

THE DEMAND FOR FLEXIBLE MICROFINANCE PRODUCTS:  
LESSONS FROM BANGLADESH

by

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# THE DEMAND FOR FLEXIBLE MICROFINANCE PRODUCTS: LESSONS FROM BANGLADESH<sup>1</sup>

## I. Introduction

Many microfinance institutions (MFIs) have developed large-scale operations by offering a few highly standardized products. In offering “one-size fits all” loan terms and conditions, they streamlined loan administration, simplified decision-making for field staff, reduced the information required from clients, and held down operating costs. By limiting the range of interest rates, repayment schedules and the way interest is charged, they also simplified the calculation of repayment obligations and the explanation of those obligations to uneducated borrowers.

Simplicity has its drawbacks, however, and these are now becoming clearer. Many MFIs are reporting high dropout rates and repeat borrowers do not demand the larger loan sizes assumed in many MFI market projections. Also there are potential clients who refuse to join programs even though the products offered were supposedly designed for them. This has led MFIs to re-evaluate their business plans and pay closer attention to product flexibility. Focus groups and marketing studies are being used to better understand client preferences. MFIs are experimenting with more flexible products designed to retain existing clients and attract new ones, especially in markets where competition among MFIs is becoming most intense.

The objective of this paper is to analyze the literature regarding these issues for Bangladesh, one of the prominent microfinance countries. Bangladesh is especially

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interesting because of its competing and innovative MFIs. Several have been operating long enough so that problems have emerged that are not yet evident elsewhere. The country is also interesting because of the high population density, the significant outreach achieved by the MFIs, and the example of the Grameen Bank considered by many to be the flagship of the industry.

The next section of this paper reviews evidence suggesting that MFIs in Bangladesh are failing to meet market demands for financial services. The third section reviews some of the changes MFIs might implement to better serve clients. The fourth section summarizes the experience of a major MFI in Bangladesh that attempted to transform its savings products. The final section identifies reasons for the slow pace of change in the country's microfinance industry.

## II. Evidence of Unmet Demand

MFIs in Bangladesh have done many things right. Outreach, for example, has expanded at a rapid pace. At the end of December, 2000, the 585 largest MFIs in the country that furnish data to the Credit and Development Forum (CDF) reported a total of over 11 million members with almost eight million holding outstanding loans in a total amount of about \$440 million (CDF, 2001). In addition, the Grameen Bank reported over 2.3 million members with total loans outstanding of about \$250 million making a total of some 13 million microfinance clients out of a population of about 130 million people.<sup>2</sup> But in recent years, there has been considerable self-examination by MFIs along with criticisms from analysts about product rigidity. The fact that MFIs have experienced high dropout rates and that many in the target population refuse to participate suggests to

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<sup>2</sup> On the one hand, this number underestimates total microfinance clients because it does not include microlending by banks, government agencies, foundations, etc. but, on the other hand, overestimates client numbers due to multiple memberships as described later in the paper.

some that something may be amiss. Although no comprehensive studies have been done, case studies and fragmentary data on five different indicators can be interpreted as evidence of client dissatisfaction and unmet demands.

#### 1. Exclusion and non-participation

Surprisingly little data are available about the number of eligible households that choose not to participate in MFI programs even though they lack access to formal finance. Bangladeshi MFIs use the rhetoric of serving “the poorest of the poor,” but it is generally understood that most do not reach the truly destitute groups composed of widows, orphans, the chronically sick, and the mobile landless (Wright, 2000).<sup>3</sup> Several explanations, including self-exclusion and other factors, are provided for this fact: the poor are too risk averse to participate and incur debt, they are too busy eeking out a living to participate in groups and attend meetings, members in group lending programs exclude the poor out of fear that they will not repay on time; and loan officers, who are evaluated on loan recovery performance, discourage the participation of the poorest out of fear they will not repay. Evans et al. (1999) listed five sets of client-related barriers to participation: insufficient resources, ill health or vulnerability to crisis, being a female head of household, lacking education, and individual and household preferences.

In an early survey, the World Bank and the Bangladesh Institute of Development Studies surveyed households during the crop year 1991-92 in 72 villages where only one of three different MFIs operated. Less than 45 percent of all eligible households participated in the MFIs that operated in these villages. The participation rates were 44

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<sup>3</sup> Sebstad and Cohen (2001) categorized 40 percent of BRAC’s clients as being extremely poor, 35 percent as being moderately poor, 25 percent as being vulnerable non-poor, and a negligible number being destitute. An implicit admission of this fact is that BRAC has designed a special program for the poor in conjunction with the government and the World Food Program that targets destitute rural women for food grain assistance and savings and credit services (Hashemi, 2001).

percent in the Grameen villages, 52 percent in the villages of the Bangladesh Rural Advancement Committee (BRAC), and 33 percent in the villages of the RD-12 program of the Bangladesh Rural Development Board (Khandker, 1998).

A 1994 survey of areas served by the Rural Development Programme of BRAC revealed that 60 to 65 percent of the eligible households did not participate (Evans et al., 1999). Nonmember households were found to have fewer assets, had lower income, were more reliant on wage labor, and were more likely to be landless compared to member households. Eligible nonmember households were also smaller in size, with lower dependency ratios, less education, and more likely to participate in other NGO programs. A more recent survey reported that of the two-thirds of rural households that did not participate in MFIs, some 30 percent were not willing to do so, but this number was inflated because it included some households not eligible according to MFI rules, such as owning too much land (BIDS, 1998).

