Country Analysis Paper

Investing in Micro Finance Sector in Bangladesh

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In this paper we aim to evaluate Bangladesh from the point of view of a foreign investment bank, looking to invest in the micro credit (micro finance) sector. Micro credit has been a major driving force behind poverty reduction in Bangladesh since 1976. Out of a population of 135 million, 60 million people live below the poverty line and 16 million of these people have benefited from micro credit. The demand for micro finance is increasing rapidly in Bangladesh and the supply of donor funds, the main source of capital, is decreasing. As a result, the demand for foreign investment in local micro finance institutions (MFIs) is increasing. Therefore, for a foreign investor the micro credit sector in Bangladesh promises to be rewarding, not just in economic sense but also in social aspects.

Our goal is to first analyze the strengths and weaknesses of investing in Bangladesh and then look at the micro finance industry and determine how these strengths and weaknesses affect the industry. Finally, we look at the opportunities from the context of foreign direct investors in the industry.

Bangladesh came into existence in 1971 when East Pakistan seceded from its union with West Pakistan.[1] About a third of this extremely poor country floods annually during the monsoon rainy season, hampering economic development. So far Bangladesh has received $30 billion in aid from World Bank, the Asian Development Bank, the U.N. Development Program, the United States, Japan, Saudi Arabia, and Western Europe since 1971, but the country remains poor and overpopulated.

According to the World Trade Organization, Bangladesh is mainly troubled by include political instability, civil unrest, natural disasters, and inadequate infrastructure.

Economy

Like most less developed countries, Bangladesh is a primarily agricultural country although it has been experiencing rapid urbanization. About two thirds of the population is employed in agriculture and agricultural output makes up 35% of GDP. It is mostly the agrarian people that get the most use out of micro credit. Over the last few years Bangladesh has experienced abundant corps and strong growth in the agricultural sector.

[1] CIA The World Factbook http://www.cia.gov/cia/publications/factbook/geos/bg.html

This has been a strength of Bangladesh that assures the success of micro credit projects. However, Bangladesh's heavy reliance on agriculture, with rice being the single-most-important product, makes the country vulnerable to natural disasters such as cyclones, floods and to world commodity prices. The natural disasters have proven to be real obstacles for economic growth given that 35% of the economy depends on agricultural productivity. In order to overcome this problem, the governments have aimed to diversify the economy from agriculture and they have made industrial development a priority.

Bangladesh has moved increasingly towards a market oriented economy although most enterprises remain under state control. Attempting to attract foreign investment, export processing zones have been established in Chittagong (the major port) and Dhaka (the capital), with plans for more such zones.

Most of the investment is coming in the natural gas, electricity, and physical infrastructure areas. Exports of natural gas could provide a major additional revenue source for Bangladesh, but the issue remains controversial, and no final decision has been made on whether to allow exports.

Major threats to investment seem to be unreliable power supply; high real interest rates; corruption and weakness in law and order. As the recipient of the largest flows of FDI, the energy SOEs require deep-rooted reforms to improve their financial and operational performance.

The key challenge for Bangladesh is to move to a higher growth path to help create jobs and, over time, lift the country out of poverty. The government is moving forward with a strategy to raise growth to 7% and to halve poverty by 2015. At the center of this strategy are reforms to boost private sector growth, improve the investment climate, and diversify exports. This is a pro-growth and pro-poor strategy that grapples squarely with the structural flaws of the economy. And this is a strategy that enjoys broad support across society.

Impediments to growth include frequent cyclones and floods, inefficient state-owned enterprises, inadequate port facilities, a rapidly growing labor force that cannot be absorbed by agriculture, delays in exploiting energy resources (natural gas), insufficient power supplies, and slow implementation of economic reforms. Economic reform is stalled in many instances by political power struggle and corruption at all levels of government. Progress also has been blocked by opposition from the bureaucracy, public sector unions, and other interest groups.

These factors have resulted especially in lower foreign direct investment than in other fast-growing countries in East Asia. The government's strategy is tackling these problems through a package of reforms:

1. Reforming the nationalized commercial banks to lower interest rates and stem new non-performing loans. If this reform succeeds, the nationalized commercial banks would become more efficient and would be able to cut their lending rates. Moreover, all banks should see their funding costs and lending rates fall if the government can rein in its own domestic borrowing needs to a sensible level and if adequate external assistance is guaranteed.
2. Reforming the state-owned enterprises, especially in the energy sector. Inefficient state-owned enterprises have been a serious drain on the budget.

