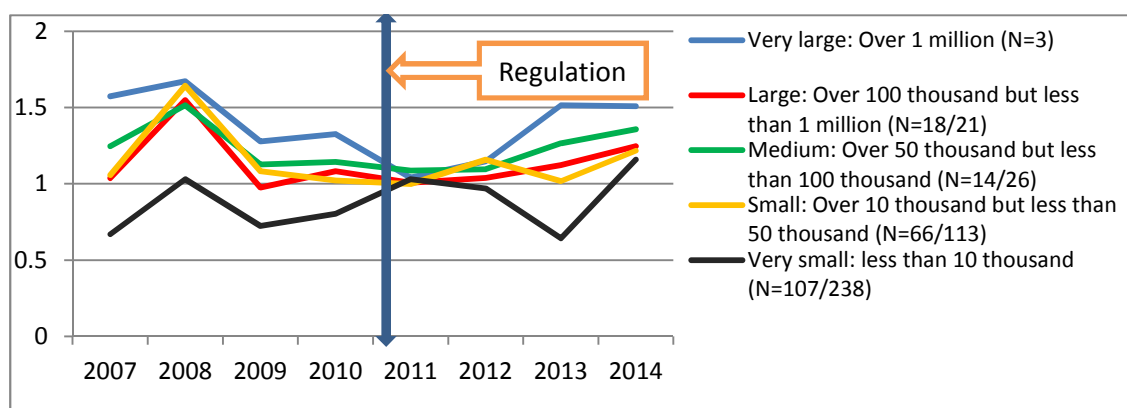


Table-2: OER (operating expense in Taka to maintain 1 taka loan outstanding at field) of NGO-MFIs, 2007-2014

License year	2007	2008	2009	2010	2011	2012	2013	2014
2007 (N=40/74)	0.17	0.15	0.20	0.20	0.18	0.22	0.19	0.13
2008 (N=125/245)	0.18	0.17	0.22	0.21	0.20	0.23	0.20	0.15
2009 (N=39/93)	0.18	0.17	0.21	0.23	0.21	0.27	0.22	0.16
All (N=204)	0.17	0.16	0.21	0.21	0.20	0.24	0.20	0.14

Figure-4: Operating expense ratio of different categories of NGO-MFIs, 2007-2014

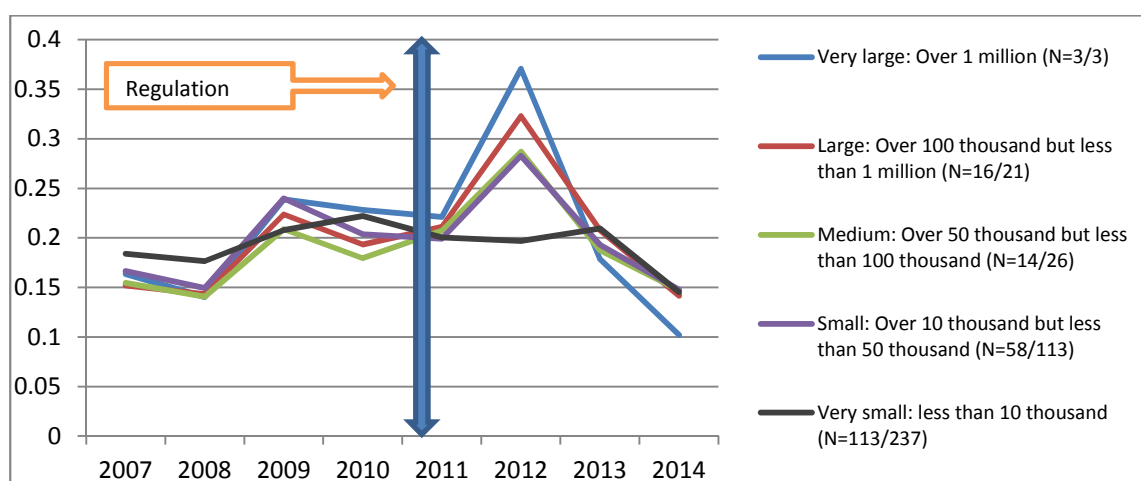


Figure-5: Cost per client (in Taka per year) of 228 licensed NGO-MFIs (according to licensing year), 2007-2014