An access study was conducted in four villages in which the Grameen Bank and BRAC were active (Hashemi, 1997). Only 57 percent of the target group households joined one of these MFIs. The major reason given for not joining was that people felt they would not have income to pay back loans and would be forced to sell what little possessions they had in order to repay. Some women reported that leaving the home to attend required meetings would violate social norms. Thirteen percent of the women wanted to join but were not accepted by group members who felt the excluded were too risky. In a 1997 study, the Association for Social Advancement (ASA) reported on interviews conducted with staff and clients to determine why its program did not reach many of the poor. The most frequent responses included the lack of minimum clothing

required to attend meetings, discouragement and threats from local elite, and age requirements (ages 18-50). By setting a relatively low maximum age requirement, ASA excluded old people who are often poor.

Wright (2000) argued that product design is one of the most important factors affecting participation. In addition to the evidence presented in the Hashemi study, he cited a study by Alamghir (1997) who found that about twenty-five percent of non-participants did not join because they were unable to make weekly savings installments, about 15 percent could not make weekly loan installments, seven percent were not interested in getting a loan, and another seven percent did not want to attend weekly meetings.

## 2. Dropouts

Dropouts (persons who stop being clients) are a concern for an MFI because of the cost of recruiting and training new members or clients to replace dropouts. Because of the cost of making the first small loan to new clients, lending usually does not become profitable in many programs until the third or fourth loan to a client. Retention, therefore, is key to profitability and sustainability. Of course, dropping out may be an advantage for a client if better services are obtained by switching to another MFI.

Only fragmentary data are available on the rate and causes of dropouts and sometimes the data reported include expelled clients. Evans et al. (1999) found that 11 percent of the eligible nonmember households in their survey were former members of BRAC's Rural Development Programme that had subsequently dropped out. Dropout households tended to be smaller, with lower education, male, and more frequently participated in other nongovernmental organizations (NGOs) than current member

households. Wright (2000) reported that in BRAC dropouts represented over 15 percent of its membership in 1992 and almost 11 percent the next year. Analysis of these dropouts showed that BRAC was losing many of its older, experienced and more cost-effective clients. The inflexibility of the BRAC model, especially the lack of access to savings in times of emergency, was identified as an important factor affecting dropouts. Strict rules governing savings deposits and withdrawals suggest that members perceive that compulsory savings are an additional cost of borrowing (Montgomery, et al., 1996). Zeller et al. (2000) found that the average size of borrowing groups fell over time because dropouts exceeded new members. For example, within the five-year period prior to the 1994 survey, the average size of BRAC groups fell from 56 to 37, while the average size of ASA groups fell from 25 to 18 persons.

More recent data on the dropout problem in large organizations were provided by the Association for Social Advancement (ASA).<sup>4</sup> The organization grew by over 25,000 members during 2000, reaching more than 1.2 million. However, to achieve that increase, it had to recruit 322,000 new members to offset the loss of 296,000 members who dropped out during the year, a dropout rate of almost 20 percent.<sup>5</sup> Annual dropout rates during 1996 to 1999 varied between 15 and 18 percent.

ASA field staff conducted a study in 1995 of the reasons for dropouts (ASA, 1996). The results identified internal factors in the program's design and operation as the major problem leading to dropouts. The program's low credit ceiling and the rule against multiple loans were the most important factors, followed by frequent loan payments and

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<sup>4</sup> Unpublished data provided courtesy of ASA.

<sup>5</sup> It is difficult to directly compare retention and dropout rates among MFIs because different formulas are used in making calculations (Rosenberg, 2000). To determine its dropout rate, ASA divides the number of members that leave during the year by the number of members at the beginning of the year plus the number of new members recruited during the year.

joint liability. No information has been reported in any study on how frequently persons labeled as voluntary dropouts were actually members expelled from programs by the staff or group members because of slow loan repayment or violation of other rules, as is implicitly recognized in the ASA dropout study.

The Thana Resource Development and Employment Programme (TRDEP), a microfinance program started in the late 1980s by the Ministry of Youth and Sports (Montgomery, et al., 1996), also reported numerous dropouts. TRDEP closely follows the Grameen Bank model except, that to spread the benefits to more clients, the program limits each client to a maximum of three one-year loans. Unpublished data from the project office show it had reached over 317,000 members with their first loan by the end of 2000. Over 95,000 (30 percent) had graduated, meaning they had received three loans, but almost 90,000 (28 percent) had dropped out before completing the three-loan cycle. Design and implementation factors contributed to the high dropout rate. It is expected that some members switched to other MFIs that expanded into areas served by TRDEP to escape the three loan constraint, even though the effective interest rate was roughly half that of many MFIs.

In addition, the temporary field staff hired to implement the TRDEP project were reportedly threatened with firing if they did not recover most loans, so this may have induced them to seek clients who were somewhat better off than those served by other organizations. It is possible, therefore, that some TRDEP dropouts qualified for commercial bank loans or were attractive candidates for other MFIs because of their above-average repayment capacity.

Murray (2001) surveyed members of the Shakti Foundation for Disadvantaged Women that is a Women's World Banking affiliate in Bangladesh. It essentially follows the Grameen Bank group lending methodology. The dropout rate was 14 percent in 1998 and nine percent in 1999.<sup>6</sup> A sample of dropouts was asked to report their reasons for leaving. The largest number (33%) reported the loan amount was too small, followed by too many meetings (28%), meetings are too long (25%), did not want to pay for a defaulting member (25%), and loans were too expensive (22%).

