

Policy and regulation for microfinance in Asia

# Getting the Framework Right

2010



**B.W**  **T.P.**  
Banking With The Poor Network

Asia's regional microfinance network

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## ABOUT THE BWTP NETWORK

The Banking with the Poor Network (BWTP Network) is Asia's microfinance network that works towards building efficient, large-scale sustainable organisations.

It does so through co-operation, training and capacity building, with the aim of achieving innovative, appropriate and demand-driven financial services for the poor. The Network is an association of diverse microfinance stakeholders committed to improving the quality of life of the poor

through promoting and facilitating their access to sustainable financial services. The BWTP Network was an initiative of the Foundation for Development Cooperation, its Secretariat based in Singapore.

## ACKNOWLEDGEMENTS

According to the constitution of the BWTP Network, one of the key mandates of the BWTP Network is to ‘act as a representative of the national and regional microfinance sectors to inform the policies and practices of governments, financial and other regulatory authorities, financial sector institutions, NGOs and technical service providers and other stakeholders in the cause of sustainable microfinance and financial inclusion.’

In 1998 the Banking with the Poor Network published the landmark document *Getting the Framework Right: Policy and Regulation for Microfinance in Asia*, which represents the third in a series of major studies of best practice in microfinance prepared by the Foundation for Development Cooperation on behalf of BWTP Network. The ‘Getting The Framework Right’, in 1998 concluded that lack of access to financial services was often a critical constraint to the establishment or expansion of viable microenterprises.

The objective of the Getting the Framework Right 2010 report is to provide an updated report of progress on microfinance policy and regulation in Asia, building upon the initial 1998 study and covering six countries- five in South Asia (Bangladesh, India, Nepal, Pakistan and Sri Lanka) and the Philippines in Southeast Asia.

The *Getting the Framework Right 2010* report was produced for the BWTP Network by Sanjay Sinha, Managing Director of M-CRIL (Introduction, India, Nepal and Pakistan chapters) and Nimal Fernando, Managing Director of Inclusive Finance International Pvt Ltd (Conclusion, Bangladesh, Philippines and Sri Lanka chapters). The report was expertly edited by Shaibal Guha Roy. Special thanks are due to Dr. John Conroy and Jamie Bedson for their support and guidance. Thanks are also due to those who peer reviewed this document and provided many excellent suggestions for its improvement and accuracy: Board members of the The Lanka Microfinance Practitioners’ Association - Sri Lanka, Abu Saleh Mohammad Musa (South Asia Microfinance Network), Allan Sicut and Lalaine Joyas (Microfinance Council of the Philippines), Achla Savyasaachi (Sa Dhan - India), Shankar Man Shrestha (Rural Microfinance Development Centre Ltd. - Nepal), Mehr Shah and Mr. Moazzam Iqbal (Pakistan Microfinance Network) and Lalitha Iyer. The BWTP Network also expresses thanks to Shawn Hunter and Tazia Gaisford from the Foundation for Development Cooperation for their assistance overseeing the production and publication of this report.

The BWTP Network and the Foundation for Development Cooperation partners with the Citi Foundation to strengthen the microfinance sector in Asia. The production of the *Getting the Framework Right 2010* report was part of the BWTP Network’s participation in the Citi Network Strengthening Project.

## CONTENTS

<b>ABOUT THE BWTP NETWORK.....</b>	<b>2</b>
<b>ACKNOWLEDGEMENTS.....</b>	<b>3</b>
<b>1. INTRODUCTION.....</b>	<b>5</b>
1.1 Structure of the Financial System relevant to Microfinance .....	5
1.2 Policy and regulation in microfinance .....	8
1.3 The ongoing crisis in India .....	10
1.4 Cooling the microfinance cauldron .....	11
<b>2. GETTING THE FRAMEWORK RIGHT 2010.....</b>	<b>13</b>
2.1 Bangladesh.....	13
2.2 India.....	25
2.3 Nepal.....	36
2.4 Pakistan .....	46
2.5 Philippines .....	55
2.6 Sri Lanka.....	69
<b>3. CONCLUSION .....</b>	<b>80</b>
3.1 Some Recommendations.....	85
<b>4. REFERENCES .....</b>	<b>87</b>

# 1. INTRODUCTION

The ‘Getting The Framework Right’ (GTFR), in 1998 concluded that lack of access to financial services was often a critical constraint to the establishment or expansion of viable microenterprises.

There was also a general agreement that people excluded from the formal financial sector could be transformed into a profitable market niche for innovative banking services; and that microfinance could play an important role in the reduction of poverty. The GTFR noted that despite the rapid growth of microfinance institutions (MFIs), particularly in years closer to its completion, microfinance outreach had remained comparatively limited to the potential demand, and few MFIs had actually attained any significant degree of self-sufficiency. The main logic in the study was that, while increased attention to many aspects of microfinance development was required, a conducive and enabling policy environment, and a sound and effective regulatory framework and supervisory system was of critical importance for ensuring a level of outreach that would unleash the true potential of microfinance for significant poverty reduction. The GTFR also highlighted the need to fully integrate microfinance into the mainstream of domestic financial system, and the value of deposit services both to the poor people and the financial institutions that intend to serve the poor.

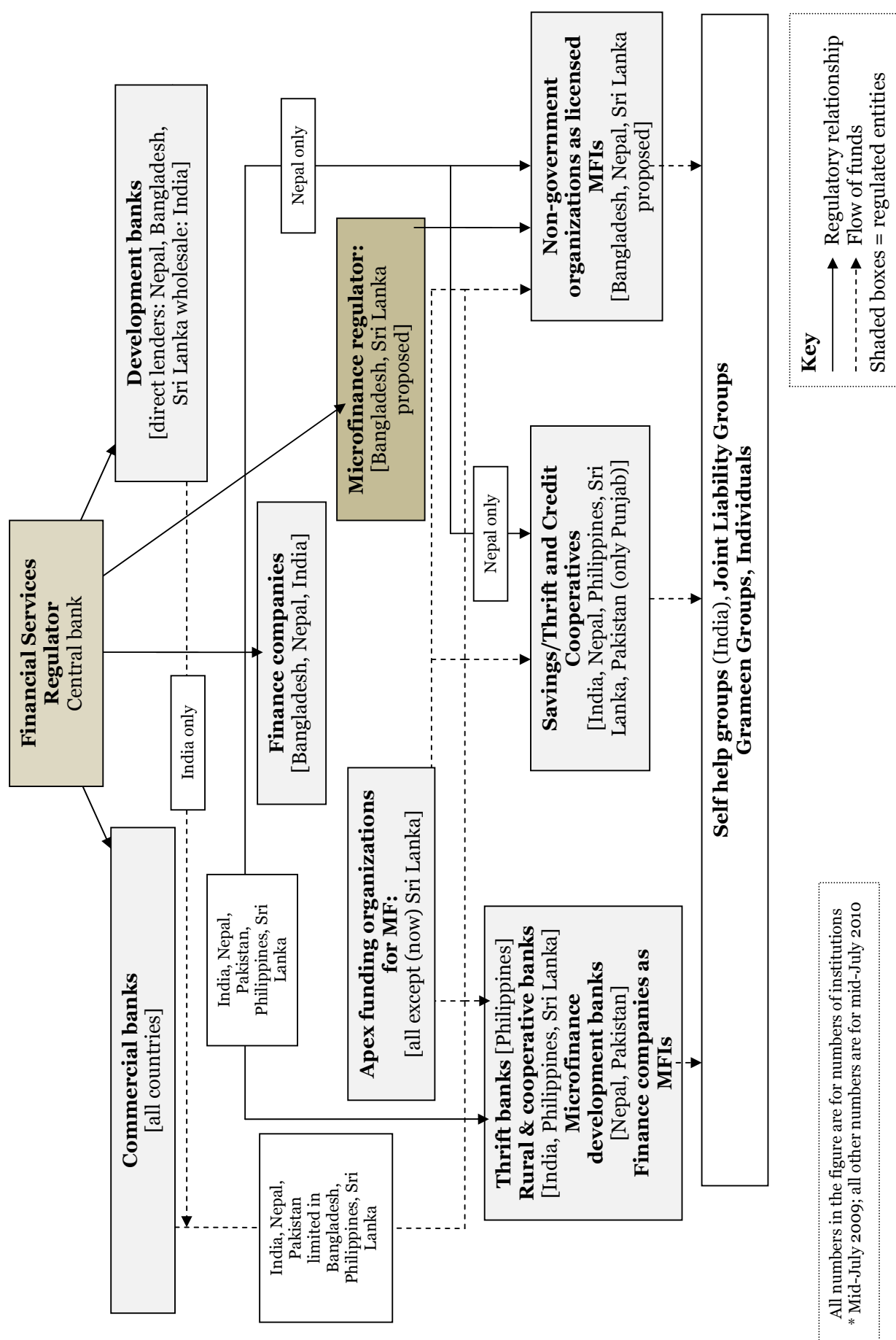
This present review of the microfinance framework in Asia, being carried out after the initial 1998 study, covers six countries - five in South Asia (Bangladesh, India,