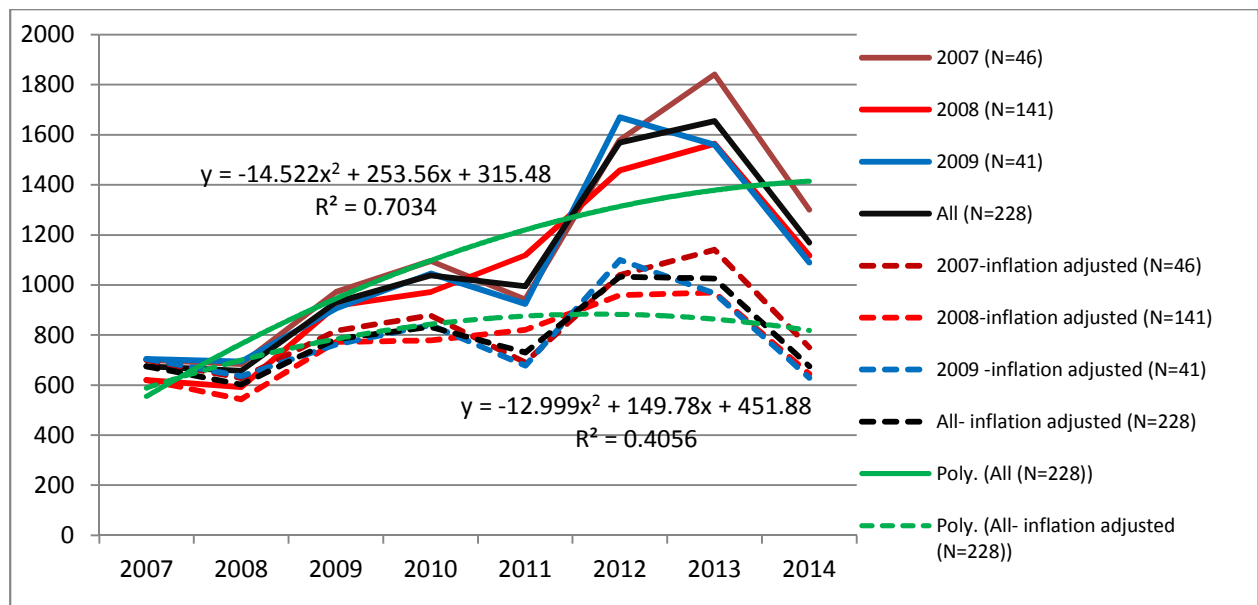


Figure-6: Cost per client (in Taka per year) for different types of NGO-MFIs (according to size of MFIs) from 2007-2014

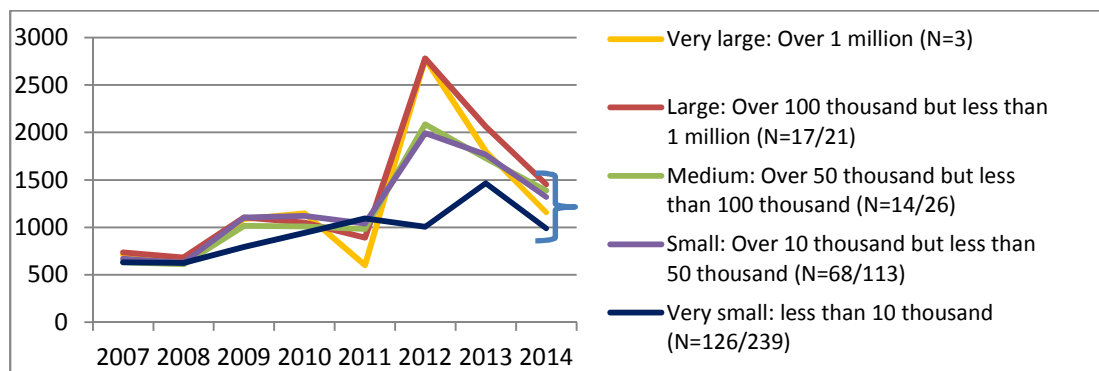


Table-3: Descriptive statistics on ‘scale on dependency’ of 20 NGO-MFIs, 2008-2013

