Leaving a legacy in market facilitation within the financial sector

-Business Finance for the Poor in Bangladesh

Section 1: The Context

Bangladesh, once known as the country for its wrenching poverty and natural disaster, has become one of the world's economic success stories. Aided by a fast-growing manufacturing sector - its garment industry being second only to China's, Bangladesh's economy has averaged above 6% annual growth for nearly a decade.

The booming economy has been largely driven by its 8 million micro and small business, which contributes to nearly 25% of the GDP and employs over half of the country's workforce. The export-oriented industrialisation has been another key area of the success story. Key export sectors include textiles, shipbuilding, fish and seafood, jute and leather goods. It has also developed near self-sufficient industries in pharmaceuticals, steel and food processing. The economy is diversifying. The service sector – including microfinance and computing contributes to 53% of the GDP. The success of the IT industry is central to digital transformation with nearly $1 billion technology products being exported every year – a figure that the government expects to increase to $5 billion by 2021.

Despite such economic growth, the financial sector of the country was still underdeveloped during the early 2010s. Only 29.1% of the adult population had bank accounts with 8.5 bank branches for every 100,000 people. Although the banks have been able to serve the big and medium enterprises well, there was a dearth of financial instruments that could serve the need of the country's emerging small and micro enterprises.

Section 2: Role of MSMEs and Market structure

Small enterprises play a crucial role in generating employment and driving economic growth and poverty reduction in Bangladesh. Data from

Bangladesh Bank (BB) estimates that the country's 8 million Micro, Small and Medium Enterprises (MSMEs) contributed to 25% of the country's GDP in 2012, generating employment for over 28 million people, and accounting for 52% of the total employment in the whole country. These firms however experience severe constraints in accessing the finance they need to grow, develop and most critically, increase their productivity. These financing constraints are particularly acute for smaller, micro-sized firms (MSEs). This is reflected in the most recent World Bank Enterprise survey in Bangladesh which found that 26.5% of small compared to 22.7% of medium sized local firms consider access to finance a major constraint. The equivalent survey in India finds that just 15% of MSMEs find access to finance a major constraint. Globally, the number is close to 30% . The unmet demand for financing in the MSME segment in developing countries is valued at $5.2 trillion.

This finance gap suggests that 59% of potential demand for MSME finance is unmet. Interestingly, within the total MSME finance gap, 14% share is attributed to the microenterprise finance gap and 86% to the SME. Such imbalances indicate that microenterprises have relatively higher unmet needs from formal sources, which might be replaced with alternative sources, such as funding from friends and family, business partners, peer-to-peer markets or informal financing arrangements.

Across regions, government and aid agencies have followed a traditional delivery approach for financial inclusion - directed lending in banking sectors, and although as a foundation for financial inclusion such initiatives do bring in results in terms of access, they are not fully sustainable because of the lack of the ecosystem support needed.

Bangladesh government has made significant progress in establishing a robust financial sector. Bangladesh's financial sector has been able to outperform countries with similar demographic and socio-economic status across the globe in terms of providing access to formal financial services for individuals and households. The microfinance sector is serving nearly 27 million clients, majority of them micro and small entrepreneurs, with SME banking portfolio of BDT 53,000 crores.

In comparison, the formal financial sector, specially the banks, was unable to serve the needs of MSMEs in Bangladesh. While MSMEs are being served only by the microfinance sector, they lack access of options of financial services that meet their needs. By addressing the constraints impacting on the ability of these enterprises to access finance, there is a potential space to make a sizable contribution to the expansion of regular paid employment for poor women and men, and, at a more macro level, contribute to the competitiveness and growth of the Bangladeshi economy. Government regulations have also seldom enforced banks to lend to the SMEs and agriculture sector, however, considering it a riskier initiative, banks have found alternatives- by doing wholesale lending through MFIs.

During the year 2013 and 2014, DFID Bangladesh together with the government decided to create a flagship initiative to directly address the problem of unserved and underserved MSEs by financial sector. They identified the lack of a nurturing ecosystem for small businesses in Bangladesh and initiated the business case for a project that would create a vibrant eco-system comprised of (a) micro and small enterprises that drive growth and employment and (b) a dynamic financial sector that offers a diverse set of products and business models to meet their needs.