According to the IMF these policies have already begun to pay off. The economy is gaining strength, industrial activity and exports are rebounding. Inflation is being held in check, even after needed adjustments in key prices. A smooth transition to a floating exchange rate has been achieved, and international reserves today are two and one-half times the level when the government took office.

Some key economic indicators for Bangladesh:

GDP/capita: $365 (2002)

GDP Growth: 4.4% (2002), 5.4% (2003f)

Total Debt/ GDP: 35.8%

Total Foreign Debt: $16.7 billion (2002):

Current Account Balance: $240 million (2002)

GDP Composition: *agriculture:* 35% *industry:* 19% *services:* 46%

Inflation rate: 3.1% (2002 est.)

Population below poverty line: 36.5%

Labor force by occupation: *agriculture* 63%, *services* 26%, *industry* 11%

Unemployment: 40% (includes underemployment)

Political:

Bangladesh became a true democracy in 1990. Until then it had been ruled by military figures in the form of a pseudo-democracy.

A new government under the leadership of Prime Minister Khaleda Zia took office in October 2001 after her Bangladesh National Party (BNP) won the majority of seats in parliament in a national election. Political tensions remain high in Bangladesh as the opposition Awami League party continues to stage strikes.

The BNP government has the parliamentary strength to push through needed reforms, but the party's political will to do so has been lacking in key areas.

Bangladesh is a secular state where Muslims make up 83% and there has always been relative harmony between the different religious groups.

Social

In the last decade education in Bangladesh has increased tremendously. Both female Prime Ministers have focused primarily on female education and gender awareness. Where female literacy rate used to be close to zero now it has reached 32%.

Further developments such as inclusion of women in labor force and resulting prosperity of women due to micro finance has raised objections from the fundamentalists. They complain that policies that empower women hurt their religious beliefs and values. Despite the opposition coming from the fundamentalists, the government strongly encourages and stands behind these policies.

Finally, child labor has been a consistent problem, but the government and the relevant sectors are performing the necessary reforms (minimum age requirement, schooling enforcement while working).

Micro Credit Industry

Before we proceed to analyze the investment opportunities in Bangladesh, an informative presentation of the sector in which we are planning to invest in is essential. What would be a formal definition of micro credit? Micro credit or micro finance can be defined as the extension of small loans to entrepreneurs too poor to qualify for traditional bank loans. It has proven to be an effective and popular measure in the ongoing struggle against poverty, enabling those without access to lending institutions to borrow at bank rates, and start a small business.

In 1976 when Professor Muhammad Yunus and his colleagues started giving out tiny loans under a system, now known as the Grameen Bank model. No one ever imagined that some day the Grameen Bank would be reaching hundreds of thousands, let alone two million, borrowers. Professor Yunus is thought to be the man who has changed the economic history of Bangladesh with what is now called micro credit. It is both terribly simple and, in the field of development and aid, completely revolutionary. Rather than donating billions to help large infrastructure ventures, Yunus gave loans of little amount to the destitute. A typical borrower from his bank would be a Bangladeshi woman (94 per cent of the bank's borrowers are women) who has never touched money before. Looked down upon and disadvantaged in the economic sense, micro credit gives her a voice of her own. Kept on the straight and narrow by a mixture of peer pressure and peer support, she uses the loan to buy an asset that can immediately start paying income-such as cotton to weave or raw materials for bangles etc. Normally the loan ranges[2] from 50-200 USD for one year with the average loan size being 80 USD. The interest on this loan ranges from 10% to 30% depending on the size of the loan. The borrower repays the loan in tiny weekly installments until she becomes self-sufficient. Then, if she wants, she can take out a new, larger loan. Either way she is no longer poor.

More specifically, the success of a micro credit program is determined by the following components[3]:

- Small loans - offer small loans (usually less than $100) in the beginning. Larger loans are given after the borrower has developed the skills, discipline and commitment needed for success.

- Primarily women - make loans mostly to women, who are much more committed to using their loans for the benefit of their families, and generally have stronger

[2] Grameen Bank Website http://www.grameen.org
[3] Mayfield, James B. *Choice Humanitarian*, Fall 98, pp2

commitment to repay their loans in order to qualify for larger loans in the future. For example, 86%[4] of the existing borrowers in Bangladesh is female.