2008	2009	2010	2011	2012	2013
Mean	0.73	Mean	0.73	Mean	0.75
Mediar	0.70	Mediar	0.69	Mediar	0.72
S Devia	0.15	Standa	0.14	S Devia	0.13
Skewne	-0.33	Skewne	0.20	Skewne	0.39
Minimu	0.38	Minimu	0.47	Minimu	0.55
Maximu	0.96	Maximu	0.96	Maximu	0.97
Count	20	Count	20	Count	20
Mean	0.73	Mean	0.73	Mean	0.75
Mediar	0.70	Mediar	0.69	Mediar	0.72
S Devia	0.15	S Devia	0.14	S Devia	0.13
Skewne	-0.33	Skewne	0.20	Skewne	0.39
Minimu	0.38	Minimu	0.47	Minimu	0.55
Maximu	0.96	Maximu	0.96	Maximu	0.97
Count	20	Count	20	Count	20
Mean	0.73	Mean	0.73	Mean	0.75
Mediar	0.70	Mediar	0.69	Mediar	0.72
S Devia	0.15	S Devia	0.14	S Devia	0.13
Skewne	-0.33	Skewne	0.20	Skewne	0.39
Minimu	0.38	Minimu	0.47	Minimu	0.55
Maximu	0.96	Maximu	0.96	Maximu	0.97
Count	20	Count	20	Count	20

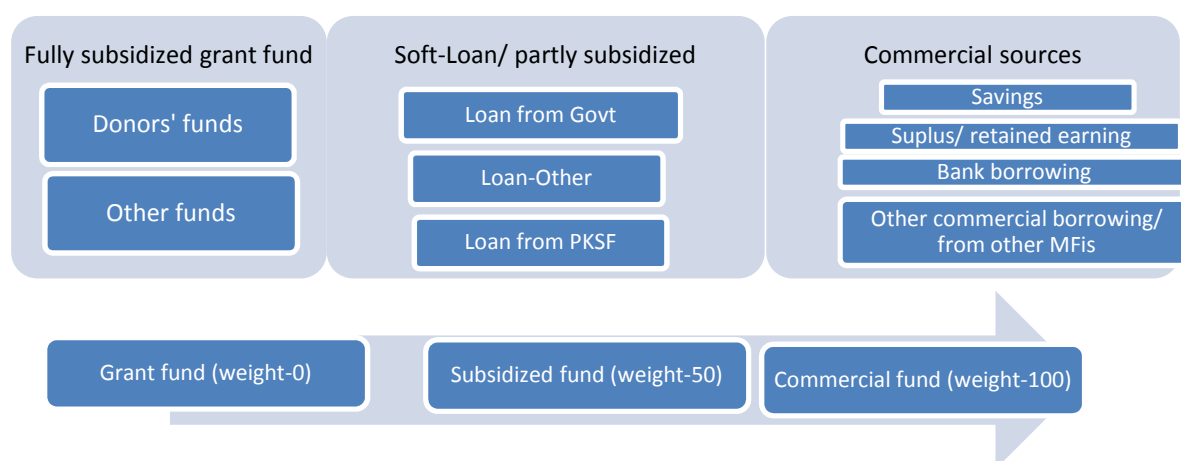
Measuring scale: Dependency on Subsidy

The MRA categorizes sources of fund for the institutions under the following nine broad heads:

- i. Savings of Clients
- ii. Cumulative Surplus
- iii. Loan from Commercial Banks
- iv. Loan from Other MFIs
- v. Other loans
- vi. Loan from Govt
- vii. Loan from PKSF
- viii. Donors' Fund
- ix. Other Funds

Different institutions have different combinations of sources of funds, so the value varies a lot and is not comparable with each other. Therefore, considering the percentage of each source in the total volume of the fund and calculating their weighted average make more sense to observe inclination of the institutions towards certain path between dependency on subsidy and dependency on commercial sources. By the assumption made (weight) about the direct and indirect cost involved with each type, the sources have been divided into following three broad headings as mentioned in the following figure.

Different Sources of Funds of NGO-MFIs in Bangladesh



On the basis of the assumption of the cost involved, each broad category has been given a separate weight (from 0 to 100) to calculate their score on the line from fully subsidized (0) on the one end, partly subsidized (50) and fully commercialized (100) at the other end. A commercial source has been given highest weight as 1 (or 100) as

it involves highest cost, all types of soft-loans has been given the weight 0.5 (or 50) as it involves roughly half of the cost compared to commercial borrowing, and donor fund has been given the weight of 0 which costs nothing. The example given below illustrates the method of calculating the weighted scores for two hypothetical MFIs:

Example: Scale of Measuring Composition of Sources of Funds-Comparing ‘A’ with ‘B’