In order to achieve that, multi-layer interventions were needed, that works at macro level to have a cohesive and nurturing policy and regulatory environment, at meso level to ensure proper infrastructures are in place and at micro level to ensure innovative business models address the lack of access to finance for MSEs. The underlying cause for the lack of ecosystem support for MSMEs is so prominent across regions is because there is:

- lack of visibility of small businesses- as majority of the small and medium enterprises do not have a formal cashflow and inventory management system, it is difficult for them to prepare paperwork that proves their financial capacity.
- lack of collateral- as majority of the micro and small entrepreneurs have limited assets, they find it difficult to show collateral which a major requirement of the banks.

Section 3: Market systems approach of BFP-B

Typically, development projects address problems instead of addressing root causes, which is why problems persist even after development projects end. Majority of the interventions of development projects acts as service providers and try to address the needs of the beneficiaries, hence when projects end, there is no provision in the market to continue.

Nathan associates, the managing agent of flagship programme- Business Finance for the Poor in Bangladesh (BFP-B) took a market systems approach as there was a need to counter-point market system approach over delivery approach, e.g., traditional approach to small business finance-directed lending. As good as these initiatives are, they cause major drain in fiscal resources and regulatory enforcement doesn't always generate sustainable results.

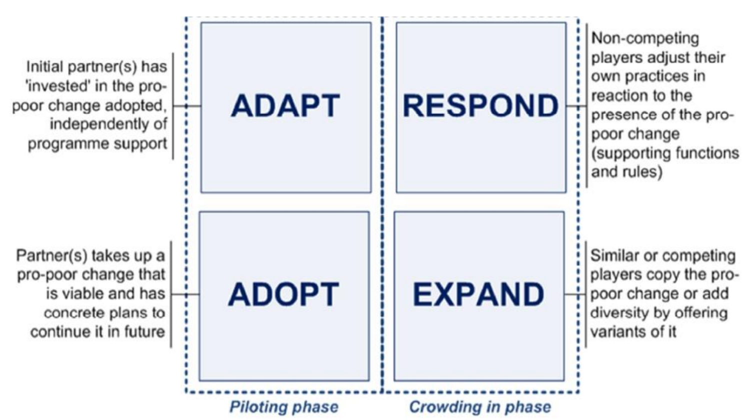
Unless financial institutions find that small businesses are a key commercial value proposition, they will only intervene through compulsion and there are limitations to that compulsion. In order for the financial institutions to consider MSEs as viable business opportunities, specific systemic constraints of the market system needed to be identified and addressed through market facilitation. The programme tried to identify root causes of underperformance of different financial sector ecosystems- focusing on three areas:

a) High cost of acquisition- manual processes to acquire and process services for MSEs was costly and time consuming
b) Lack of engagement with small businesses- there wasn't a clear recognition of lifetime value of small businesses to banks
c) Lack of pipeline for investors -there wasn't any structured mechanism for investors to invest in MSEs

BFP-B has taken a facilitative and non-linear approach with these constraint areas where they engaged with market actors and re-designed incentive mechanisms for the market actors to continuously offer services beyond project life cycle. Multi-layer interventions were implemented to address the macro level, meso level and micro level challenges.

a) Policy - by generating evidence and recommendations to build the case for regulatory change, improving sector coordination and building consensus between regulators and market actors to facilitate adoption of recommendations for policy change, and advising and assisting the Ministry of Finance and regulators to put the changes into operation.
b) Challenge fund - by absorbing some of the financial-risks associated with investing in these business models through a grant of up to 50% of the project, BFP-B buffered the private sector to overcome market failures that would otherwise prevent them from making an initial investment, either from the cost of information discovery, costs of mitigating risks or simple lack of available capital.
c) CIB - by helping the government to establish a functioning credit information bureau for the microfinance sub-sector that will generate credit reports for microfinance borrowers, at least 30% of which are classified as small businesses.
Improved credit histories can -
i. enhance credit worthiness of microfinance borrowers
ii. improve loan portfolio quality of microfinance institutions
iii. create the condition for graduation of small businesses from the microfinance sector to the commercial bank
iv. create opportunities for the microfinance sector to secure additional capital from investors

An effective way of addressing the constraints would be, the entry into the market, adoption of business models and initiation of operations by early adopters, gradually paving the way for other firms. However, that's not enough if the ecosystem is weak and restrictive. Refining ecosystems needs use-case evidence. This approach fits into the market systems development programmes that aim for systemic change leaving behind systems that work



better for the poor. A systemic change framework was developed in response to two-fold management and measurement needs.