- Groups of five – organize women in groups of five with each person in the group committing to guarantee the loan payments of the other members in the group.
- Weekly payments - payments are made on a weekly basis, thus helping to build discipline and consistency. Weekly payments on small loans over a period of 52 weeks also ensure that the payments required each week are small enough, that if one person in the group could not pay in a given week, the others would be able to make the payment for her.
- Lower poor - provide loans only to the poorest of the poor. These women have no other alternatives, so they are much more committed to repaying the loans.
- Required savings - require all borrowers to put some amount of money into a savings account each week that will earn interest. Establishing these savings accounts appear to strengthen the borrowers' commitment to the program, but also help to build their sense of discipline, self-esteem, and well-being.
- Interest charged - charge an appropriate level of interest usually higher than what a bank might charge, but much less than what a money lender would charge. For example, return made from interest of a new loan is generally between 2-3% of the loan per month initially, just enough to pay salaries of the employees supervising the program in the area. The interest rate charged is positively related to the size of the loan. Therefore, the return increases with the increase in the size of the loan.
- Banking business - usually hire people with a business or banking background to be village bank workers and the program is perceived to be a banking program, pure and simple in which the borrowers are clients, not beneficiaries.
- High commitment to training - a strong commitment is developed to meet with the borrowers every week on a regular schedule, to give training in literacy, health and community development, in addition to training in accounting, marketing and entrepreneurial skills.

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[4] Source: CDF

Past experience has proved that the countries most successful in implementing micro credit are often the poorest countries of the world. Let us now look at some of the basic elements that made micro credit so successful in Bangladesh:

1. Densely populated areas – The reason why micro credit programs succeed in densely populated areas is because this fact is closely related to the principles of the micro credit systems. These principles are:

    a) Group solidarity: group members are accountable to one another individually, and also are responsible for each other jointly. Thus if one member in the group cannot pay back the loan or defaults then the other members bear her liability and are responsible for paying back her loan.

    b) Peer pressure: group members put pressure on each other for proper utilization and timely repayment of the loan. Proper utilization of loan is very important in micro credit programs because it is expected that the loan will be used for generating income, and from this income the loan will be repaid. If the loan is misused the repayment becomes a burden to the poor client.

    c) The third important principle is the attendance in the weekly meeting. The meeting is important because it becomes a forum where group members see each other periodically and discuss issue and problems. Members also pay back the loan's installments in the weekly meeting and in case of default by a member the others can take joint decisions.

    d) For financial sustainability and administrative convenience of the program it is necessary that a certain number of members must live in close proximity.

2. Flexibility in NGO operations from governmental control in terms of operations of the loan programs and charging of interest on loan –

Bangladesh is one of the few countries in which non profit organizations (NGOs) have had complete freedom from government regulations to experiment with different models of micro credit programs. In the early 1970s, just after independence, a few NGOs like Grameen Bank and BRAC started with very small credit programs. As benefits of these programs became evident, more and more NGOs took up similar programs, and in the 80s and 90s witnessed a mushrooming of credit programs all over the country. The foreign donors also supported this activity and as a result there was a massive inflow of funds in the micro credit sector both for the government and the non-profit sector. Not only that, these NGOs also began to experiment with new models, retaining successful elements of programs and discarding elements that did not work well. This unregulated environment, plus government's policy in supporting micro credit programs, was instrumental in making the micro credit programs successful in Bangladesh.

3. Supportive macro-economic policy, which has chosen micro credit as a tool for poverty reduction -

Since its independence in 1971, almost all the country's macro plans (5 year national Plans) have adopted micro credit as one of the important tools for alleviation of poverty, and by doing so have given recognition and support to the micro credit programs of non-governmental organizations.

However, the sector presents weaknesses as well, that should be taken into account. The major weaknesses are:

- Over-indebtedness and dependency circles among recipient groups
- Distribution of loans too "thin" that diminish the individual impact
- Strong informal and personal networks are impairing the impartiality of the process
- There is significant response to natural disasters

Regarding the opportunities of the micro finance programs in Bangladesh, they can be summarized as following:

- Development of new and better financial products and services
- Linking MFIs with formal financial markets

- Micro-insurance
- Private sector involvement
- Shift towards "Enterprise loans"
- Flexible savings and credit

Finally, among the threats for the micro finance sector in Bangladesh that we can highlight:

- The existence of too many programs reduce coordination and efficiency
- The discovery of arsenic in the country's groundwater, which is toxic with long-term consumption
- More careful selection of recipients needed for portfolio diversification
- Growing concerns for a possible nationwide HIV/AIDS epidemic, due to evidence of high-risk behavior among the population

Foreign Direct Investment

Now, let us look at the reasons as to why as foreign investors we want to invest in local MFIs in Bangladesh. In addition to the above-mentioned strengths of the sector, there is a strong existing infrastructure of micro credit organizations due to large donor contributions in this field. In fact, the micro finance industry has covered all the sixty-four districts in Bangladesh. As of December 2002, there were 15,848,442[5] existing borrowers of micro finance in Bangladesh. Therefore, there is huge a market of existing borrowers who have successfully practiced micro credit and need bigger loan to expand their enterprises. According to the latest publication of PKSF, the largest government organization dedicated to research and development of micro finance, 58,923,630 people are below poverty line out of which the micro credit industry has covered 12,131,336 people. Therefore, there is a huge market of potential borrowers in the sixty-four districts in Bangladesh.