Parameter and Weight (Total Score 0-1)		Institution-A		Institution-B	
		% of Source in total	Combined weight	% of Source in total	Combined weight
Commercial Weight-1	Savings	33.68%	89.23%	24.99%	44.22%
	Income	19.20%		14.03%	
	Bank borrowing	36.35%		0	
	Borrowing from other MFIs	0		5.2%	
Soft-Loan Weight-0.5	Loan-Govt	0	1.87%	0.26%	11.99%
	Loan-Other	3.75%		0	
	Loan-PKSF	0		23.72%	
Donation Weight-0	Donor	5.1%	0	29.71%	0
	Other	0		2.28%	
Total Score		91.10%, more towards commercialized sources		56.22%, less commercialized and more towards subsidy dependency	

Most of the big MFIs in Bangladesh have started their journey with the help of donors and thereafter they have received subsidized funds from the PKSF. At the later phase, some of them have gradually been coming out of the subsidized fund and moving more towards commercial sources like deposit collection and bank loan. I have collected data on fund composition of 20 MFIs for the period 2008-2014⁴⁵⁷, among them two were very large, and 18 were large organisations. And again 14 were PKSF’s partners; some of them were long time partners, and some were new. Two very large organisations, BRAC & ASA, were not PKSF’s partners during data collection, but they had old dues since they had been involved with the PKSF earlier. Now BRAC has been focusing more on deposit collection and bank loan, as one of the costlier organisations BRAC does not have as surplus fund as does ASA. ASA, on the other hand, has been giving emphasis more on retained earnings (surplus fund)

⁴⁵⁷ Data on fund composition (on the same format) is not available before year 2008 of these MFIs

and deposit collection as it is enjoying the opportunity of having lowest cost operation as shown in the table below.

Trends in Composition of Sources of Funds of BRAC & ASA, 2008-2013

Year	Donor/Other fund	PKSF	Other loan	Banks	Deposit	Surplus
BRAC						
2008	4.76%	2.28%	0.83%	44.91%	32.51%	14.71%
2009	4.42%	2.03%	0.50%	40.65%	34.86%	17.99%
2010	4.23%	0.72%	1.17%	31.70%	39.91%	22.26%
2011	4.12%	0.12%	0.28%	29.20%	41.70%	24.55%
2012	3.34%	0.00%	0.00%	34.01%	38.64%	24.01%
2013	2.91%	0.00%	0.00%	31.86%	38.24%	26.99%
ASA						
2008	2.38%	0.99%	1.43%	3.38%	21.73%	70.08%
2009	2.87%	0.27%	1.79%	2.24%	25.49%	67.35%
2010	12.17%*	0.00%	1.85%	4.12%	23.26%	58.60%
2011	11.85%*	0.00%	1.26%	2.13%	24.91%	59.76%
2012	10.80%*	0.00%	1.00%	0.00%	25.19%	63.02%
2013	9.48%*	0.00%	0.86%	1.36%	25.97%	62.33%

* No explanation was found for the figures mentioned under 'other fund'

APPENDIX-F7

Table-1: Average yield of top MFIs during the period from 2007-2014

	2007	2008	2009	2010	2011	2012	2013	2014
No. of NGO- MFIs	86	85	75	93	99	98	90	99
Av loan outstand per borrower in taka (nominal)	5236	5477	5742	6709	7973	9245	10715	12583
Av loan outstand per borrower in taka (inflation adjusted-real)	5236	5020	4833	5382	5848	6084	6638	7258
Change in average loan (real)		-4.13%	-3.73%	11.36%	8.66%	4.04%	9.11%	9.34%
Av Yield	22.34%	25.42%	27.53%	26.77%	26.21%	25.58%	25.12%	24.96%
Loan loss as % of loan outstanding	1.38%	1.09%	2.19%	2.46%	2.03%	1.67%	1.52%	1.55%