Most MFIs in Bangladesh put their clients on a "treadmill of continuously increasing loan size," and it is alleged that loan officers have "pushed" larger loans to reach disbursement targets (Sinha and Matin, 1998.). However, Wright (2000) reported that the MFI BURO Tangail experienced a dropout rate of only three percent in 1997 because it allowed members the possibility of borrowing when they want to and offered them attractive savings products. As a result, only about half the members actually had loans at any one time. This suggests that not all members want loans all of the time.

### 3. Delinquencies

Delinquencies and defaults arise when borrowers are unable to repay, and also when borrowers do not value access to future services enough to maintain a relationship with the MFI. It is difficult to get a clear picture of loan delinquency and default rates in Bangladesh by consulting MFI reports because many exaggerate their loan recovery performance to impress donors. Most of the 585 MFIs providing data to the CDF reported loan recovery rates of 90 percent and above, so the average recovery rate was over 95 percent (CDF, 2001). However, these data may be misleading. Some MFIs use

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<sup>6</sup> The dropout rate was calculated as  $1 - (\text{number of end of period borrowers} - \text{number of new borrowers in the period}) / \text{number of borrowers at the beginning of the period}$ .

reporting definitions that are lax by international standards, such as not classifying loans as overdue until one year after the final installment falls due (Montgomery, et al., 1996; Matin, 2000).

Detailed field studies that probe loan portfolios give a more accurate picture of repayment problems. For example, Matin (1997) studied borrowers in four villages where Grameen had been operating since 1980. Almost 56 percent of the loans taken in 1994 were overdue as of the end of 1995. The repayment rates among the borrowing groups varied from 28 to 56 percent. Many borrowers with overdue loans had stopped paying entirely while others were repaying intermittently. “Unzipping” of joint liability was occurring and the whole system was beginning to operate on the basis of individual liability. A follow-up survey was conducted in the same villages in May 1997. The data revealed 56 percent of the loans in default in 1995 were still in default in 1997, suggesting eventual loan losses would be high. Moreover, about 59 percent of the loans that were not yet due in 1995 were delinquent in 1997. On-time loan recovery steadily deteriorated from 89 percent in 1993 to 41 percent in 1996 (Matin, 2000). None of the borrowers interviewed believed that poor repayment performance by the groups or centers affected their chances of getting future Grameen loans. Loan sizes increased rapidly during this period as loan officers were under pressure to meet disbursement targets. Since loan size was found to be positively correlated with delinquency and default, it was argued that this rapid expansion in lending contributed to the decline in recovery rates.

Zeller et al. (2001) also found repayment problems that appeared more serious than usually reported in MFI data. In 1994, they conducted a survey of 350 households

of which over 120 were members of MFIs, primarily in three organizations making group loans at the time (ASA, BRAC, and Rangpur-Dinajpur-Rural Services-RDRS). This was a period in which microlending was expanding rapidly. The respondents reported 70 percent of their loans were fully repaid on time and another 25 percent were fully paid, but late. On average, the partially defaulted loans were fully repaid after 84 days. The remainder of over four percent of the loans was still in default at the time of the survey. Some of these loans might eventually be repaid but loan losses of two to three percent or more would not be surprising given this level of delinquency.

At the end of 1995, Grameen experienced an unusual repayment problem because of a widespread strike among clients in Tangail who demanded access to their compulsory group savings funds. Before the strike was settled and Grameen provided greater access to savings, some 60,000 borrowers with payments more than 25 weeks overdue had an unpaid amount of over Tk. 82 million or US\$2 million (Wright, 1999).

The huge expansion of microfinance in Bangladesh has led to such intense competition for clients that some have argued it will undermine the industry (Wright, Christen, and Matin, 2001). Repayment discipline is declining, as clients are increasingly willing to default with one MFI confident in the belief that a competing MFI will make a follow-on loan.

#### 4. Overlap

Most MFIs prohibit members from belonging to more than one organization at a time, yet multiple memberships or overlap exists. Since it is against the rules, it is difficult to get members to admit to it. Moreover, little is known about multiple memberships when all members of households are considered in contrast to just

individual members. Wright (2000) reports that multiple memberships can be as high as 40-50 percent in areas where many MFIs are operating. Part of the explanation is over-borrowing by members who borrow from one source to repay another. But part of the explanation is that the rigidity of some MFIs forces clients to manage their finances by working with several organizations simultaneously. Moreover, if credit ceilings are low and all group members receive the same size loan, a dynamic borrower may need to borrow from several MFIs to obtain the total amount desired. Multiple memberships can also arise when members shop around prior to switching from one MFI to another to obtain more attractive services.

The most detailed data on multiple memberships were collected by Chaudhury and Matin (2001) in a study of the dimensions and dynamic processes that prompt families to participate in multiple MFIs. Their results overstate the incidence of overlap because they selected Tangail district for the survey due to its high levels of overlap. They found 27 NGO-MFIs operating in the study area. They interviewed members of BRAC village organizations that have on average 30 adult female members. Only 16 percent of the 240 households surveyed had someone from the household who was a client solely of BRAC. In 30 percent of the households, the BRAC member was also a client of another NGO. In 27 percent of the households, the BRAC member was exclusively a BRAC client but other household members were clients of other NGOs. Finally, in 27 percent of the households the BRAC clients as well as other household members were members of other NGOs. As would be expected, the total amount borrowed per household rose as the total number of memberships increased.

## 5. Use of Informal Finance

One of the arguments given for expanding the microfinance industry is to help poor people escape the clutches of “evil moneylenders” who allegedly charge usurious rates of interest. Formal finance is expected to substitute for informal sources. Yet there is widespread evidence that MFI clients widely use informal finance as part of their financial management strategy. For example, Zaman (1999) reported that during the 1998 flood, the main source of cash for loan repayments by BRAC borrowers was interest-free loans from relatives.