[5] Source: CDF

Moreover, the concept of micro credit has been tested for almost thirty years and the recovery rate from the borrowers have been phenomenal (for example, Grameen Bank has over two million borrowers with a loan recovery rate of over 90%). The micro finance institutions are already operating as quasi banks in local conditions. The micro finance institutions are increasingly borrowing from local commercial sources, as donor grant is receding. According to Bangladesh Bank, the central bank of Bangladesh, the micro finance institutions have always been cited as exemplary in repaying their loans to the local commercial sources. The MFIs are borrowing from the local commercial sources at interest rate of 8-12% with the average rate being 10%. The MFIs, in return, are lending the money to the borrowers at interest rate of 15-25%. Even with 3-7% operating costs, MFIs usually secure a profit of 2-6%, to be further invested in the institution. Shakti Foundation for Disadvantaged Women, an urban micro credit organization, borrows from a local bank at an interest rate of 10%. Shakti lends money to its borrowers at an average rate of 17%, with interest rate as low as 14% for the new borrowers and as high as 22% for the existing trained borrowers. With an expense of 3-5% in operational costs, Shakti manages to secure profits of 2-4%, thereby maintaining its self-sufficiency.

Therefore, considering the risk involved, investing in local micro finance institutions makes good financial and commercial sense because a return of 10% is guaranteed as the MFIs are already paying that interest rate to the local commercial sources and the demand for significant amount of loans in the is increasing. According to the recent publication of Women's World Banking[6], Bangladesh ranks among the top countries to offer the highest return on investments in MFIs.

Now let us look at the issues that concern us foreign investors most when we consider investing in a local micro finance institution in Bangladesh -

Sovereign Macro Economic Analysis

Sovereign macro economic analysis has been done in the earlier part of the paper. We know that Bangladesh has a stable inflation rate of 3.1% and a GDP growth rate of almost 5.5%. The inefficiency of the public sector has no impact on the micro finance

[6] Women's World Banking, http://www.swwb.org

sector. Inefficient state-owned enterprises, inadequate port facilities and power supply also have no major impact on the micro finance industry. In addition, factors such as corruption and civil unrest do not affect the industry significantly because of the unique nature of the industry. The major setback of investing in Bangladesh can be its vulnerability to natural disasters.

Regulatory Environment

Micro finance institutions in the countries around the world have no authority to operate as banks by taking deposits from their clients. The practice is considered technically illegal even though the central banks of most of the countries tend to overlook the practice. In fact, in countries like India, such kind of practice is declared illegal by the Central Bank of India. The Bangladesh Bank, till now, overlooked the economic practice of the MFIs. In fact, the Bank almost had no regulation of financial activities in the local MFIs. Currently, Bangladesh bank is working on this matter with some leading micro finance institutions to create a monitoring system appropriate to the interests of both the parties. The idea is to create a monitoring unit with functions similar to the NGO Affairs Bureau, which looks at the social activities of the NGOs in Bangladesh. The NGO Affairs Bureau requires local NGOs to submit a proposal outlining their activities for the year in the beginning of each year. The Bureau monitors the activities by the NGOs throughout the year to see how successfully they are achieving the set goals. The NGO Affairs Bureau is known to be extremely cooperative and helpful to the needs of the local NGOs. The monitoring unit of the Bangladesh Bank will provide similar services specifically to the local MFIs, instead of all the NGOs. Therefore, historically and currently, the government directive backs the financial activities of the local MFIs – a great plus for the foreign direct investors to invest in the micro finance industry in Bangladesh.

Sector/Industry Analysis

In addition to the strengths and weaknesses of the micro finance industry discussed earlier, we analyze the risk of investing in the industry by also looking at the growth rate of the industry. The number of borrowers of micro credit is growing in a phenomenal rate and so is the disbursement of loans to the new and existing borrowers. According to CDF data, the amounts disbursed in loans to the new borrowers were US$ 1,540,603.33 in 1999, and by 2002, the amount disbursed went up to US$ 3,476,984.17. The increase in the amounts of new loans disbursed in 2002 from 2001 is more than 35%. When we look at the past growth rate, we see that the increase in 2001 from 2000 was over 40% and the increase in 2000 from 1999 has been over 30%. We need to also look at the growth rate of individual MFIs. It is important to look at the credit risk and the liquidity risk of the institution of interest. Since most of the MFIs already perform external auditing due to donor requirement, reliable data is not difficult to obtain from successful MFIs. Due to the tremendous flexibility given by the government in this sector compared to the other countries in the world, the growth rate of micro credit has been exceptional, prompting micro credit to expand much faster in Bangladesh.