Figure-1: Interest Yield and Loan Loss, 2007-2014

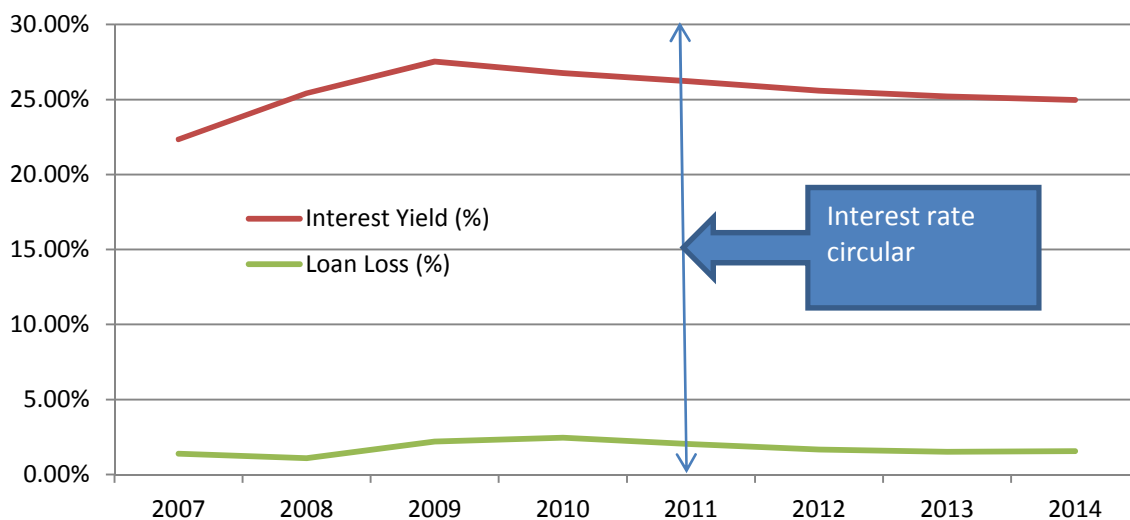


Table-2: Interest yield, operating expense, and margin of top 100 NGO-MFIs, 2007-2014

Year	Interest Yield (%)	Operating expense (%)	Margin (Yield-Expens) in %
2007	22.34%	17.00%	5.34%
2008	25.42%	16.00%	9.42%
2009	27.53%	21.00%	6.53%
2010	26.77%	21.00%	5.77%
2011	26.21%	20.00%	6.21%
2012	25.58%	24.00%	1.58%
2013	25.21%	20.00%	5.21%
2014	24.96%	14.00%	10.96%

APPENDIX-F8

Table-1: Clients under different age group in different districts

Age group (year)	District (120)			
	Kurigram (43)	Tangail (30)	Patuakhali (27)	Dhaka city (20)
18-30	51.16%	40.00%	14.81%	55.00%
>30-40	27.91%	30.00%	37.04%	30.00%
>40-50	18.60%	13.33%	7.41%	10.00%
>50	2.33%	16.67%	11.11%	0.00%

Table-2: Clients classified by different educational levels in various districts

Education	District (120)			
	Kurigram (43)	Tangail (30)	Patuakhali (27)	Dhaka city (20)
Never went school	44.19%	73.33%	29.63%	45.00%
Primary	25.58%	20.00%	48.15%	35.00%
Secondary	27.91%	6.67%	14.81%	10.00%
Higher secondary (college)	2.33%	0.00%	7.41%	5.00%

Table-3: Social indicators of clients in different districts

Social indicator	District (120)			
	Kurigram (43)	Tangail (30)	Patuakhali (27)	Dhaka city (20)
Have electricity	25.58%	93.00%	67.00%	95.00%
Use Sanitary latrine	7.00%	47.00%	63.00%	55.00%
Have access to safe drinking water	93.00%	97.00%	96.00%	95.00%