NGO clients also make informal loans. Zeller et al. (2001) summarized the total assets for the 350 households interviewed and found that over 10 percent of NGO member assets represented loans made to other persons. The corresponding value for non-members with similar landholdings below 0.5 acres was over 5 percent.

Todd (1996) describes in great detail the complex financial management practices of women members of the Grameen Bank. There are rich narratives describing cross-financing in which women borrow from Grameen to pay moneylender and other informal loans, and borrow small sums informally to meet Grameen loan installments or to access large sums of money quickly in advance of their next Grameen loan. These practices are sensible ways for women to use financial services in response to demands for resources and cash flow constraints. Each source offers products with different attributes of size, repayment schedule, ease of access, and financial and transaction costs that make each attractive in given situations. For example, the higher interest costs of informal finance may be offset by lower transaction costs in securing loans. Individuals who have established repayment reputations with moneylenders can often count on them to make

loans quickly in times of emergencies in ways that are nearly impossible for the typical MFI.

Sinha and Matin (1998) conducted a case study that collected detailed information on all credit transactions in a sample of households in northern Bangladesh in a region where several MFIs compete. Almost all households (87 percent) reported borrowing from informal sources and the proportion was higher for MFI clients than for non-clients. Household consumption and payment of other loans were the two most frequently reported uses of the informal loans.<sup>7</sup> Surprisingly, these same reasons were among the most frequently reported uses of MFI loans as well. This observation was confirmed in an analysis of the Grameen Bank clients in the survey. Due to the large increase in Grameen lending that was occurring,<sup>8</sup> some internal cross-financing was taking place in which the proceeds from one loan were being used to repay another. Moreover, clients reported borrowing from informal sources so they could maintain high repayment rates with Grameen and be eligible for larger future loans.

Zeller et al. (2001) concluded that the same thing was occurring in the rural households they surveyed in 1994. Their study revealed that NGO borrowers received 20 percent of their total debt outstanding from friends and relatives and another 18 percent from shopkeepers and other informal sources. Nine percent of the funds borrowed from informal sources were reportedly used to pay existing debt while 11 percent of formal loans were supposedly used for that purpose. Caution must be used in accepting these

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<sup>7</sup> Zeller and Sharma (2001) also reported on credit access and use in Bangladesh as part of a multi-country analysis. They found that the poor in Bangladesh, as in the other developing countries, borrow from a variety of sources. The poorer they are, the greater is the frequency of reported use of loans for consumption smoothing.

<sup>8</sup> The authors cite evidence that loan disbursements by Grameen increased more than threefold between 1991 and 1994. The rapid expansion in lending occurred with the introduction of seasonal loans in addition to the regular general loans, which facilitated internal cross financing.

reports at face value because of the fungibility of funds. MFI members reporting borrowing more from the informal sector than did eligible non-members (Tk. 1,305 compared to Tk. 1,011).

This section summarized research in Bangladesh that points to the role that product and institutional design plays in explaining non-participation in MFIs, dropouts, delinquencies, overlap and the use of informal finance. The obvious questions are: To what extent do these data reflect product inflexibility? What changes can the industry make to counter these problems and more adequately meet the preferences of poor people for financial services?

### III. Responding to Client Demands and Preferences

MFIs in Bangladesh must move beyond the first phase of “one size fits all” standardized microlending towards a second phase with more flexible financial policies and products to meet client demands and preferences. Indeed, some MFIs are already experimenting along these lines. The industry also needs to learn from experiences in countries that are further advanced in resolving these issues. Four types of changes in policies and products are briefly discussed in this section.

#### 1. Adjust repayment schedules

The one-year working capital group loan made to poor women with weekly installments and little or no grace period is the bread and butter product for most Bangladeshi MFIs. The advantage of this product is that it is easy for clients to understand, for loan officers to manage, and for MFIs to maintain internal control with manual bookkeeping systems. Weekly meetings provide loan officers the opportunity to monitor clients and to collect loan payments and savings deposits. However, many

clients do not have enterprises that produce a regular pattern of income that neatly matches this weekly repayment schedule. They have to make loan payments out of normal family household income derived from other sources when income is not immediately earned from investments financed by their loans (Wright, 1999).<sup>9</sup> Some clients would be better served with shorter loans, others with longer-term loans, in order to match payments with income streams derived from new investments.<sup>10</sup> Those with significant agricultural income would be better served with seasonal loans that carry periodic interest payments but only a single lump sum principal payment at the end.

Matching repayment schedules with expected cash flow is an obvious way to reduce delinquencies and client fears that they will not have income when needed to repay loans.<sup>11</sup> Because of their poverty, it is difficult for borrowers to save money in times of surplus liquidity for future loan payments. The Grameen Bank has been a leader in developing various types of loans, each with its own terms, conditions, and repayment schedules, but has retained its basic group lending approach with fixed terms and conditions for all borrowers of each type of loan.

Even borrowers highly motivated to repay occasionally become delinquent because of emergencies, unexpected problems and shortfalls in income. Ex-post adjustments are needed in their repayment schedules, including extensions for those projected to quickly acquire sufficient liquidity to resume regular payments, and formal loan rescheduling for those expected to face major longer-term repayment problems. Those who experience

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<sup>9</sup> Exceptions occur such as when borrowers invest in milk cows or rickshaws that generate income almost immediately.

<sup>10</sup> The SafeSave program in the urban slums of Dhaka has found that the average length of loan term between time of disbursement and repayment in its highly flexible repayment system is 6.1 months (Matin, Rutherford, and Maniruzzaman, 2000).