Nepal, Pakistan and Sri Lanka) and the Philippines in Southeast Asia. In terms of broad characteristics, the economies and recent development in the economics of these countries are remarkably similar. The economies of all the countries have been growing relatively rapidly in recent years, with a substantial increase in their per capita income over the past decade (with the exception of Nepal) and a high growth in the volume of remittance from un- and semi-skilled emigrant workers, enhancing the earnings of the low income sections of the population.

All have more than 50 percent of their population based in rural areas, relatively high levels of poverty, and low levels of human development, though the Philippines and Sri Lanka perform somewhat better on the human development indicators than the other countries. The levels of productivity in the agricultural sector are low, and employment opportunities in other sectors of the economy remains limited; and it is this that is the proximate cause of poverty. While inflation has not been a major issue in most of the countries, population growth rates continue to be relatively high (near or over 2 percent per annum) in all countries except Sri Lanka.

## 1.1 Structure of the Financial System relevant to Microfinance

**Figure 1** summarises the structure of the financial system in the six countries, as relevant to the delivery of microfinance services. Essentially, with the central bank as the regulator, all countries have some form of licensed financial entity providing microfinance services and also many unlicensed ones. Usually, the licensed entities



Type of institution	Description
<b>Development banks</b>	Usually government owned institutions charged with the responsibility for promoting special interests like agriculture, rural development or small enterprises.
<b>Commercial banks</b>	Either government or privately owned banks undertaking commercial banking business and offering a full range of financial services including credit, deposits (term and cheque book accounts), money transfers, bill discounting, foreign exchange services, and so on. Usually unrestricted operational areas, but some restrictions on branch expansion and often with requirements to direct credit to particular development areas such as poverty lending (including microfinance).
<b>Thrift, Rural or Cooperative banks</b>	Banks with lower minimum capital requirements but accompanied by significant restrictions on areas of operation and financial services they can provide. Services limited to credit, deposits and transfer but include limitations on checking accounts.
<b>Microfinance development banks, microfinance companies</b>	Similar to rural banks but with limits on the size of particularly asset accounts to ensure that the main thrust of their business is directed at micro-clients. Usually for profit companies relatively closely held by promoters or a few equity investors.
<b>NGO MFIs</b>	Not for profit institutions often with a strong social motivation to facilitate the livelihoods of low income families and to reduce poverty. The social motivation can result in a 'welfarist' approach that is a constraint in the practice of microfinance as a business. A few in Nepal and (now) many in Bangladesh are licensed to offer deposit services.
<b>Thrift &amp; Credit Cooperatives</b>	Usually village or cluster level cooperatives that offer deposit and credit services to their members. Often formed as part of government programmes and, in South Asia, regarded as quasi-government institutions with governance dominated by local elites.

– thrift, rural and cooperative banks in the Philippines and rural and cooperative banks in India, as well as microfinance development banks in Nepal and Pakistan and licensed NGOs in Bangladesh and Nepal – are able to offer some form of deposit service. However, in India, in particular, the licensed microfinance companies are specifically excluded from offering deposit services resulting in a uni-dimensional relationship with their low income clients. Yet, it is the finance companies rather than rural banks in India that offer products within reach of low income clients in terms of both loan size and geography. In Bangladesh, by contrast, it is the NGO-MFIs that have the requisite geographical outreach and those that have obtained a licence from the regulatory authority are allowed to offer deposit services.

In India, commercial (and development) banks provide substantial wholesale funding to MFIs, accounting for around 75 percent of their total funds. To a lesser extent, MFIs in Nepal, Pakistan and Bangladesh (in order of magnitude) also have access to commercial bank funding. However, since in all of these countries much of microfinance is now offered by institutions that are licensed to offer deposit services, both the scope for and magnitude of commercial bank funding is more limited. In the Philippines and Bangladesh the need is substantially curtailed by the dominance of the international donor funded apex funding organisations, People's Credit and Finance Corporation (PCFC) and Palli Karma-Sahayak Foundation (PKSF), respectively in the provision of debt funds for microfinance. Rural Microfinance Development Centre (RMDC) in Nepal also has a significant role in the financing of MFIs. In Sri Lanka, the industry is dominated by state-sponsored microfinance with the public sector institutions supporting decentralised

NGO (Samurdhi societies) and cooperative institutions to provide retail services to low income clients.

Outreach of microfinance services remain variable across the six countries, ranging from 65-80 percent coverage in Bangladesh and Sri Lanka, to just about 5 percent of financially excluded low income families in Pakistan. While India now has a microfinance outreach to rival the 28 million clients claimed by the Bangladesh microfinance industry, the much larger population numbers in India mean coverage is still of the order of 25-30 percent of the overall microfinance potential. There is, in addition, the SHG-bank linkage programme in India with substantial apparent outreach, but both its unique coverage and the small average size of client accounts (often less than \$50-70 compared to average client borrowings in excess of \$300 and up to \$500) means that its role in satisfying client needs is relatively limited.

## 1.2 Policy and regulation in microfinance

Since the previous GTFR study in the late 1990s, there has been considerable progress in the development of policy and regulation in the six study countries. Nepal, Pakistan and Bangladesh, in that sequential order, have instituted specific microfinance legislation, while the Philippines have made extensive provisions for microfinance via central bank circulars as part of its mainstream financial sector legislation. India and Sri Lanka are further behind in this respect. Both countries have proposed legal frameworks for microfinance, but these have been debated for many years without any real progress being made. India has also made some regulatory concessions for the practice of microfinance, in particular, the inclusion of lending to

MFIs in the list of priority sector activities to be financed by commercial banks, but Sri Lanka has relied almost entirely on direct government financing for this purpose.

In terms of the internationally recognised quality of microfinance regulatory frameworks, the Philippines and Pakistan are clearly ahead of the rest. The Philippines, in particular, has focused on facilitating and encouraging its existing hierarchy of rural (including cooperative) banks and thrift banks to undertake microfinance while at the same time creating space for the development of mobile banking and branchless banking networks for the purpose. On account of the lack of a significant branch banking network of the virtually single tier commercial banking system in Pakistan, the promotion of microfinance services has required the creation of microfinance banks tiered to the national, provincial and district levels. In addition, supplemented by mobile banking guidelines, this system is gradually being rolled out across the Punjab and Sind provinces, though progress has been slow partly on account of the periodically recurring questions of political stability in that country. Nepal was, in fact the first to create a tiered structure of microfinance banks at various levels in the country and the number of licensed banks has now increased significantly, but the well known geographical constraints of the country (especially the difficulty of expanding doorstep services in the hilly and mountainous terrain), compounded by the political instability of the past decade, has hindered growth.

The Bangladesh legislation, so far, is unique in the study countries, since it has actually created a separate regulatory authority for microfinance, resulting in a two-tier regulatory framework. The aim of this two-tier approach is to avoid embroiling the central bank (Bangladesh Bank) in the huge additional task

of regulating hundreds of MFIs (over 600 have now been licensed), where it has neither the specialist understanding, nor the large human resource capacity required, to perform the regulatory task in a manner worthy of an august national institution. In this situation, the Microcredit Regulatory Authority would create a microfinance oriented regulatory framework and gradually develop the frameworks, policies and resources necessary for the purpose. However, progress during the four years since the authority was established has been slow.