The piloting phase – the firm level stages:

Adopt
A market player has successfully adopted a behaviour/practice change to the ultimate benefit of the poor producer/worker/consumer, recognises the value of continuing with these changes irrespective of programme inputs, and has accordingly made plans to invest in upholding these changes and cover any associated recurrent costs.

Adapt
The market player(s) that adopted the behaviour/practice changes pioneered during the pilot
has made qualitative and/or quantitative investments that allow them to continue with or augment changed practices, without programme support. These actions, independent of the programme, constitute an 'acid test' for whether pro-poor outcomes will sustain at any level.

The crowding in phase- the market level stages:

Expand
A number of market players, similar to those that pioneered the pro-poor behaviour/practice changes, have adopted comparable changes - either pure copies or variants on the original innovation - that are upheld without programme support.

Respond
The emergence and continued presence of the pro-poor changes have incited market players in supporting systems to react to the new market reality by re-organising, assuming new/improved roles, developing their own offers, or moving to take advantage of any opportunities that have been created. The response enables pro-poor behaviour/practice changes to develop further, or evolve, and indicates a new capability within the system, suggesting that it can and wants to support pro-poor solutions to emerge and grow.

Section 4 – Analysis of BFP-B initiatives across the financial sector

National Financial Inclusion Strategy-Bangladesh

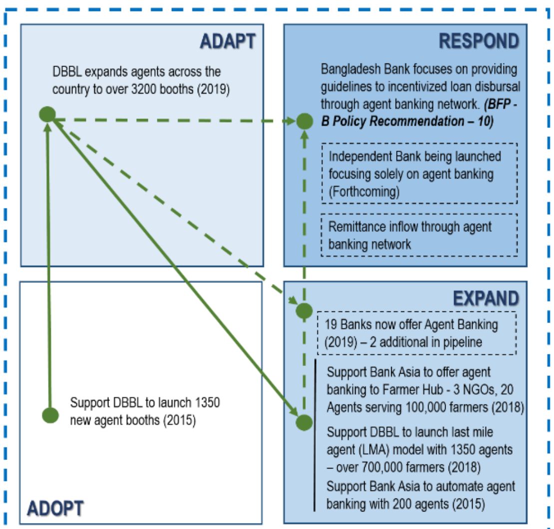
BFP-B with support from Financial Institutions Division, Ministry of Finance and renowned policy experts developed an overarching strategy to ensure a cohesive ecosystem support for the MSMEs. The National Financial Inclusion Strategy (NFIS) was developed to support the government to ensure sustainable and impactful financial inclusion through digitisation and innovation.

NFIS is a roadmap of actions, agreed and defined at the national or sub-national level, which stakeholders follow to achieve financial inclusion objectives. It provides an important opportunity to introduce an evidence-based, prioritised, better resourced, and more comprehensive approach to expanding access and usage of financial services. This strategy has been formulated with 5 objectives and 12 strategic goals consisting of 65 targets on financial inclusion of Bangladesh. To implement NFIS-B, the role of financial service providers and development partners has been elaborated. The coordination structure of NFIS-B has been segregated in four tiers by keeping the Minister, Ministry of Finance on top as the strategic chief. Bangladesh Bank has been identified as central implementing agency to establish the national secretariat of NFIS-B.

The successful implementation of NFIS in Bangladesh would strengthen financial sector and institutions as well as improve efficiency of transactions. It will also help to extend support to businesses to manage liquidity, access credit, mobilise savings for investment and mitigate economic shocks.

Making digital transformation and omni channels work in the banking sector

Rural and semi-rural MSEs lacked access to banking services due to inadequate bank network penetration. Accessibility to banking facilities was difficult as on average each person had to travel 7 km to go to the nearest banking facility. In 2015 only DBBL and Bank Asia started its agent banking operations and had a small portfolio of just over 1200 outlets. BFP-B played a pivotal role in expanding agent banking network across the country, when it partnered with these two first adopters.