<sup>11</sup> Sinha and Matin (1998) suggest mimicking the informal lenders by allowing for repayment flexibility and setting ceilings on total loan size per household for loans to poorer households that face seasonality in incomes and severe dietary stress during the agricultural lean season.

major disasters need new contracts that roll over existing balances and provide new funds to restart businesses.<sup>12</sup> In worst case scenarios where full repayment is unlikely from clients affected by disasters, it may be preferable to write off part of the loan principal and lower the interest rate on the remaining balance to induce good faith efforts to pay at least part of the obligation.

At least four problems constrain MFIs from formally changing loan contracts ex post. First, most MFIs adhere to a zero tolerance policy for delinquencies to avoid what is perceived as a slippery slope of deteriorating recovery if one borrower observes that another is permitted to delay payments.<sup>13</sup> Moreover, most loans are without collateral so the MFI cannot threaten confiscation for borrowers perceived as not making good faith efforts to repay. Second, and related to the first, MFIs do not trust their loan officers to employ discretion if they delegated the authority to adjust the standard loan contract.<sup>14</sup> . Third, the cost of adjusting existing loan records to reflect new repayment schedules is similar to the cost of recording new loans for MFIs without computerized systems. To keep accounting simple, many MFIs do not add service charges or penalty interest on delinquent loan installments to compensate for lost interest earnings. Fourth, large scale

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<sup>12</sup> The large MFIs and Grameen made these adjustments selectively for their clients most severely affected by the 1998 floods.

<sup>13</sup> In a June 17, 2001 posting in the dfn listserve <http://nt1.ids.ac.uk/cgap/devfinance/index.htm> Matin reported that loan officers made some field level adjustments to strict weekly repayment schedules in response to seasonality. In lean periods, clients were allowed to pay less which they make up during peak periods. He also noted these ad hoc renegotiations can become rent-seeking arrangements and can lead to breakdowns in the system.

<sup>14</sup> SafeSave tries to avoid rent-seeking behavior of its staff by delegating the main activities of collecting and withdrawing savings and issuing and collecting loans, but standardizing all rules about size and term of loans that can be disbursed (Matin, Rutherford, and Maniruzzaman, 2000).

rescheduling of loans can create serious cash flow problems for MFIs without large cash reserves.<sup>15</sup>

## 2. Adjust loan sizes

Perhaps the single most important change that would be attractive to both existing and potential clients would be more flexibility in loan sizes. Some potential clients would borrow if they could get smaller loans while some dynamic clients with good repayment capacity would not drop out or incur the costs of multiple memberships if they could borrow larger amounts than permitted in the typical lock step MFI program. This adjustment would require a transformation in credit technology. At a minimum, loan officers would have to collect more data to analyze client loan-repayment capacity rather than relying on peer group recommendations to determine amounts to lend.

Some MFIs might follow ASA's example by recognizing the limits of group lending and switching to individual lending.<sup>16</sup> Group meetings are then used primarily as a method to reduce the cost of collecting savings and loan payments rather than to exert peer pressure on clients, although group leaders are still involved in assisting with collections from overdue borrowers. Weekly meetings are also discontinued entirely by some MFI loan officers for their long-term clients who organize informal collectors to assemble payments and passbooks for weekly collection and recording of payments by loan officers. Group meetings may have useful externalities for female borrowers as it gives them opportunities to leave the home and learn from other entrepreneurs, but

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<sup>15</sup> Brown and Nagarajan (2000) studied MFI responses to the 1998 floods. MFIs permitted rescheduling on a case-by-case basis and this permitted them to avoid losses and defaults. But rescheduling created temporary cash flow crises for small MFIs with limited internal reserves.

<sup>16</sup> BURO Tangail began in 1999 to slowly offer an individual loan product for larger loans between Tk. 20,000 to 200,000 for successful entrepreneurs. These loans have now grown to four percent of its' total portfolio (Wright and Hossain, 2001). This has required the organization to develop systems for assessing and processing loan applications, including analyzing businesses and household cash flows that will be used to repay the loans, as well as evaluating assets offered as collateral.

meetings represent high transaction costs for many borrowers, and there is little evidence that useful training occurs in these meetings after the initial training period. Sinha and Matin (1998) argue that MFIs should consider offering individual loans for long-term clients with good repayment records and who borrow large sums. Many of them have collateral for loans so do not need to be bound to social collateral in the form of groups. This would reduce transaction costs for the borrowers and create the right incentives for high rates of loan recovery.

### 3. Differential Loan Pricing

On the one hand, MFIs in Bangladesh lag behind the industry in other countries where interest rates are set high enough to cover risks, lending costs, and market rates for financial resources but, on the other hand, they impose high transaction costs on borrowers in the form of training, group formation, peer monitoring, and weekly meetings. This approach is consistent with traditional thinking that the poor cannot pay market rates of interest. The availability of subsidized funds from PKSF and other sources allows MFIs to cover costs by charging lower interest rates than would prevail if they were forced to mobilize funds at market rates.<sup>17</sup> The Bangladeshi MFIs charge different fees and interest rates by type of loan but, like most of the industry worldwide, they do not offer different rates by size of loan or for repeat borrowers. This implies that

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<sup>17</sup> The government created the Palli Karma-Sahayak Foundation (PKSF) in 1990 as a second tier organization to provide funds and training to MFIs (excluding Grameen because it is a bank) (Alamgir, 2000). As of December 2000, it had lent to 195 NGOs and had reached a cumulative disbursement of over Tk. 8.3 billion, equivalent to about \$165 million (CDF, 2001). Until recently, it charged an interest rate of 3 to 5 percent to its borrowers, a rate that is obviously much lower than they would have to pay if funds were mobilized from market sources. Several NGOs reported that over 90 percent of their loanable funds came from PKSF. Moreover, many of these NGOs would probably be perceived as being too risky to raise funds from market sources at any rate. Alamgir (2000) reported that operations have been suspended with some NGOs due to poor performance. PKSF will receive another major injection of capital as the World Bank recently approved a second project in the amount of \$151 million to expand its funds and services (World Bank, 2000). The MFIs that do not qualify to borrow from PKSF are usually quite small and rely on a variety of subsidized government, donor, and international NGO sources.

borrowers of larger loans subsidize the interest costs of small, repeat borrowers.