The problem in both Sri Lanka and India, even more so than in Nepal and Bangladesh, has been the lack of a coherent understanding of microfinance as an integral part of the financial system. In both countries the entities sought to be regulated by the proposed legal framework are independent NGOs and, in neither case, are such entities central to the current practice of microfinance. In India, the past 7-8 years have seen the accelerating transformation of microfinance NGOs into for-profit microfinance companies as increasing resources have become available to the latter from commercial banks. The banks have been far more willing to commit large resources to microfinance companies with their defined ownership and governance structures than to NGOs that have indeterminate ownership and often very weak governance. Given that microfinance NGOs in India are usually very small and managerially weak institutions, virtually all the stronger ones having transformed to companies, the proposal to limit microfinance regulation to them has raised many concerns. This is particularly so since regulation is presumed to include permission to raise deposits from microfinance clients. In Sri Lanka, the 'welfarist' approach to microfinance makes any form of regulation of independent institutions virtually irrelevant.

### 1.3 The ongoing crisis in India

Since mid-October 2010, microfinance in India has been in a state of crisis. Much of this study was undertaken in the period before September 2010, earlier to the onset of the crisis. Since the causes of the crisis have been evident in the operations of MFIs over the past year and more, there is some reference to these in the India chapter but the aftermath has, naturally, not been covered.

In mid-October 2010 the Government of the state of Andhra Pradesh (AP) promulgated an ordinance placing severe restrictions on the operations of microfinance institutions operating in the state. At the same time, both politicians and, informally, the bureaucracy went around the countryside, including urban areas, urging microfinance borrowers not to repay their loans. Since AP is, by far, the largest state in India in terms of microfinance operations, accounting for 25 percent of the total number of client loan accounts and around 30 percent of the combined portfolio of all microfinance institutions in India, this had a devastating effect on the practice of microfinance in India as a whole. The net effect is that collections in AP are down to 20-50 percent levels in different parts of the state, resulting in a substantial impact on the cash flows of MFIs operating there.

MFIs operating in other parts of the country have also been affected by the crisis as a state of uncertainty has descended over the entire industry. As a result, commercial banks that were so active in lending to MFIs before the crisis have suddenly frozen sanctions of wholesale loans to them, having a further adverse impact on MFI cash flows. As of now, not only is the expansion of the microfinance industry at a standstill, but there is a shrinkage in its coverage as MFI managements have turned cautious, preferring to bolster their liquidity positions rather than making fresh disbursements of any significant scale.

Essentially, the crisis in Indian microfinance has been caused by the runaway growth of the industry over the past few years. It is a case of an industry over-heating based on the irrational exuberance of a few leading microfinance company promoters, encouraged by the high valuations being paid for their equity by not very well informed, and poorly advised, investors. The quest for growth became necessary to justify the high equity valuations and led to the recruitment of large numbers of staff who, relatively recently trained, as they were, then had to enrol large numbers of clients, and disburse funds in a hurry. The net result of “street fighting” over clients in the by-lanes of villages and small towns in many parts of the country led to a large (but as yet indeterminate) amount of multiple lending. This in turn resulted in over-indebtedness in a significant number of cases, and the consequent difficulties in repayment, leading to some coercive recovery methods by the MFI staff, and the consequent suicides of a few clients. Though, the linkage of suicides in the state with microfinance over-indebtedness is as yet unproven, it was sufficient reason for the bureaucracy and politicians in the state to decide to make an example of the industry – hence, the AP Microfinance Institutions Ordinance (now an Act duly passed by the state legislature).

The Indian (central) government’s reaction to this crisis was to urge the central bank to investigate the proximate causes of the crisis and to suggest solutions so that the practice of microfinance would not be brought to a halt. This, the Reserve Bank of India (RBI) did by appointing a sub-committee of its Board of Directors led by a respected Chartered Accountant, Mr Y H Malegam. At the time of writing (January 2011), the Committee has submitted its report, but its recommendations have generated a storm of protest from both MFIs and industry analysts alike. The recommendations specify low income limits for both the overall annual household

incomes of microfinance borrowers and the size of loans to be provided to them. The committee also specifies limits on the effective interest rate to be charged (24 percent) and the margins to be allowed to MFIs (10-12 percent) above the cost of funds. In addition, it prescribes various rules of operation for the MFIs which amounts to considerable specification of the business relationship between the MFI and its client.

All of this rather devalues the benefits of the one overarching recommendation of the committee: that the central bank should create a specific category of 'microfinance company', to be known as NBFC MFI, and to regulate that category directly for the benefit of low income people. This far-sighted recommendation alone would have had a substantially transformative effect on microfinance in India by finally conveying the message to all concerned that microfinance is an important part of the financial system, and financial inclusion will be pursued and promoted with all seriousness by the government; provided, of course, that the acceptance of this recommendation is not hemmed in by the committee's effort at micro-managing the entire sector. As of now, the future remains uncertain, and the central bank is yet to decide upon its course of action.

The role of regulation, or rather the lack of it, in contributing to this crisis needs to be understood. The RBI has, for many years, argued that the microfinance sector represents too small a portion of the Indian financial system to warrant its attention. For profit microfinance companies that fell under its overall regulation of non-bank finance companies were lightly regulated in the generalised framework of NBFC regulation. However, the phenomenal growth of the past three years in particular has resulted in microfinance covering large numbers of people, now accounting for around 40 percent

of all microloan accounts in the entire Indian financial system. In the meantime, generalised regulation has led to inadequate consideration of microfinance-specific concerns. Thus, multiple lending and client protection concerns fell under the RBI's radar until the AP state government came down with its sledge-hammer regulation. The inadequacy of the central bank's response to a growing industry of relevance to large numbers of low income families is an issue of political economy that bears examination.

#### 1.4 Cooling the microfinance cauldron

The practice of microfinance in much of Asia has increasingly become akin to a cauldron. Over-heating has occurred not just in India but has also already resulted in a localised crisis in Pakistan, heightened delinquency concerns in Cambodia in 2009 and concerns in Nepal and the Philippines about the state of the sector. In this context, the response of MFIs to the crisis in India also bears examination.

1. Through 2009 and 2010, as the multiple lending issue developed, MFIs started to talk of the establishment of a credit bureau. Pakistan was the first to launch one on a pilot basis through the network while microfinance NBFCs in India banded together both to form their own separate network and to invest in a licensed credit bureau that would provide information on the extent of multiple lending in their areas of operation. This credit bureau in India is currently launching its operations. However, while credit bureaus represent a helpful instrument for avoiding over-indebtedness, their utility is dependent on factors such as timely reporting by all the main MFIs and the attainment of a critical mass of information which will take time to achieve. It is not a short term instrument.

2. Self-regulation by MFIs has also drawn increased attention. Most microfinance networks now have for their members Codes of Conduct that are designed to ensure client protection and the avoidance of over-indebtedness. While efforts to apply these codes are apparently being made the question of how a network can apply meaningful penalties to deviant members remains. The application of self-regulation will take a substantial effort to be successful.
3. Inevitably, the share value-return nexus that is largely the cause of the Indian crisis has generated debate. The RBI's Malegam Committee attempts to address with heavy handed interest rate and margin ceilings that ignore localised conditions are, therefore, unworkable in a national context. In the context of the ethical implications of earning high profits from low income customers some way of limiting returns needs to be found. One way, as an off-shoot of self-regulation, could be a voluntary limitation of profits to a fair return, perhaps to a return on assets of around 2 percent translating to a 15 percent return on equity. This may be inadequate for drawing in commercial funds but in an era of growing philanthropy it should not be impossible to tap the segment of socially responsible investors.

Finally, the reason microfinance is needed at all is because financial services are otherwise unavailable to low income families. Its importance as an economic activity stems from its contribution to the lives and livelihoods of such families. For this reason, financial inclusion is widely regarded as a desirable objective both from the perspective of economic development and of human rights. To the extent that financial inclusion is to be promoted, it needs to incorporate deposit, insurance and remittance services as well as credit. Prudential concerns often inhibit central banks from providing MFIs with the permission to provide such services. For this reason, real inclusion would require the creation of an intermediary category of small banks that operate in relatively small geographical areas. It is only restrictions such as geography that can push banks towards working with low income clients. This would create a two-tier network of banks (large & small) but, given the failure of the large banks to work with such clients until now, it is unlikely that any incentives will be sufficient to encourage them to do so. A relatively bold approach to financial inclusion is warranted.