Initially BFP-B worked with DBBL to expand their network with 1350 agent booths in 2015-16 (Adopt); back then DBBL had roughly 1500 booths, which now stands at over 3300. Following success of this intervention, BFP-B further partnered with DBBL to deepen the outreach of the established agent network outreach by offering door to door banking services to individuals and small businesses. This initiative extended banking services and financial literacy to clients. This model was a massive success because the original target of 250,000 had already reached over 700,000 clients (Expand).

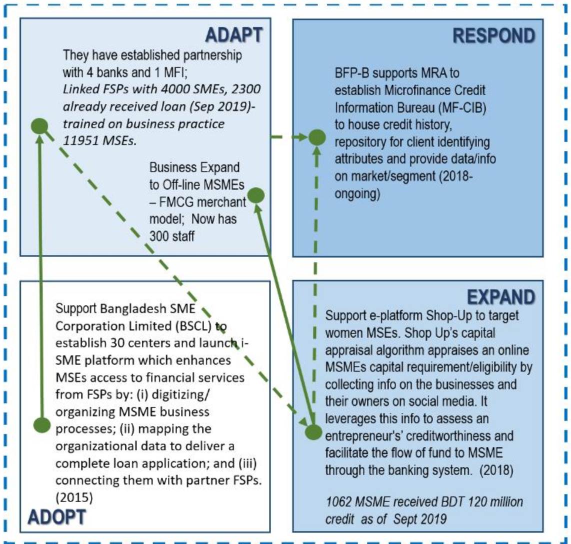
BFP-B also supported Bank Asia in improving cost efficiency by triggering digital transformation in their business processes and through setting up one-stop service centres for agri-entreprenuers. The model helped to reduce processing times and transaction cost (Expand).

BFP-B has also commissioned policy research and influenced Bangladesh Bank to formulate guideline that will incentivise banks to offer credit through their agent network. Once this guideline is issued (forthcoming in Feb 2020) i.e. institutionalised, this will create 'response' in the financial market and expand the credit market through agent banking network (AAER)- see backward arrow above.

Agent banking sector now has over 9000 outlets operating across the country and nearly 40 lakh accounts that have mobilised remittances of TK 11,937 crores and deposits of TK 6,169 crores in 5 years. The success of such innovative initiatives has contributed towards a systemic change in the market by facilitating country wide expansion and improving cost efficiency. However, DBBL and Bank Asia still owns 89% of the market share despite having 19 banks operating in this space, implying that a proper crowding-in in this sector hasn't happened yet. Another important factor that needs addressing is the low AD ratio, which was at 5% by the end of 2019 and is far from the ideal ratio of 75-80%. This implies that loan disbursement through this channel has not picked up yet and the credit potential of the rural population is still unmet.

Making digital transformation work in the microfinance sector

Fintech for MFI client acquisition- Rural smallholder farmers and agro MSEs are often financially excluded because they lack the preparedness and financial literacy to comply with bank requirements and thus are discouraged from applying for fear of rejection. MSEs lack the internal readiness which would allow banks the necessary confidence to evaluate and extend financial products to them.



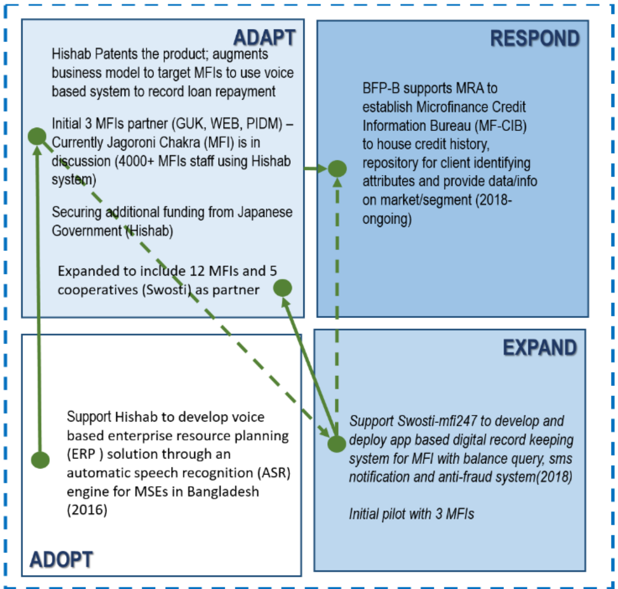
To address this issue, BFP-B tried different approaches. In 2015, BFP-B partnered with Bangladesh SME Corporation Limited (BSCL), to establish a semi-automated ERP platform for MSEs which would help to link the MSEs to the FSPs. The i-SME platform enhances MSEs access to financial services from FSPs by: (i) digitising/ organising MSME business processes; (ii) mapping the organisational and financial data to deliver a complete loan application; and (iii) connecting them with partner FSPs. So far, they have already linked FSPs with over 4000 SMEs, out of which nearly 2300 have already received loans. Using such a data-enabled platform would enable the MSEs avail further opportunities for accessing all types of financial products including venture capital funds.

