Over the years, the microfinance sector in Bangladesh has undergone significant transformation.

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Scaling microfinance is a prime need

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

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

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

At present, there seems to be a consensus on the broad objectives of microfinance—outreach to low-income people and financial sustainability. Given these two objectives, MFIs need to address two central issues in their day-to-day operations: (i) the information issue: how to establish borrowers' ability and willingness to repay; and (ii) the cost issue: how to handle small financial transactions cost-effectively, which are generally required by low-income people.

- Microfinance in Bangladesh has evolved from microcredit to a diverse range of financial products, focusing on small loans for the poor who lack access to formal financial services.
- Despite challenges such as high transaction costs and small loan amounts, microfinance institutions play a crucial role in providing financial services to rural households and microenterprises.
- The adoption of digital financial services is transforming microfinance by reducing transaction costs and expanding access to financial products for low-income populations.
- Microfinance's dual objectives of outreach and financial sustainability require balancing the needs of different clientele, including the ultra-poor and microentrepreneurs.
- The increasing focus on relationship-based lending and microenterprise loans reflects a shift towards more sustainable and scalable microfinance models, while addressing the needs of both vulnerable households and small businesses.

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

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

Despite these dilemmas, Bangladesh's microfinance sector has created a unique space as important financial intermediaries with significant value propositions to their client base and the national economy. MFIs extend financial products, including basic social services, to clients, especially in rural and remote areas, through their widespread network and infrastructure. This has enabled MFIs to gain valuable experience in providing financial and human development services to extremely poor populations and offering microenterprise loans to credit-hungry cottage and microenterprises (CMEs), especially in the rural economy.

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

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

The concentration ratio of the microfinance sector is relatively high in Bangladesh. Overall, the 20 largest MFIs control nearly three-quarters of the market share, while the two largest MFIs (BRAC and ASA) control half in terms of both clients and financial portfolios.

Structural transformation of microfinance: Over the years, the microfinance sector in Bangladesh has undergone significant transformation, evolving from group-based, limited-scale microcredit operations to individual microenterprise operations to create widespread and sustainable development impacts. Over time, microcredit has graduated from its mainstream activity of supporting the basic needs of the poor to nurturing broader farm and nonfarm activities and microenterprises for graduating microcredit borrowers and microentrepreneurs. The focus on "appropriate" finance—scaling up credit to meet the threshold level of activities for sustainable livelihoods, targeting extremely poor groups and remote areas, mobilising the poor to promote social development, creating awareness of health, education, women empowerment, and other social issues, and fostering green and climate-resilient activities—has provided MFIs with a unique opportunity to emerge as key development partners in Bangladesh.

Over the decades, the sources of financing for MFIs' operations have broadened to include loanable funds from several sources, such as members' savings, cumulative net surplus, borrowing from banks, concessional loans (e.g., from Palli Karma-Sahayak Foundation), loans from large MFIs, loans from non-institutional sources (e.g., board and client members), and

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