## 2. GETTING THE FRAMEWORK RIGHT 2010

### 2.1 Bangladesh

#### 2.1.1 Introduction

Bangladesh has experienced major demographic and socio-economic changes since the completion of the 'Getting the Framework Right' (GTFR) in 1998.

According to Bangladesh Bank (BB) data (2009, p.191), the population has increased from 122.6 million in 1997 to 144.2 million in 2009, and the population density remains high at 977 people per square kilometre. The annual per capita income has increased from an estimated \$240 in 1995 to \$599 in 2009.

Although Bangladesh has made progress in poverty reduction, according to the World Bank's poverty data, poverty continues to be an acute problem with an estimated 77 million people living on \$1.25 or less a day, and some 123 million people living on less than \$2.00 a day (approximately 82 percent of the population, 2005); with poverty being more acute in rural areas than in urban areas.

Seventy-five percent of the population live in rural areas, with about forty-eight percent of them engaged in agriculture. However, the share of agriculture in the GDP has declined from 25.8 percent in 1997 to about 18.9 percent in 2007 (ADB, 2008, p.141). Significantly, low productivity of labour in agriculture and a lack of more productive

employment opportunities for those in agricultural employment tend to suggest that microfinance still has an important role to play in development.

Two major developments in the economy have a potentially profound impact on the microfinance industry. First is the dramatic increase in inflow of workers' remittances, from about \$3.1 billion in 2003 to about \$9.7 billion in 2009 (Bangladesh Bank, 2009, p.214). The actual inflow must be higher because some still use informal channels. The second is the rapid growth in the number of mobile phone subscribers. According to the Bangladesh Telecommunication Regulatory Commission, the total number of subscribers has increased from about 34 million in 2007 to about 62 million in July 2009. The large inflows of remittances coupled with increasing mobile phone density offer new opportunities in the microfinance market.

#### 2.1.2 Overview of the Formal Financial System

The formal financial system in Bangladesh has grown and developed when compared with the situation at the time of the completion of the GTFR. The number of private commercial banks has increased from 18 in 1997 to 30 in 2008. Grameen Bank, which is a specialised microfinance bank, has also grown to become a medium-scale bank. BRAC Bank is an important addition to the sector because it is a bank established from scratch by the country's largest NGO-MFI, BRAC<sup>1</sup>, in 2001. These and other banks are regulated and supervised by BB, the central bank of the country. Insurance companies, which comprise a smaller part of the financial system, are regulated now under the Insurance Regulatory Authority

1 Formerly Bangladesh Rural Advancement Committee, but it does not use the full form any more.

Act of 2010. Bangladesh, unlike many other countries in the region, does not still have a substructure of small banks operating at the local level.

A large number of newly licensed microfinance institutions (LMFIs) are also part of the formal financial system. As of 8 September 2010, the number of LMFIs was 537. This number is expected to further increase in the near future when the Microcredit Regulatory Authority (MRA) clears 831 applications under processing.

More liberalised policies and banking reforms have enabled private banks to increase their market share in recent years. At the end of 2008, domestic private commercial banks (PCBs), for example, accounted for 54.2 percent of the total assets and 56.6 percent of the total deposits of the banking sector (BB, 2009, p.35). In FY 2009-10, domestic PCBs also handled 69 percent of the \$10.98 billion inflow of overseas remittances into the country as against 49 percent of the total inflow of \$4.8 billion in FY 2005-06 (The Daily Star, 2010).

### 2.1.3 Overview of Microfinance

Bangladesh continues to have a vast microfinance sector and dominates the global microfinance operations in terms of outreach. Although the institutional structure is diverse, Grameen Bank, NGO-MFIs and the Bangladesh Rural Development Board (BRDB), which is a government institution, are the main service providers. A number of major MFIs also have micro-insurance programmes.

At the time of the GTFR, the Bangladesh microfinance sector was reaching about 6 million borrowers. By the end of June 2009, 503 LMFIs had over 30 million clients, 24.5 million borrowers, \$2,200 million loans outstanding and \$685 million in outstanding deposits (Rashid et al. 2010, p.5). Grameen Bank, the market leader, reported 7.97 million

active borrowers at the end of 2009. Of the LMFIs, BRAC and Association of Social Advancement (ASA) had a combined total of about 10.2 million active borrowers. Some LMFIs are the size of small banks. Women account for over 90 percent of the clients. MFI loans are equal to 3 percent of GDP, twice the figure in FY 02.

However, if borrower numbers are adjusted roughly for multiple borrowing and outreach to the non-poor, the industry's poverty outreach may be around 15 million households. This indicates a market penetration rate of over 65 percent, probably the second highest microfinance market penetration in the world.

The dramatic growth in mobilisation of micro-savings is another major development. GTFR noted that the Grameen Bank was not mobilising deposits despite its legal charter to do so (McGuire, 1998.p.103). However with the reforms in 2002, the Bank has transformed itself into a true financial intermediary and reported 7.7 million depositors at the end of 2009. This number includes both members and non-members of the bank. At the end of July 2010, the Grameen Bank's deposits amounted to \$1.34 billion with member and non-member deposits accounting for 53 and 47 percent, respectively. The deposits to loans ratio was about 149 percent ([www.grameen-info.org](http://www.grameen-info.org)). BRAC, the market leader among the LMFIs, also had 8.36 million depositors with \$267 million in deposits (based on data accessed from [www.mixmarket.org](http://www.mixmarket.org)). Member savings account for about 24 percent of the funds for the LMFIs.

LMFIs are also involved in providing remittance services as partners of commercial banks and money transfer companies such as the Western Union. LMFIs with such partnerships include BRAC, ASA and other medium-scale LMFIs.

The Bangladesh Krishi (agriculture) Bank (BKB) and the Bangladesh Rural Development Board (BRDB) continue to operate microfinance programmes. At the end of 2007, BKB and BRDB reported 521,000 and 4.7 million active borrowers, respectively (Daley-Harris. 2009, pp.44-45). The operations of these institutions involve heavy subsidies (Ferrari. 2008; Fernando.2007. p.6). The state-owned commercial banks focus on providing wholesale financing for MFIs.

GTFR noted that apart from the Grameen Bank, “banks do not tend to lend to the poor” and the PCBs and foreign banks have “largely stayed away from the rural credit sector” (McGuire et. al., 1998. p.94). About five years later, an Asian Development Bank (ADB) study also noted the minute presence of PCBs in microfinance (Charitenonko and Rahman. 2003, p.x). This has changed to some extent in recent years and domestic PCBs have begun to provide wholesale funding for MFIs. Some foreign commercial banks have also provided such funding. For example, bank loans accounted for 38 percent of BRAC’s revolving loan fund at the end of December 2009 (BRAC. 2009, p.51). According to the Credit and Development Foundation (CDF), the Bank Asia Limited, Mutual Trust Bank and BRAC Bank have extended wholesale funding for a total of 43 MFIs in recent years. Citi Bank and Standard Chartered Bank have financed 7 MFIs during 2005-2008.

In FY 09, PCBs disbursed TK 17.8 billion or 25.5 percent of the total amount of agricultural credit disbursed by the banking system (Bangladesh Bank, 2009.p. 71). The agricultural credit directives of BB seem to have played a major role in this increase, though their outreach to the poor is still minimal.

Micro-insurance provision has also increased in the post-GTFR period. Many medium and large-scale NGO-MFIs have expanded from loan-insurance to cover other types of risks, although in limited ways. For example, ASA offers a mini life insurance service to its members. Delta Life Insurance is the major provider of micro-insurance in rural areas. However, reliable data on the outreach of micro-insurance are not readily available.

Despite its remarkable growth, the industry suffers from a multitude of problems (BWTP/ SEEP. 2009). Many MFIs, including one of the largest MFIs (Proshika), have negative return on assets and the management capacity of most small MFIs remains inadequate. According to industry leaders such as BRAC and ASA, the industry’s outreach to the poorest households is still limited. Marginal and small farmers, and most sharecroppers, remain largely excluded from the services of the microfinance industry and lending to micro and small-enterprises is still low (Ferrari. 2008, p.26). Recent research, notably the financial diary studies (Collins et, al.2009), tend to suggest that most clients of the microfinance industry may be under-served and using informal sources of finance to manage their cash flows. Most low-income households in particular lack access to reliable deposit services that meet their demand effectively and efficiently. Thus it may be reasonable to conclude that there remains considerable room for expansion of demand-driven microfinance products and services in Bangladesh.