Figure-1: Clients involvement with the MFIs

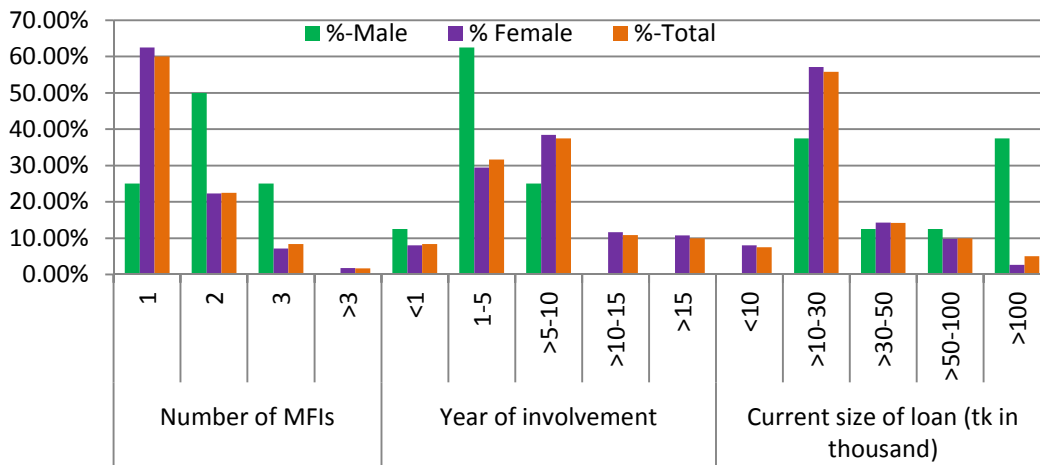


Figure-2: % of clients with multiple MFIs

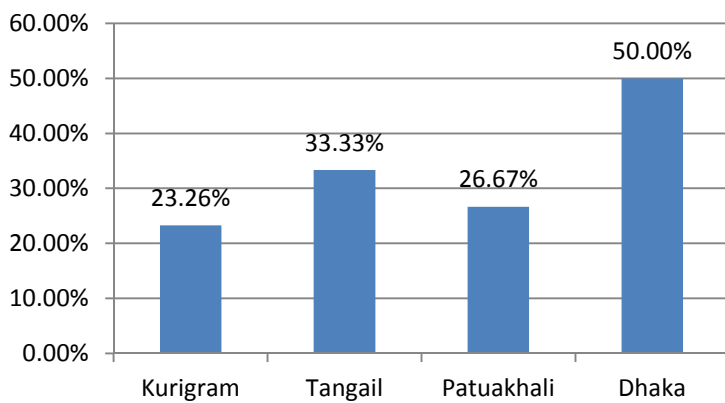


Figure-3: Average year of involvement with the MFIs

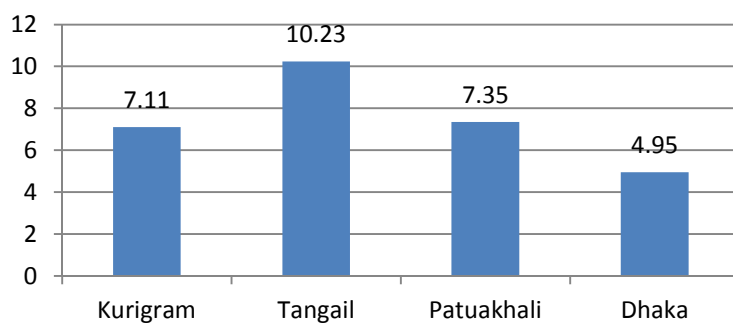


Table-4: Number of borrowers under different categories of loan size

Loan size (taka in thousand)	Number of borrowers
<10	9 (all female)
>10-30	67 (3 male 64 female)
>30-50	17 (1 male 16 female)
>50-100	12 (1 male 11 female)
>100	6 (3 male 3 female)