Therefore, to improve sustainability, the industry should strive to raise average interest rates, while at the same time reducing the rates charged for repeat customers and larger loans. This would align the interest rates charged to clients with the costs of serving them and would increase the incentives for repeat borrowing. Borrowers of small loans would still be charged rates lower than are usually cited as being charged by moneylenders.

#### 4. Expand the product line

The heavy reliance on lending to assist the poor represents a fundamental misunderstanding of the demand for financial services. There is evidence that some of the poor can make profitable use of loans to augment physical capital and expand and begin enterprises in the traditional investment pathway through which financial services help reduce poverty. But a larger number of poor people have greater demands for savings, insurance, leasing and other financial services. The poorer the household, the more important are non-lending services to assure food security, smooth consumption, manage risks, reduce vulnerability and meet other basic needs (Rutherford, 2000; Sebstad and Cohen, 2001; World Bank, 2001; Zeller, et al., 1997).

Savings services have been ignored relative to credit by the entire microfinance industry. An experimental project implemented by SafeSave since 1996 in the slums of Dhaka demonstrates that strong demand exists for voluntary open-access savings among the very poor, and they are motivated and capable of saving when offered attractive, convenient and flexible savings and credit services. SafeSave collectors travel daily throughout the slums to call on clients who have the choice of making deposits of any

size that day or waiting until another day. Withdrawals are available upon demand from current accounts. Contractual savings products and loans are also offered. Clients earn the automatic right to borrow an amount equal to their current savings balances plus a future amount that grows with each loan repayment (Matin, Rutherford, and Maniruzzaman, 2000). Loans can be paid back at any time but the interest charges of three percent per month calculated on the declining balance must be paid monthly, and there is no joint liability. Loan recovery has been satisfactory in spite of insecure tenure, slum clearances and fires. The number of clients and volume of savings mobilized and loans outstanding have grown steadily (SafeSave, 2000).<sup>18</sup> An experiment will be undertaken to determine if this type of program can be successfully replicated in rural areas where there is more seasonality and lower population density.

By comparison, most MFIs require all clients to save fixed amounts on a weekly basis, and savers cannot access their compulsory savings until they repay their loans and discontinue their membership. The large MFIs have viewed compulsory savings as a means to fund their loan portfolios and provide a lump sum pension when the clients leave the organization (Zaman, 1999). Some MFIs require group savings that are managed by the group and can be lent to group members or used for emergencies. Access to compulsory savings has been a contentious issue and has caused strikes and ill will between clients and MFIs. BURO Tangail is one of the few MFIs that stresses voluntary savings and was one of the first to offer “associate member” status to those

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<sup>18</sup> As of Sept. 30, 2001, it had over 5,300 clients with total loans outstanding amounting to Tk. 15.6 million (US\$1=Tk. 57). Loan write offs were running about 1.5 percent of loans outstanding. These data were reported on the SafeSave website [www.safesave.org](http://www.safesave.org) as of October 29, 2001.

who want to save and not borrow.<sup>19</sup> ASA undertook a major effort to offer voluntary open-access savings products, and its experience is summarized in the next section.

The 1998 flood in Bangladesh revealed the weaknesses of MFI savings programs for clients in times of emergency. First, most MFIs require small amounts of compulsory savings so the accumulated balances were usually too small to cover the losses experienced by many clients. Only the clients of MFIs that promoted voluntary savings, such as BURO Tangail, had accumulated substantial amounts of funds. Second, when Grameen, BRAC and smaller MFIs opened access to clients' compulsory savings during the emergency, they struggled to meet the demand for funds. Grameen, for example, reported that 95 percent of affected clients' compulsory savings were withdrawn in the four months that access was permitted (Brown and Nagarajan, 2000). Two-thirds of affected BRAC members withdrew more than half of their compulsory savings. Some MFIs were able to release only 25-50 percent of the amounts demanded. The flood may have motivated clients to withdraw but they had incentives to withdraw the maximum available because disaster situations are the only time withdraws have been permitted without incurring substantial costs.

Insurance is another product that may appeal to the poor and is being introduced by MFIs on an experimental basis. It is still in the early stages of development and is often subsidized. Brown and Churchill (2000) conducted a worldwide survey and identified several MFIs offering insurance in Bangladesh. For example, the Grameen Bank requires all-risk property insurance for all loans granted to buy livestock. This insurance covers half the value of the outstanding loan. Grameen Kalyan, a sister company of the

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<sup>19</sup> Being a bank, Grameen is the only MFI that can legally mobilize savings from nonmembers. The legality, regulation and supervision of MFIs that mobilize savings are important policy issues in Bangladesh.

Grameen Bank, has sold health insurance to over 30,000 families, mostly members of the Grameen Bank. Both BRAC and ASA have mandatory life insurance policies for their borrowers. BRAC offers a basic term insurance plan, while ASA's plan provides a cash benefit equal to the paid up portion of the outstanding loan, in addition to forgiving the outstanding loan balance of the deceased borrower. By making the coverage mandatory, the insurance is cheaper to provide and it reduces loan defaults and collection costs. The problem up to now has been that clients perceive that insurance is designed largely to protect the MFIs so it is considered as just another cost of borrowing.