#### 2.1.4 The Microfinance Policy

The government of Bangladesh has actively supported the development of the microfinance sector since the early 1980s, starting with its support for the establishment and expansion of the Grameen

Bank. However, there was no overarching microfinance development policy similar to what countries like the Philippines had, even at the time of the GTFR. This continues to be the case to-date.

Although not articulated in a policy document, the government policies have been liberal and pro-microfinance in general. The absence of interest rate caps on microcredit until October 2010, despite growing concerns among some political leaders, including ministers of finance (Fernando, 2006, p.1) about relatively “high” interest rates in the microfinance sector, reflected this positive policy. The government has been following a “two-track” policy: it allows NGOs to expand their microcredit operations, while intervening to provide microcredit through its own agencies. At the end of 2006, about 13 ministries and 15 divisions of the government were dealing with microfinance activities (BWTP/SEEP, 2009, p.17).

The Government changed its liberal policy on interest rates in November 2010 by imposing a ceiling on microcredit interest rates at 27 percent per annum (on a declining balance basis). The Microcredit Regulatory Authority is of the view that this ceiling will not have an adverse impact on the industry growth and would induce LMFIs to be more efficient. However, most industry leaders fear that this would constraint future growth.

It appears that there has also been a major paradigm-shift in government policy since the middle of 2009 to clearly emphasise “financial inclusion.” This shift is a result of the change of the leadership at BB in May 2009. The new Governor of BB has expressed his firm commitment to promote financial inclusion. The Governor has on many occasions emphasised the importance of deepening financial inclusion through his

public speeches in the country and overseas, and his written work. The Governor considers that *“developing an inclusive financial system is a necessary element for achieving both high level of income and low level of income disparity in developing countries like Bangladesh.”* In the Governor’s view *“the relationship between the access to financial services and economic growth makes inclusive financial sector a major policy agenda in Bangladesh.”* It has been declared that BB *“will continue its move towards strengthening financial inclusion as an economic war against poverty”* (Rahman, 2010, p.32).

To translate this policy into action, BB has taken the major new initiatives presented in **Table 1.**

These initiatives are commendable and the intentions of BB are, without doubt, laudable. The commitment of the new Governor of the BB for the cause of financial inclusion is strong and unwavering. However, the sustainability of some of these initiatives remains questionable. Many observers believe that to achieve sustainable outcomes, measures aimed to improve financial inclusion must be viable for the private sector; directives and refinance facilities from the BB are not the right approach.

BB also continues to provide concessional refinance for agricultural credit, although the amount has declined from TK 6.72 billion in FY08 to TK 2.94 billion in FY09 (BB, 2009, p.74). The dominant user of these funds is the BKB. Although these funds are meant for agriculture credit, the access to these funds indirectly supports BKB’s microfinance activities.

Table 1: Major Financial Inclusion Initiatives of the Bangladesh Bank

Initiative	Description and Remarks
<b>1. Refinanced Credit Scheme for Sharecroppers</b> (Introduced in September 2009)	<ul style="list-style-type: none"> <li>• BB allocated TK 5.0 billion for refinancing the programme exclusively through BRAC</li> <li>• Refinance provided at the Bank rate of 5 percent per year</li> <li>• BRAC is required to provide credit to participating sharecroppers at an interest rate of 10 percent per year (the interest is actually charged on a flat rate basis)</li> <li>• Target group is sharecroppers unserved by banks and MFIs</li> <li>• BRAC has lent TK 888 million to over 77,200 farmers (97 percent are males) by July 2010</li> </ul>
<b>2. No-frill bank account for farmers</b> (January 2010)	<ul style="list-style-type: none"> <li>• BB issued a Circular mandating all state-owned banks to allow farmers to open an account with an initial deposit of TK 10</li> <li>• Banks not allowed to impose additional charges on accounts</li> <li>• Banks have opened 8.9 million accounts by end of July 2010</li> </ul>
<b>3. Refinanced SME Credit Programme</b> - a Small Enterprise Fund (SEF) of TK 6.0 billion from BB's own resources	<ul style="list-style-type: none"> <li>• Banks were requested to set their own targets for SME lending (targets aggregated to TK 240.0 billion for 2010)</li> <li>• At least 40 percent of the enterprises financed by banks must be "small" enterprises and 15 percent of the loan disbursements must be for women entrepreneurs</li> <li>• Lower limit of the loans given under the refinanced scheme lowered from TK 200,000 to TK 50,000</li> <li>• Banks are required to grant refinanced SME loans at an interest rate equal to Bank rate plus 5 percent per annum. Banks charge interest on a reducing balance basis.</li> </ul>
<b>4. Inclusion of Financial Access in Strategic Plan (2010-2014) of BB</b>	<ul style="list-style-type: none"> <li>• Plan states that "large segments of the population and economic activities still remain unserved or underserved by the financial market"</li> <li>• "Proactive thrust on further financial inclusion is important for rapid poverty eradication with inclusive growth" (BB. 2010,)</li> </ul>
<b>5. Organisational Changes in BB for Financial Inclusion</b>	<ul style="list-style-type: none"> <li>• Re-established a separate department for agricultural credit to provide guidance for and monitor agricultural lending operations of the banking sector</li> <li>• Established a SME and Special Programmes Department</li> </ul>

### 2.1.5 Regulatory Framework for Microfinance

For many years since the completion of the GTFR, microfinance outside the Grameen Bank operations grew without a formal regulatory framework. The Grameen Bank is also subject to very little prudential regulation. Many observers attributed the rapid growth of the microfinance industry to the absence of a formal regulatory framework and hurdles that stifle innovations.

Although NGO-MFIs were prohibited from mobilising deposits, most NGO-MFIs fund part of their growth with compulsory and voluntary deposits from its members. With the declining trend in donor funds since the late 1990s, the NGO-MFIs required, and sought, greater access to funds from the market to finance growth. This led to increased efforts to mobilise savings beyond compulsory deposits and access to commercial sources of funds. Most NGO-MFIs, particularly large ones, saw the absence of a proper legal and regulatory framework as a constraint on such access. NGO-MFIs registered under various Acts had to undergo certain difficulties in accessing foreign funding, as noted in the GTFR (McGuire 1998, pp.102-103). In this context, some NGO-MFIs, including some large-scale MFIs, want a legal framework that would facilitate mobilisation of deposits from members and non-members.

Funding agencies such as the ADB also emphasised the need for a proper legal and regulatory framework for sustainable development of commercial microfinance in Bangladesh (Charitonenko and Rahman, 2003). BB and various other government institutions were also wary about the lack of a legal framework, especially with the growth of some NGO-MFIs into large multi-service institutions.

During the post-GTFR period, policy and regulation for microfinance has changed and made some progress, although not necessarily along the lines recommended by the GTFR. In some cases, the policies have deviated significantly from the GTFR's recommendations and international best practice.

### 2.1.6 Regulatory Framework for NGO-MFIs

The burgeoning interest in the microfinance community to the regulation of NGO-MFIs in the mid-1990s, among other factors, led BB to commission a study in 1997 to examine the regulatory aspects of MFIs and linking MFIs with the formal financial sector. The study concluded that (i) the regulatory framework of the existing banking laws is not appropriate to cater to the needs of the MF sector; (ii) legal recognition of MFIs through enactment of a law is required to access formal sources of funds by MFIs; and (iii) self-regulation based on an agreed "Code of norms/Conduct" can be an alternative or may supplement the existing or new government regulation.

The Government, in 1999 formed a committee of seven members under the chairmanship of the Governor of BB to make recommendations regarding a regulatory framework and to propose a body to regulate and supervise these institutions. The committee submitted its report in March 2000 recommending the formulation of prudential guidelines for the microfinance sector, and creation of a separate regulatory body.

In May 2000, BB established a special unit, namely "Microfinance Research and Reference Unit (MRRU)" in BB to function under the supervision of a National Steering Committee (NSC) formed through a government order in June 2000. The Governor of BB headed the NSC which consisted of 10 other members

including representatives from the Ministry of Finance (MoF), NGO Affairs Bureau, Palli Karma-Sahayak Foundation (PKSF), Grameen Bank and BRAC, among others. The NSC's terms of reference included recommendations for preparing a legal framework in support of the MRRU or a new regulatory authority for the MFIs.