As further expansion into the area of alternative credit rating, BFP-B has invested in Shop-Up mainly for developing alternative credit assessment algorithm, loan application app, providing business development services to merchants who are using ShopUp app to run their online businesses, train MSEs on the loan application process, developing merchant success stories and promoting the success stories through social media. BFP-B's investment in Shop-Up gave it credibility and acted as a catalyst resulting in additional investment from other sources (e.g. Gates Foundation). From a small start-up that BFP-B invested in, Shop-Up is now a company with over 300 staff. They have also adapted their business model and are shifting to offline MSE support as well which has the potential to be a major source of revenue in future. Through this platform so far, over 1000 MSEs received credit valued at BDT 120 million.

Through another initiative, BFP-B partnered with CRAB to pilot an alternative credit scoring tool to address the complexity of client provided information verification and conventional risk assessment process. This initiative would utilise transaction data and telco data coupled with machine learning approach to generate credit scores for clients. So far, the credit scoring tool has been developed and the firm is seeking to partner with microfinance institutions and banks to link the clients to them. This would be a ground-breaking model for financial inclusion. With XX million subscribers, practically this initiative has the potential to bring every mobile phone user under formal financial service with particular focus on credit access.

BFP-B's efforts in supporting creditworthiness of MSEs goes beyond working with the private sector. A major initiative of BFP-B is supporting MRA to establish MF-CIB, a credit information bureau for MFI clients. This initiative will be a massive leap to ensure financial visibility of the MSMEs and would play a big role to address the credit gap of the MSME sector. Furthermore, this initiative will give the MSEs an opportunity to graduate to formal banking sector to utilise their full credit potential as they would be able to meet the credit history requirements set out by most banks.

Fintech for MFI efficiency- The microfinance sector is the most easily accessed financial services for the MSEs, however, this comes at a price-high interest rate. The rates are high as the microfinance sector has high cost of operation since majority of the process is manual and requires more manpower compared to other FSPs in the financial market.



BFP-B ventured into an opportunity to work with MFIs to improve their cost efficiency with Hishab, an innovative Fintech provider, to support their development of voice-based enterprise resource planning (ERP) solution through an automatic speech recognition (ASR) engine for MSEs in Bangladesh. The partnership began in 2016 and initially was supposed to target MSEs directly, however, since the model has been augmented and Hishab has partnered with 3 MFIs to use their patented voice-based recognition system to record repayment from client. This significantly brings down transaction cost, delays in record keeping and even reduces incidence of financial misappropriations at the field level. With this new model Hishab has moved away from directly targeting MSEs to targeting MFIs and so far, has partnered with 4 MFIs covering 4000 MFI agents. This initiative's success has also helped to secure funding from JICA.

With the intention of driving cost efficiency by supporting digital transformation within MFIs, BFP-B partnered with Swosti mfi-247. It is a digital platform that digitises MFI back office business processes, courtyard meetings and replaces the paper-based loan application processes. The model has so far expanded with the company partnering with 12 MFIs and 5 cooperatives. In the long run such models increase efficiency and staff productivity for MFIs and thus incentivising them to reduce cost of capital and compete with other FSPs.