#### IV. Challenges in Meeting Client Demands – ASA's Experimentation with Flexible Savings

The research reported here clearly suggests that clients demand a greater variety of and more flexible financial products than is typically offered by most MFIs, but it is not a trivial matter for MFIs to supply them, as described in the well-documented attempt by ASA to offer more flexible savings services (Wright, Christen, and Matin, 2001).<sup>20</sup> In 1997, ASA followed the example of Grameen and BRAC and began to offer voluntary savings products. ASA's chief objective was to continue to disburse and recover small loans in an efficient manner, especially to women, but voluntary savings were seen as an excellent way to access relatively cheap capital, increase outreach and loan volume, maintain portfolio quality, increase productivity, and reduce poverty and vulnerability.<sup>21</sup> By improving its financial services, it was hoped that loan quality would improve and

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<sup>20</sup> Wright and Hessian (2001) report on the product development process of the MFI BURO Tangail. Like ASA, this MFI introduced some products that had to be subsequently withdrawn because of lack of demand or high cost.

<sup>21</sup> ASA has two categories of clients. General members are women who borrow smaller amounts in annual loans. Small Enterprise Development Programme (SEDP) members are entrepreneurs, mostly male traders in local markets, eligible to borrow larger amounts. As of June 30, 2001, ASA had 1.34 million clients of which about 60,000 were SEDP members.

dropouts would be reduced. During 1997 and 1998, ASA modified its existing savings products and introduced new ones as follows:

- General Members Savings Accounts – the standard weekly savings account requiring savings of Tk.10 (\$0.20) per week was modified to offer open access subject to the members’ maintaining a balance of at least 10 percent of their current loan balance. Eight percent interest was paid on these accounts if no withdrawals were made for a year.
- Small Enterprise Development Program Members Savings Accounts – modified to carry terms similar to the General Members Savings Account but savers were required to save Tk.25 (\$0.50) per week.
- Associate (nonborrowing) Members Savings Accounts – new product permitting deposits and withdrawals at any time with interest paid at seven percent. The savers who were attracted to this product were usually drawn from the households and relatives of members.
- Long Term Savings Accounts – new five-year contractual savings scheme for members and associate members requiring a monthly contribution of Tk.100 to 500 (\$2 -\$10). After five years, the savers would receive their savings with nine percent interest compounded annually; eight percent interest would be paid in the event of early withdrawals during the contract period, and penalties were assessed for late monthly deposits.
- Term Deposit Scheme – new product for amounts of more than Tk.1,000 (\$20) in Tk.1,000 increments. Nine percent interest compounded

annually was paid, with withdrawals before the due date resulting in zero interest earned for the year.

Initially the clients showed great interest in these products but in the end the results were disappointing. First, the amount of savings mobilized was less than projected under the previous system of compulsory locked-in savings. In some periods, actual deposits doubled and tripled the level that would have been expected under the previous system, but withdrawals rose at an even faster rate. Second, much of the savings balance was highly liquid and required ASA to maintain substantial additional reserves. Third, there was no significant impact on the client dropout rate. Fourth, several changes were required in ASA's internal and management control systems. Additional regional managers and auditors had to be hired, managers had to make more frequent field visits to check passbooks and verify field accounts, and liquidity management procedures had to be strengthened. The interest plus the non-interest costs of savings mobilization were estimated to be about 10.5 percent of the funds it mobilized. At the same time, ASA borrowed from PKSf at five percent<sup>22</sup> and commercial banks at nine percent. As a result of these negative outcomes, ASA was forced to discontinue much of the program and revert to the previous regime of compulsory savings with limitations on withdrawals.

This example demonstrates the challenge of successfully introducing institutional and product changes that benefit both clients and MFIs. The trade-off between the quality of services and cost of producing them is clear (Wright, 2001). Significant changes are required if a MFI primarily geared to making standardized loans efficiently shifts to aggressively mobilizing savings even if the clients find the changes attractive. The lack of a savings culture and experience in dealing with richer non-clients, coupled with

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<sup>22</sup> The interest rate PKSf now charges ASA has been raised to seven percent.

cheaper alternative sources of funds and intense competition from other MFIs and regulated banks, complicated the task. Introducing savings services in an organization like ASA requires significant re-engineering of the entire MFI with major changes in organizational objectives, staff capabilities, and internal management and control.

## V. Impediments to Change

Professor Yunus and his students in Chittagong University pioneered the microfinance movement in Bangladesh in the mid 1970s using careful market research and pilot testing. Their innovations eventually resulted in the creation of the Grameen Bank (Bornstein, 1996; Wright, 2000). That spirit of market research and product development is needed as much today as it was then in order for the industry to meet its current threats and opportunities. The initial phase of rapidly expanding outreach has ended and the industry must be transformed into one capable of retaining existing clients and reaching those who have been left behind. This will contribute to reducing costs and improving the sustainability of MFIs in Bangladesh, most of which are highly subsidy dependent. But several impediments retard the development of more flexible products.

### 1. Commitments to the status quo

The large MFIs in Bangladesh as elsewhere have expended great effort to create their unique models and have a vested interest in maintaining their “franchise value.” They have convinced donors and the government to support their specific approach to alleviating poverty, empowering women, and reducing vulnerability. Their primary objective is to expand the supply of a standard package of products, and some have been successful in attracting support to export their models to other countries. For example, within Bangladesh and around the world, countless MFIs have adopted a variant of

Grameen's group lending model. It would be difficult, therefore, for the entire Grameen system to suddenly change, such as abandoning its group model in favor of individual lending, even if the change would reduce dropouts and overlap.