NSC, in consultation with the microfinance practitioners and other stakeholders, prepared a draft law for setting up a separate regulatory authority for the microfinance sector and submitted it to the government. The draft law proposed for an independent regulatory authority that would be responsible for licensing NGO-MFIs and monitoring their activities ([www.mra.gov.bd](http://www.mra.gov.bd)).

#### 2.1.7 Microcredit Regulatory Authority Act (MRAA)

The enactment of the MRAA in 2006 marked a major change in policy on NGO-MFIs. The MRAA:

- requires the government to establish a microcredit regulatory authority under the chairmanship of the Governor of BB, for regulation of microcredit activities of microcredit organisations in the country with a view to ensuring transparency and accountability of their operations;
- requires NGO-MFIs to become LMFIs if they want to continue their operations;
- makes operating a MFI without a license illegal;
- permits LMFIs to mobilise deposits only from their members; and
- allows LMFIs to “provide various insurance services and other loans for social welfare purpose to the creditors and their family members.”

It is interesting to note that the government has chosen to use the term “microcredit” and avoided using the term “microfinance” for both the Act and the regulatory authority.

According to the MRAA, the regulatory authority is required to establish and maintain a Depositors Security Fund to “secure and protect” deposits. The MRAA also includes a provision that enables the regulatory authority to prescribe a “service charge” (interest rates) on microcredit of LMFIs.

A LMFI is also required to have a reserve fund that should be operated in a prescribed manner. LMFIs require prior approval of the regulatory authority to pay out any profit. However, any MFI whose tax is waived or exempted, or who receive any other financial assistance from the government are barred from distributing any profit.

Although providing a legal charter for NGO-MFIs to operate is a major development, the MRAA does not address a number of critical issues that GTFR noted and even the NSC emphasised in its final report and recommendations to the government. The MRAA:

- does not allow for the transformation of licensed MFIs to become microfinance banks;
- includes a provision for the regulatory authority to prescribe interest rates on microcredit extended by LMFIs;
- does not allow licensed MFIs to mobilise deposits from the public; and
- does not cover micro-insurance (BWTP/ SEEP. 2009, p.16) which is an integral part of microfinance.

### 2.1.8 Microcredit Regulatory Authority (MRA)

The government established the MRA in August 2006 to regulate microfinance operations. MRA called for applications from NGO-MFIs for licensing and gave a final deadline until the end of 2009 for applications. An MFI was required to meet the minimum criteria of 1,000 active borrowers or an outstanding loan portfolio of Taka 400,000 (about \$58,000) to be considered for a license. This minimum criterion has been set on the basis of the number of borrowers or the loan portfolio that is considered necessary to make a single-branched MFI sustainable (Rashid et. al.2010).

MRA has received over 4,240 applications, rejected 2872 by 8 September 2010 and licensed 537 NGO-MFIs, the rest remain to be processed.

The LMFIs have a legal charter to mobilise deposits from their members subject to a ceiling of 80 percent of the outstanding loan amount. However, large-scale LMFIs, such as BRAC and ASA, and a number of medium-scale LMFIs, such as Buro Bangladesh, with potential to expand their deposit mobilisation well over this ceiling, find it restrictive and non-enabling. MRA is of the view that it is not appropriate to place this ceiling at a higher level given that most LMFIs have borrowings from commercial and other sources.

The creation of a legal and regulatory framework provides a strong legal basis for activities of MFIs in the country. As noted in a World Bank study (2006. p.91) *“this should facilitate their access to commercial funding and improve their transparency and accountability.”*

The MRA does not have adequate staff or resources to supervise the large number of LMFIs under its purview. Some LMFIs are as large as small banks. It was the low

threshold set for licensing which brought too many institutions under MRA’s purview. The low threshold suggests that the MRA had intentions to license even single-branched, very small-scale MFIs, the rationale for which is unclear. And this is not in line with the Guiding Principles on Regulation and Supervision of Microfinance issued by the Consultative Group to Assist the Poor (CGAP) (2003). The MRA has heavily underestimated the regulatory and supervisory capacity issues.

Another worrying development is the interest rate ceiling on microcredit imposed by the MRA at 27 percent per annum in the last quarter of 2010. Prior to this, MRA, together with PKSF, commissioned a report on microcredit interest rates. The report apparently suggested measures to improve price transparency of MFIs. Although interest rate ceilings are not the answer to lack of price transparency in the country’s microfinance sector, MRA chose to impose a cap perhaps partly due to the strong lobby supporting caps on microcredit interest rates in Bangladesh and its own poverty-focused approach to microfinance regulation. Professor Yunus, the founder of Grameen Bank, has repeatedly emphasised the need to standardise microcredit interest rates in Bangladesh, and elsewhere. These debates and efforts confirm that GTFR’s concern about interest rates issues remain valid to-date.

### 2.1.9 Regulatory Framework for Banks in Microfinance

In Bangladesh, the Grameen Bank continues to be the only microfinance bank. Unlike in the case of the Philippines and other South Asian countries, Bangladesh still does not have small local banks. The PCBs in the country are irrelevant in retail microfinance. Because of these factors and the dominance of NGOs in microfinance with their extensive outreach, Bangladesh does not have a regulatory framework for banks in microfinance. Certainly nothing like what has

been developed in the Philippines.

The Grameen Bank is regulated under its own ordinance, the Grameen Bank Ordinance of 1983, as at the time of the GTFR. Although BB has the regulatory responsibility over this bank, the bank has been subject to very little prudential regulation (McGuire et al. 1998, p.104). However, at the time of the GTFR, the Grameen Bank was not mobilising public deposits, despite the legal provisions for such deposits from members and the general public. This is no longer the case. The Grameen Bank, as noted elsewhere, has been mobilising deposits from the public since late 2002. Even with this development, the Bank continues to operate without prudential regulation of the BB. For example, BB's revised policy on loan classification and provisioning for microfinance and agricultural credit issued in January 1999 (BB.2003) was not applied to the Grameen Bank. The exclusion of a financial institution taking deposits from the general public is not in line with the international good practice that suggests strict regulation and supervision of such institutions.

#### 2.1.10 Regulatory Framework for Branchless Banking

The rapid increase in the number of mobile phone subscribers coupled with the expansion of branchless banking in other countries such as Brazil, Kenya and the Philippines (CGAP. 2010; 2008; Kumar. 2005) seem to have influenced BB to develop regulations to promote branchless banking in Bangladesh. In August 2008, BB issued a revised draft of the Bangladesh Mobile Payment Guidelines. BB clearly recognises that its role is to “*ensure the safety, soundness and security of the payments methods that are introduced*” (BB.2008, p.3). The August 2009 draft outlined the rules concerning licensing, protection of customers' funds, capital, liquidity and risk management, among other

things. The draft clearly stated that “*there shall be no licensing requirement for a scheduled bank seeking to introduce mobile payment services*”, although they will be required to comply with some of the other regulatory requirements applicable to the nonbank-based model of branchless banking. The regulatory framework for branchless banking was strengthened in 2009 with the approval of the Bangladesh Payment and Settlement Systems Regulation. “*This regulation is the bedrock of the payment system's modernisation in Bangladesh*” (BB, 2009. p.105).

Despite strengthening payment systems regulation and formulating detailed mobile payment guidelines even in a revised draft form for non-bank-based model, BB has made a decision to pursue the bank-based model “*because of prudential regulatory and consumer protection issues*” (Rahman. 2010, p.24). Although it limits the entry of Mobile Network Operators (MNOs) into the mobile financial services sector, this decision sounds rational, and the approach cautious, given the currently limited regulatory capacity of the BB.

BB has issued licenses to eight banks to launch bank-based models of mobile phone banking and these banks are at varying stages of developing their programmes. One of the banks in this category is BRAC Bank. No mobile-phone-based microfinance delivery system of any significant scale exists in the country at present.