Management Quality of Institution

The management works mostly in two levels in most of the local MFIs in Bangladesh – the board and the management. The major policies of the institution are determined by the general committee of the board while the administration is monitored and supervised by the executive committee of the board. While looking at a potential MFI to invest in, it is important to look at the members of the board because the constitution of the board is a good indicator of how solid the institution is. A strong board often reflects a capable management because the efficiency, skills and the knowledge of the management are constantly tested. The quality of the different units of the management, for example, the discipline of the Finance Unit or the experience of Administration Unit, often reflects the future performance and the stability of the institution along with some other indicators, depending on the nature of the institution. For example, Citigroup looks at its capital structure, capital planning, forecasting etc. to determine the management quality of its institutions.

Operating Financial Analysis

We need to look at the self-sufficiency of the MFIs that we are interested to invest in. As mentioned before, due to the donor requirements, most of the MFIs perform external audits by reliable external audit firms. Therefore, reasonably accurate financial statements can be collected, which will give us sufficient data to look at indicators that will point towards the level of self sufficiency of the institution. The financial statements, that is, the balance sheets, the income statements and the statement of cash flows allows us to perform accounting tests like tests of profitability, tests of liquidity and tests of solvency. These tests and the accounting ratios used in these tests give us a general picture of the performance of the institution and broadly answers the key question whether the institution is profitable, liquid solvent enough to pay back the investment with return. It is also important to look at the repayment rate of the borrowers to the MFI. The repayment rate determines how much money is being paid back by the borrowers to the MFI and the on time repayment rate and accounts receivable informs us about the efficiency and competency.

Moody's Investors Service, for example, addresses several of these factors while rating a MFI in a country. Moody's performs sovereign macro economic analysis of the country, looks at the regulatory environment of the country as a whole and by the sector of interest. In addition, Moody's analyzes the industry looking at the past and future growth rates and the credit risk and liquidity risk of the institutions in the industry. Also, Moody's pays attention to the management quality and the financial analysis of the institution before rating the MFI.

The foreign investors like us, therefore, want these MFIs to be rated by credible rating institutions to address most of these concerns so that we can look at the ratings and set the minimum standard required for us to invest in different MFIs. This way we can select specific MFIs we are interested to invest in and send our own analysts to the institutions to do more detailed analysis.

Some of the financial instruments offered to or by foreign investors are bonds, security and capital equity. Local micro finance institutions can issue bonds to the foreign direct investors and raise money to invest in the organization. Grameen Bank issued bonds in its early days to raise money from the local commercial sector. The foreign direct investors can also provide security to local commercial sources to lend money to the local MFIs. Shakti Foundation borrowed money from a local bank using SDC (Swiss

Development Corporation) as the guarantor. Capital equity is another instrument where foreign investors invest a fixed amount of money, say US $100,000 in a local bank for a fixed interest rate and time. Then the investors ask the bank to lend some multiple of the amount with low interest rate to a local institution for a fixed period of time.

Names of some of the Foreign Investors who have expressed interest in investing in the micro finance institutions in Bangladesh are Oikocredit (Netherlands), Triodos Bank, BIO, Deutsche Bank, Shore bank and Citibank. Some of the credible institutions that have been rating the local micro finance institutions are Microrate, Moody's, Fitch and Standard & Poor.

We can take the recent investment made by Deutsche bank in a local MFI in Bangladesh in Bangladesh. Microrate has recently rated Shakti Foundation *alpha*, the highest rating given by the rating institution. Deutsche Bank's decision to invest in Shakti Foundation in the form of Capital Equity was significantly influenced by the rating, along with factors such as the return on investment and the social benevolence.

Therefore, after analyzing Bangladesh, the micro credit industry and the strengths and weaknesses of investing in the industry as foreign direct investors, we believe that we should invest in the micro finance sector in Bangladesh. Investing in micro finance not only offers us a safe return on our investment, but also provides us with the opportunity to establish the disadvantaged poor in the society. We are convinced from our analysis that the sector has ample potential to expand and grow. If we invest now, we can also expand our investments with the growth of the industry. Therefore, as mentioned earlier, we need to look at the ratings of the local MFIs, select the ones we are interested to invest in and send our own analysts to do more detailed analysis.

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