



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.

PHOTO: ICAB

## Scaling microfinance is a prime need

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other sources like reserve funds, staff security funds, and loan loss provision funds. The most important sources of funds for MFIs are the savings of their members/clients (43 percent), followed by cumulative net surplus (31 percent) and borrowings from banks (19 percent).

Overall, MFIs have contributed significantly to expanding access to microfinance services for poor and low-income households. In Bangladesh, microfinance—especially for poor women—is widely regarded as a virtuous tool and is seen as valuable for poverty reduction efforts. Microfinance is also considered a relatively efficient means of assisting the poor. Although interest rates on micro-loans are relatively high, they serve as a positive mechanism for rationing the limited volume of microfinance to borrowers who can earn sufficient returns to cover costs. In practice, this self-selection process is far from perfect, as the poor may borrow in desperation and become locked in a cycle of indebtedness. Moral hazard problems may also arise.

The controversy surrounding the effectiveness of microfinance in poverty reduction in Bangladesh runs deep. A comprehensive assessment of its capacity to reduce poverty requires an economy-wide framework. While microfinance can provide short-term relief from poverty, it is unlikely to serve as a long-term solution, especially for households with small amounts of land or productive assets. Modern agriculture's strong positive economies of scale are difficult for small farms to leverage effectively. Similarly, nonfarm economic opportunities may remain limited without strong economic growth and technological innovation.

A more important aspect of microfinance, however, is its role in enhancing the status of women and their bargaining power within families, as most micro-loans in Bangladesh are given to women. Although some studies show that increased access to microfinance does not necessarily improve women's health and education or enhance their role in household decision-making, these findings may be context-specific. The overall picture in Bangladeshi society is more positive, as many women have been empowered and have become successful microentrepreneurs using microcredit as their stepping stone.

Extrapolating the effects of microfinance on individual households to the rural economy provides insights into its broader impact. Increased individual capacity to deal with shocks reduces the effects of covariant shocks on the rural population as a whole, particularly when

a substantial share of the population is within the financial frontier. Furthermore, increased savings in financial assets shift wealth away from low productivity assets, aiding financial deepening and reducing inequality while raising the incomes of poorer segments of the population.

Financial deepening has direct relevance for microfinance in rural areas, as providing rural households with access to savings and credit is its core objective. Its effects go beyond individual MFI-household links, as the availability of capital for new, productive clients fundamentally affects economic relationships in rural areas. Enlarging microfinance to include a substantial share of the rural population enhances its positive effects.

Over the years, civic organisations (e.g., NGOs) have worked with local government institutions (LGIs) in Bangladesh to achieve transformative changes at the grassroots level, creating linkages upward—not just with government initiatives, but also to transform underlying behaviours and ideas that underpin social development. These micro-efforts and their macro-level transmissions provide a powerful stimulus for rapid social outcomes in Bangladesh.

**Challenges of microfinance:** Despite significant achievements, a major challenge for MFIs is their high transaction costs. Supporting a large volume of small transactions results in high costs with low returns per transaction.

For the poor in Bangladesh, there is a need to redesign conventional financial products to reflect their specific requirements and demands. In this context, MFIs are well-equipped to serve the poor effectively. Moreover, MFIs must find the right balance between financing income-generating activities for the poor and deprived groups and financing CMEs through larger loans.

MFIs must also focus on designing innovative financial products and services with terms and conditions suitable for vulnerable and risk-averse poor households. These products should emphasise creating multiple income sources, accumulating productive assets, and adopting risk-minimising techniques (e.g., microinsurance). In addition to appropriate supply-side policies, demand-side interventions are necessary to ensure that poor and low-income households are financially literate and capable of using services productively.

Policy implications are twofold: (i) the government's policy attention for rural finance is validated, not to provide capital directly but to enable financial institutions to mediate between savers and borrowers; and (ii) policies need to encourage financial institutions (including MFIs) to push the financial frontier to include new, low-income rural households by tackling

information problems through innovative screening, monitoring, and enforcement procedures.

**Microfinance and digital financial services:** To increase access and perform more efficiently, MFIs need to capitalise on rapid advances in mobile communications and digital payment services (DFS) to connect poor households to affordable and reliable financial services. For the poor, access to financial services helps them successfully adopt new farming technologies, invest in new business opportunities, or find new and more productive jobs. At the same time, access to DFS prevents a large number of people from falling back into poverty or into deeper poverty due to health problems, financial setbacks, and other shocks. Simple yet powerful innovations, such as digital wallets and other innovations, help reach a greater number of poor people and drive down transaction costs. Although Bangladesh still has a long way to go to

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take full advantage of digital finance, the country is moving rapidly to build the required ecosystems and remove barriers to ensure progression from payments to solutions "beyond payments."

To exploit digital technology both effectively and efficiently, key issues for MFIs are to ensure that: (i) financial products and services are tailored to the specific needs of different customer groups; are transparent and secure; and provide an optimal balance between different features of products and their prices; (ii) DFS are introduced through adopting well-sequenced and well-coordinated policies to nurture in-house technological innovation and ensure that financial operations become more efficient and diversified; (iii) to harness the widespread transformative power of digital technology, MFIs need to identify both opportunities and challenges so that management is prepared for both the rewards and risks of digitising

financial services and reaching members of financially excluded groups; (iv) in digitising financial services, MFIs must place emphasis on designing customer-centric financial products and services, especially suited to low-income and financially excluded individuals and enterprises.

For MFIs, adopting a customer-centric approach is instrumental in bridging the "access-usage gap" in digital technologies. Although more than 90 percent of MFI borrowers are women, less than 20 percent of digital finance users are women. This shows the existence of a significant gender divide in access to DFS, which has strong repercussions on the uptake of digital technology by MFI members.

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

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

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

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