#### 2.1.11 Regulatory Framework for Micro-insurance

The insurance industry in Bangladesh, including micro-insurance subsector, is fast growing. LMFIs and private insurance companies are engaged in micro-insurance. There is, however, no regulatory framework for micro-insurance, and insurance companies

which were regulated under the Insurance Act of 1938 are now regulated under the Insurance Regulatory Authority Act (IRAA) of 2010, enacted in March 2010. The government also passed the Insurance Act 2010 at the same time. The IRAA has paved the way for an independent regulatory authority for insurance and enables the introduction of a set of new regulations for the sector. The new authority will need to formulate micro-insurance regulation within the new overall regulatory framework for insurance. The MRA has not included micro-insurance as part of the products of LMFIs (BWTP/SEEP. 2009, p. 16). It is unrealistic to assume that micro-insurance regulations will come into force within the next 2-3 years.

#### 2.1.12 Performance and Reporting Standards of PKSf

As emphasised in the GTFR, PKSf as a wholesale funding agency plays an important role in improving performance and reporting standards of its borrowing MFIs. PKSf has formulated a set of 12 major policy guidelines (Charitonenko and Rahman. 2002, p.30) and standards that include, among other things, measures to protect savings in MFIs. These include (i) guidelines for management of savings; (ii) policy for loan classification and reserve; (iii) guidelines for avoiding borrower overlap; (iv) policy for use of disaster management funds; (v) early warning indicators for monitoring loan repayment; and (vi) internal control for partner organisations (POs).

The standards and guidelines regarding savings are vitally important because they have a bearing on the fundamental issue of prudential regulation of microfinance, which is the protection of people's deposits. These standards and guidelines include norms and procedures of savings mobilisation, maintenance of savings accounts, withdrawal of savings, use of savings by POs and

maintenance of sufficient reserves at licensed banks. PKSf's requirement that all POs should submit monthly reports continues. PKSf also exercises close on- and off-site monitoring of the POs it funds which could partially compensate for the weak oversight by MRA.

PKSf made a significant change in its interest rate policy in the post-GTFR period. As noted in the GTFR, PKSf imposed "*a minimum lending rate of 16 percent to ensure that MFIs do not lend below commercial bank rates*" (McGuire et al. 1998, p.105). In contrast, PKSf imposed a ceiling interest rate on its POs' loans to member borrowers at 12.5 percent per annum on a flat rate basis, effective 2004. It is possible that the ceiling caused financial difficulties for some of its POs who were charging interest rates beyond this ceiling rate, reducing their potential for sustainability. This policy is not in line with international best practices and the recommendations of the GTFR on interest rate policies for microfinance.

#### 2.1.13 Self-Regulation

Self-regulation can have a positive impact on operational performance of MFIs, depending on its comprehensiveness and the seriousness with which it is implemented. For this reason, GTFR underscored the importance of self-regulation. However, feasibility of self-regulation depends on the effective coordination among MFIs, generally achieved through industry level networks. At the time of the GTFR, Bangladesh had the Credit and Development Forum (CDF) and PKSf to carry out this coordination function. Although PKSf was active in promoting self-regulation, primarily to ensure its own sustainability, CDF had not been "*actively involved in trying to establish standards for self-regulation of the microfinance sector*" (McGuire et. al., 1998, p.107). What PKSf was doing for self-regulation was important in a context where there was no system of

formal regulation backed by an appropriate legal and regulatory framework. However, it is important to recognise the limitations of self-regulation. As noted by CGAP (2003, p.28), historical evidence clearly suggests that “*self-regulation has virtually never been effective in protecting the soundness of the regulated organisations.*”

The present context in the microfinance sector is fundamentally different from that which existed at the time of the GTFR. There is now a legal framework to regulate and supervise LMFIs. The new context requires PKSF to adjust its on-going self-regulation measures and CDF to re-think of whether and how it should play a role in self-regulation. In general, PKSF measures are effective with its POs, which number 192, while other MFIs are free to adopt its performance measures and standards. In contrast, CDF has a wider membership that includes a larger number of MFIs, but it lacks the capacity to ensure member adoption of whatever regulatory measures it puts in place. Further, costs and benefits of self-regulation in the current context need to be carefully examined.

#### 2.1.14 Summary and Recommendations

The microfinance sector in Bangladesh has grown dramatically in the last decade. Today's microfinance sector is profoundly different from the sector which existed at the time of the GTFR. Despite institutional proliferation, a significant level of consolidation is evident in the sector. The Grameen Bank, now a true financial intermediary, and a few large-scale LMFIs dominate the industry. Some LMFIs are as large as small banks and mobilise a relatively large amount of deposits.

In this context, any systemic failure in the microfinance sector can have adverse consequences on the stability of the overall financial system, and political stability as well,

because the sector covers over 65 percent of the poor households in the country. While rapid growth has made the task of regulation more difficult, political-economic importance of effective regulation has also increased profoundly.

The new legal and regulatory framework introduced for MFIs in 2006 is an improvement, although some in the industry still fear that regulation could retard growth and innovation. The interest rate cap imposed by the MRA in the last quarter of 2010 is a deviation from the country's liberal policy on interest rates and most likely will have an adverse impact on the industry growth.

Although Bangladesh has a regulatory framework since 2006, it does not seem to have got the regulatory framework right; it does not meet the sector's needs for sustainable growth. Nor does it fall in line with the international good practice. First, it formalises financial sector dualism by placing LMFIs in an airtight compartment without options to become banks, impeding the integration of microfinance with the broader financial sector. Second, it does not seem to offer adequate space for the integration of new technology-based approaches such as mobile phone banking. For these reasons, it tends to make the financial system less, not more, inclusive.

To make matters worse, the MRA has made the task of regulation unwieldy for itself by setting the licensing threshold at a very low level. It is therefore critical to urgently address the capacity constraint issues of the MRA.

On mobile phone banking, BB has chosen the bank-based model and not allowed MNOs to directly contract customers for the provision of financial services. In the current circumstances this seems a rational decision, given BB's limited capacity for regulation

and supervision of financial institutions, and the lack of experience in regulation and supervision of mobile phone-based financial service provision.

The government needs to consider the new regulatory framework for microfinance as a starting point and begin the next step for transforming it into a framework that meets the industry's critical needs in a manner that would ensure safety and soundness of the sector and its growth. It is essential to consider providing legal space for transformation of large-scale MFIs into microfinance banks. This would enable these LMFIs to expand their deposit services to the public and meet their funding requirements, while providing valuable service to their clients.

Shifting to a forward looking regulatory framework that would permit both banks and nonbanks to provide a broad range of financial services to the poor and unbanked people on a level playing field is a major challenge. A good part of this challenge constitutes a very basic issue: how could the regulator allow a multitude of service providers to operate and expand their services while ensuring safety of customers' funds? In addressing this issue, the regulator could benefit from rich experience in countries such as Kenya and the Philippines.

However, before BB opens the branchless banking door to MNOs, it may be wise to observe for few years how the bank-based model will evolve and perform in the country. It will also provide sufficient time for BB to build its regulatory capacity for branchless banking.

BB also needs to begin prudential regulation of the Grameen Bank. The Bank's risk profile has significantly changed since 2003: it now mobilises deposits from the general public;

holds a large amount of long-term deposits from members and non-members; and operates in a fiercely competitive microcredit market. In this context, the absence of effective regulation and supervision of the Grameen Bank is an alarming trend. And the lack of effective regulation and supervision of this bank also makes the playing field for microfinance uncomfortably uneven for LMFIs such as BRAC, ASA and Buro Bangladesh. It also reflects the political economic factors underlying microfinance regulation in the country.

The MRA's authority to prescribe microcredit interest rates is another major concern in the LMFI community. The restrictive ceiling imposed in the last quarter of 2010, because of the MRA's poverty-focused approach to regulation, would undermine the sustainability of many LMFIs and retard the sector's growth. It will help the microfinance industry if MRA reconsider this decision and withdraw the ceiling as early as possible.

The government needs to improve the operating environment for microfinance by phasing out government microfinance programmes. GTFR also made this recommendation. The existence of a plethora of government microfinance programmes in a country where a thriving non-government microfinance sector exists is superfluous. These programmes are not only subsidy-dependent but also lack transparency. LMFIs are capable of more efficiently serving the clients reached by these programmes.