Figure-4: Decision making on loan

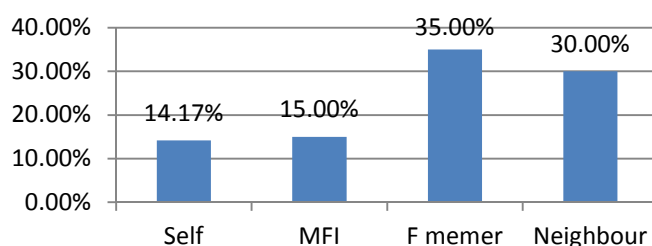


Figure-5: Decision making in choosing MFIs

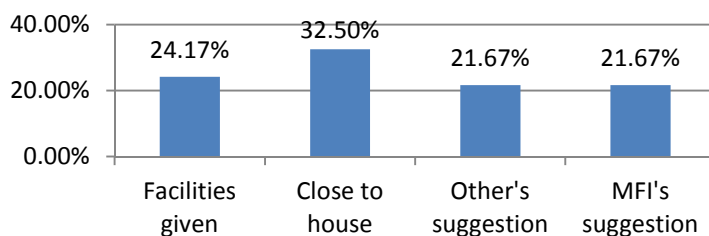
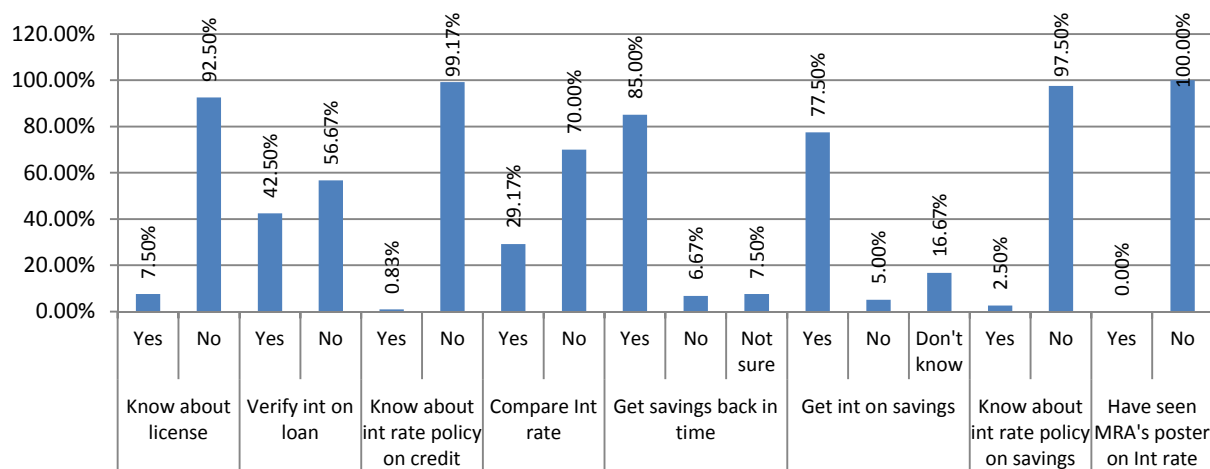


Figure-6: Responses of clients on their rights and responsibilities



A Pathetic Story of a Client [Patu_Bau_Goa_03]

This is the story of a woman called Champa (name changed). She is around 25 years old, never went school, now married and has two children. She is a housewife though sometimes she works as a helper in neighbour's house to augment her income. Her husband has completed primary school, now works as a day-labourer.

According to her, her husband wanted to buy a cow. She was not at all interested in borrowing money from NGOs, but it was her husband who forced her to take the loan. He scolded her by mentioning that everybody was helping their husband, but she did not and she was not treating him as a good wife should. So he reprimanded her, why had he married her? He also mentioned that she was disobeying her husband. She felt that this loan would be an additional burden for her because her husband did not have any regular income, though he said that he would pay but she did not have faith in his words. One day, while he was shouting at her, the in-laws and other neighbours came to them and requested her to accede to his request. They also assured her that if he (her husband) did not re-pay the instalments, they would force him to pay, or they would force him to surrender to the NGO officer. Ultimately she agreed to apply for the loan and requested her husband that he should buy the cow immediately on getting the loan. She and her husband went to the NGO office and borrowed Tk 10000. Her husband took the money from the NGO office while she signed for the loan. He went to the local market straight from the NGO office because of her request ('you could not come back home without the cow') and bought a cow for Tk 9700.

They paid back the full amount in accordance with the rules. The loan officer offered her another loan of a higher amount since she had paid back the money without missing a single instalment. Her husband again pressurized her to get another loan of a higher amount. This time too, she was not interested in getting a loan as it was a huge burden on her. Again she had to surrender because of peace in the family. Both of them went to the office, and her husband took Tk 15000 immediately after her signature on paper. This time, her husband did not invest that money anywhere; he spent that money with friends in the local market by having tea, and fun. He stopped working for the neighbour which he promised to do. She asked her husband to pay

back the loan; he gave her back part of it in response. Thereafter, He started shouting and had not given a single penny back to her. Instead, he said, “Oh, now you have become empowered to spend money by yourself! What kind of lady you are? Do you earn money? I am the one who makes money and repays your loan”.

Now she was faced with the problem of paying back the loan instalments. She had to keep money aside without spending it for food; sometimes she had to borrow money to pay the instalment. She said that the NGO officer did not budge without getting the full amount of that '*kisthi*,' not even by Taka 25. One day her *kisti* was Taka 425, but she did not have money at home. She could borrow only Tk 300, and requested the officer to adjust the rest of the money from her savings, but he adjusted only Tk100. She requested to give her the opportunity to pay the balance amount of Tk 25 later, but the officer did not accept her request. Instead, he realized her dues of Tk 25 from another borrower who came that day to pay her money. So, he took Taka 25 more from that lady and told Champa to pay that lady later. She said that it surprised her to see that she had become a debtor to another person for Tk 25, without her prior knowledge and concurrence.