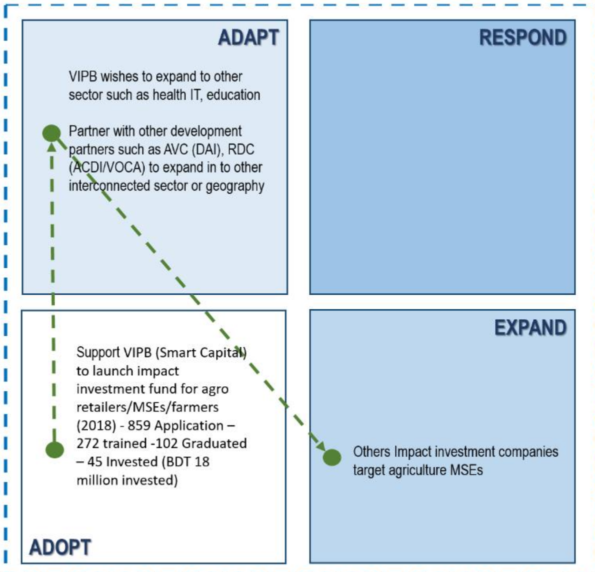
These fintech based interventions within the microfinance sector to drive the cost efficiency and ensure visibility for MFI clients by itself are big successes, however, to ensure systemic change, more such interventions need to be implemented in a much bigger scale.

BFP-B has also worked with Microcredit Regulatory Authority to develop guideline on Microenterprise lending to structure lending policies for micro enterprises. This policy would help MFIs to have identify and differentiate micro enterprises with the structured definition and standardise the lending process and reporting procedures.

Making blended finance work for MSEs

Rural smallholder farmers and agro-based MSEs often lack the access to formal financing that suits their repayment capability. Formal finances are available in the market, such as microfinance which is of short term and do not always suit the repayment capability of farmers/MSMEs. To address this, in 2018, BFP-B with VIPB along with its consortium members invested in launching a comprehensive program that includes running an accelerator programme for agri-entreprenuers, establishing and operationalising farmers' hub through seed and quasi-equity investments.

VIPB is a long-term business model as they need to invest for at least 4 years before expecting any return. While it is still too early for having meaningful progress towards systemic change, BFP-B's contribution did support VIPB to secure additional collaboration with other corporate and donor agencies. The following diagram showcases how BFP-B envisages this intervention to evolve after the project comes to an end. Through this



initiative 272 MSEs received training through the accelerator programme, out of which 102 MSEs graduated. Patient capital, equity and quasi-equity investments in rural areas were completely unheard of specially in Bangladesh. Bringing this type of financing tools to rural MSEs is a major step towards broadening the scope of financial instruments within the capital market as this offers the much-needed financial choice for agro-based MSEs.

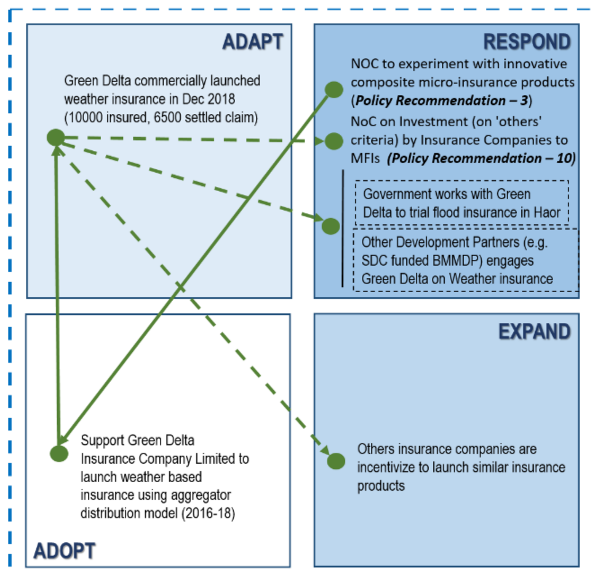
BFP-B has also worked with ACACIA and its consortium members to develop for the first time in Bangladesh, an investment platform to manage the impact focused fund invested in MSEs. The platform has an extensive array of features including screening, investing, monitoring, reporting and assisting better management of MSME portfolio. The platform enables the measurement of impact generated through investment made by the fund.

Overall, through these initiatives BFP-B facilitated seed and equity investment of over GBP 1.6million across over 1,300 MSEs.

In order to initiate innovative MSE financing at a broader scale, conducted a policy study on Innovative MSE Financing products and delivery channels. The recommendations include taking a regulatory sandbox approach to test visibility of innovative MSE financing instruments and amending the existing Bangladesh Security Exchange Commission (BSEC) Alternative Investment rules, 2015 to include crowdfunding as an alternative investment tool.