Developing new products and institutions requires refocusing on clients, listening to their demands and preferences, and learning about their financial strategies.

Understanding client behavior requires an awareness of the economic goals of poor households, of how poor people manage resources and activities, and how they deal with risk (Sebstad and Cohen, 2001). Microfinance needs to be fundamentally reexamined, not simply fine tuning the existing approaches. The entire industry must overcome its institutional inertia of simply replicating current models.

## 2. Cost and complexity of change and innovation

ASA's experiment with voluntary open-access savings revealed the magnitude of changes required to transform a MFI from efficiently making loans to becoming a financial intermediary. The challenge includes developing a better understanding of the complexity of financial markets and of client behavior. Once the market and clients are understood, there is a need to modify existing and create new products, train staff to service new products and clients, revise and strengthen internal controls to prevent fraud and maintain client confidence, develop more complex procedures for liquidity management, and modify MIS systems to provide monitoring information.

These challenges require a fundamental transformation of the organization and other MFIs in Bangladesh would face similar problems to those of ASA if they fundamentally changed their mission. ASA apparently underestimated the costs of mobilizing savings and adding new products. There are several advantages for a MFI in offering only a few

standardized products. Costs are reduced. Field staff do not need to be as well trained, nor do they need as much decision-making authority. Internal control is easier because it is simpler to anticipate the amount of funds needed for loan disbursement and the amount of money that should be collected for savings deposits and loan payments. There are fewer opportunities for employees to engage in fraud and rent-seeking behavior. Liquidity and reserves management are easier. Therefore, the benefits of serving clients better have to be balanced against the greater costs incurred by the institutions. This potential tradeoff needs to be examined by all MFIs and they must be prepared to charge higher costs to clients who are willing to pay them. Most MFIs in Bangladesh are not prepared to accept this idea and this represents a fundamental obstacle to the expansion of market-driven financial services for the poor.

### 3. Competition and the financial system

Competition and the financial system within which the MFIs operate both accelerate and retard change and innovation. Competition is keen in Bangladesh and there is relatively little scope remaining for the major players to continue the past growth strategy of penetrating underserved areas. Future growth will require MFIs to innovate to retain existing clients and serve those clients who have been left behind in past expansions into new territory. Smaller MFIs may be adept at identifying niche markets bypassed by the larger players. Innovations can be easily copied, and MFIs that ignore them may quickly lose clients to their competitors. This may explain why Grameen, BRAC and ASA started voluntary open-access savings soon after BURO Tangail in the mid 1990s. The banking system is widespread so it serves most MFIs, and is a source of funds for those that can demonstrate they are creditworthy. To counter the threats of floods and other

shocks, it should be possible to develop a system of emergency borrowing facilities for affected MFIs from commercial banks or from the Central Bank. Insurance products may also be needed for clients who frequently face these emergencies.

But the financial system also imposes constraints. The ease with which innovations become public goods may discourage innovators who anticipate they will not be able to fully recover costs. This encourages secrecy and restricts the flow of information and ideas among MFIs. Since there is intense competition in many locations, it is risky for an MFI to be a leader when it can easily lose clients who reject a policy or product change. Savings mobilization by MFIs may also be constrained by the proximity of commercial banks, which provide many clients the choice of borrowing from MFIs and saving with banks. Moreover, the security of savings may be an issue because, unlike banks, MFIs are not regulated and supervised. But if the Central Bank would assume this regulatory responsibility, its rules and regulations would increase MFI costs and might constrain innovation.

MFI salaries and personnel policies cannot be implemented in isolation. For example, Grameen Bank was forced to raise employee salaries to bank levels after it was transformed from a NGO to a bank. Financial incentives to improve staff productivity cannot be used as creatively in Bangladesh as elsewhere in the microfinance industry because of the pervasive influence of rigid employment procedures in government and banking. PKSF provides the opportunity for MFIs to grow rapidly with access to subsidized funds, but this is a disincentive to savings mobilization, as noted in the ASA experience. This situation will probably worsen with the new World Bank funding, as PKSF will likely need to aggressively push loans. Innovation in lending may also suffer

because PKSF prefers that its borrowers use the dominant group-lending product of a working capital loan for one year with weekly repayment (Matin, Rutherford, and Maniruzzaman, 2000).

## VI. Conclusions

This literature shows that the phase of horizontal expansion of microfinance is drawing to a close in Bangladesh. Dropouts, overlap and delinquencies appear to be rising, many of the poor refuse to use MFI products, and informal sources continue to be important for poor households. This points to the need for a re-engineering of most MFIs that is based on careful market research and pilot testing, which characterized the pioneering work in the early days of the Grameen Bank.

The changes required for the industry to better serve its clients are fundamental and significant. They must feature new products and policies that will not be easy or simple to develop and implement. Moreover, the commitment to the status quo is strong and there is a bias in favor of quantity of outreach rather than quality of service. The trade-off between product flexibility and client satisfaction, on the one hand, and costs and risk for the MFIs, on the other, must be recognized and managed. The pressures to do a better job of serving the very poor complicates the task and the historical belief that the poor need externally imposed discipline to encourage them to save discourages attempts to provide the poor with the very financial service that may be most valuable. The MFIs in Bangladesh have enjoyed a worldwide reputation as leaders in the microfinance industry. They are now being challenged to demonstrate that they can successfully move into the next phase of supplying demand-driven financial services.

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