Making digital transformation work in the insurance sector

Bangladesh has one of the lowest insurance penetration rate of less than 1% in the world. Insurance penetration in majority of the developing countries is within the range of 20-25%. There are multiple systemic constraints for this low penetration, which includes lack of suitable products, lack of ecosystem for offering tailored for agriculture and livestock, lack of trust and lack of



suitable technology for widespread adoption and diffusion of insurance services.

In 2016, BFP-B partnered with GDIC, the sole insurance company in Bangladesh offering agro-insurance, to promote agriculture weather-based insurance product using aggregator or distribution partner model. They developed a weather index-based insurance targeting agricultural cultivation. The intervention was quite successful and has reached over 10,000 farmers and settled nearly 6500 claims. Furthermore, GDIC has commercially launched the product in Dec 2018 (Adapt).

Again in 2018, BFP-B partnered with GDIC and BRAC bank to support an innovative cattle insurance project that insures the cattle financed by BRAC Bank. This model provides risk assurance for cattle farming, which is a high-risk initiative as cattle are always subject to death from disease, accidents and calving. This initiative is first of its kind as it provides bank loans for farmers without requiring any form of collateral.

Another major initiative of BFP-B in the insurance sector is the collaboration with Pragati and INAFI as for the first time in Bangladesh they developed a composite natured insurance product that covers MFI borrowers for life, assets and liability. This initiative is first of its kind between microfinance and insurance sector for the MSMEs who are more vulnerable to various risks. However, due to regulatory constraints, no other agencies other than insurance companies can offer insurance products. Therefore BFP-B together with MRA and IDRA, the MFI and insurance regulatory authority respectively, obtained a No Objection Certificate which would allow this pilot scheme to continue. It is envisaged that other insurance companies will enter the market in view of this (Expand).

To address bottlenecks on MFIs and insurance companies working together, BFP-B further 'broadened' its collaboration with IDRA and MRA and after series of consultations and facilitations, IDRA is now poised to issue NoC on 'Investment by Insurance Companies in MFIs'. Once approved, it will incentivise insurance companies to collaborate with MFIs and expand crop insurance. While this is a direct outcome of the challenge fund initiative, the experience informed in the decision making thus demonstrating that one initiative taken to address one issue, can lead to a conversation and thus addressing further issues in that area.

Section 4: Conclusion and way forward

The multifaceted approach of BFP-B across the subsectors has addressed numerous supply-side, demand-side and regulatory issues. **It has facilitated for financial and business development services for 1.4 million MSEs, loans worth GBP 115 million, mobilised deposits worth GBP 145 million and leveraged private sector funding of GBP 204 million .**

All these interventions have contributed to the rapidly transforming financial market however, more such interventions are required to achieve systemic change. Sustaining the momentum triggered by BFP-B across the sectors and taking forward such innovative business models and policy reforms is critical. Lessons and learnings from the multi-layer initiatives needs to be taken forward by both the public and private sector partners

- **Taking the banking sector forward with digital transformation and omni channels:**
    - Adopt alternative credit scoring tools to assess small ticket loans
    - Establish single service points for financing, insurance and transaction services
    - Establish interoperable systems across the multi-channels
    - Redesign with digital infrastructure for a unified distribution channel approach – a seamless blend of physical and digital channels
- **Digitising the microfinance sector to improve productivity and cost efficiency:**
    - Implement end-to-end digital transformation in financial institutions- processes, infrastructure and human resources

    - Collaborate on shared platforms to reduce capital expenditure
    - Establish one-stop solutions for cross-sectoral regulatory approvals
- **Digitising the insurance sector to introduce tailored products for MSEs:**
    - Continue experimentation with insurance products to meet MSE requirements
    - Focus on development of support service market (weather-data, distribution model, actuary) for competitive pricing of insurance services
    - Establish one-stop solutions for cross-sectoral regulatory approvals
- **Creating blended finance for catalysing investments for MSEs:**
    - Inform and coordinate with regulators to activate regulatory support
    - Assist in robust business modelling and preto-typing by strengthening the network of mentors and accelerators
    - Create an investment platform for early stage startups and corporate innovative venture

While BFP-B has made meaningful progress in this journey, it will require sustained public sector commitment and development partner support in building an eco-system which will incentivise the private sector to innovate, introduce disruptive business models and channel investment to growing businesses.