The microfinance environment can also be improved by broadening the coverage of the Credit Information Bureau (CIB). This is particularly important because multiple borrowing is exposing LMFIs to greater risks. Currently loans granted by LMFIs are not included in the CIB's data base.

## 2.2 India

### 2.2.1 Introduction and Background

India is seventh largest country in the world and the largest in South Asia in terms of total land area, covering 3.28 million square kilometres. The northern frontier of the country is defined by the Himalayan mountain ranges and it shares political boundaries with Pakistan, China, Nepal, Bhutan, Myanmar and Bangladesh. According to the latest data the country's population is 1.18 billion, the second largest in the world, after China. This translates to a population density of 360 persons per square kilometre, some 11 percent higher than at the last population census in 2001. The country has 2.4 percent of the entire world's geographical area but supports over 17.3 percent of the population. Although in recent years, the growth rate of population has reduced from 1.8 percent per annum in 1995 to 1.5 percent currently; the birth rate of 22.22 births per 1,000 is well above that of a majority of countries.

The per capita income (nominal) of \$1,030 in 2008 was ranked 139<sup>th</sup> in the world, whereas the per capita income of \$2,940 at purchasing power parity (PPP) ranked it 128<sup>th</sup>. The economic growth rate of India has seen a substantial surge in recent years, owing to its shift in the 1990s from protectionist, socio-democratic policies to a more market based, liberalised economic approach. From 2004 until the second quarter of 2010, India's average quarterly GDP growth was 8.4 percent. In the second quarter of 2010 (April-June), the Indian economy expanded at a robust rate of 8.8 percent according to Government of India figures and the Reserve Bank of India (RBI, the central bank), forecasts an annual growth rate of 8 percent for the 2010-11 financial year (April to March). A sector wise analysis of the Indian economy

shows a shift in the structure of production with the service sector registering high growth and now contributing 60 percent of the country's gross domestic product compared to the 18 percent contribution of agriculture and 22 percent of industry. Its economy is the eleventh largest in the world in nominal terms and fourth in terms of PPP (and likely to overtake Japan within the next 2 years).

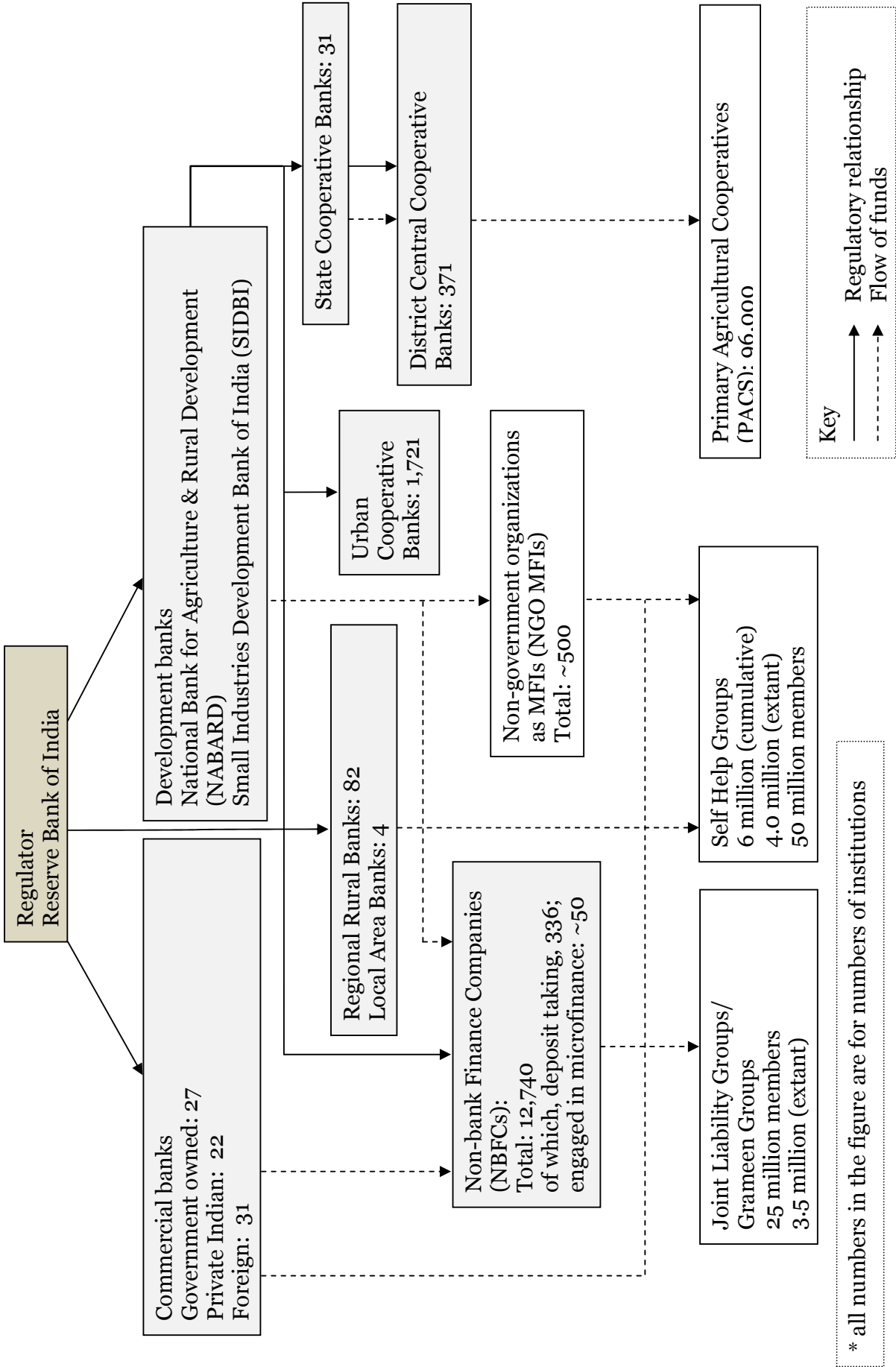
On the other hand, the social indicators of development remain poor, with India lying on the lower rung of human development. Though life expectancy at 69 years and an infant mortality rate of 51 per 1,000 live births have improved steadily over the decade, India ranks a low 134 in the Human Development Index with a numerical score of just 0.612.

### 2.2.2 The Financial System

Over the years, the Indian financial system has made considerable progress in terms of resource mobilisation, geographical and functional reach and financial viability.

**Figure 2** provides a schematic presentation of the structure of the financial system in India (with particular reference to microfinance). At end-March 2009, the banking sector comprised of 80 commercial banks with a consolidated asset base of Rs 5.2 million crore (US\$1.16 trillion). In addition, there were 82 Regional Rural Banks (RRBs). The RRBs were established by government-owned commercial banks in partnership with the government under the provisions of an act of Parliament (RRB Act 1976), with the objective of maximising institutional credit to agriculture and other rural sectors. The RRBs aimed to mobilise financial resources from rural and semi-urban areas and make loans to small and marginal farmers, landless workers, rural artisans and other small entrepreneurs. In 1996, the RBI also mandated the establishment of Local Area Banks which were private banks with a similar mandate to the public sector RRBs. In addition, there

**Figure 2** Structure of the financial system and microfinance delivery in India



were 12,740 Non-Bank Finance Companies operating in India, out of which 336 were permitted to accept/hold public deposits. There is also a network of cooperative banks, with 31 state cooperative banks (SCBs) and 371 district centre cooperative banks (DCCBs). The main aim of these cooperative banks is to provide crop and other working capital loans, primarily for short term purposes to farmers and rural artisans. The cooperative banks do this either directly or by financing those of the 96,000 primary agricultural cooperatives functioning in their operational areas. In urban areas, the financial services of the banks and Non-Banking Finance Companies (NBFCs) are supplemented by the operations of over 1,700 urban cooperative banks.

All the banking institutions mentioned above, except NBFCs, operate under the legal ambit of the Banking Regulation Act, 1949, whereas NBFCs are registered under the Companies Act of 1956. All these institutions are subject to prudential regulation determined by the RBI under the Reserve Bank of India Act, 1949. The RBI is entrusted with directly regulating and supervising the functioning of commercial banks, urban cooperative banks, local area banks and NBFCs. The supervision of Regional Rural Banks and State and Central Cooperative Banks is undertaken by National Bank for Agriculture and Rural Development (NABARD), which was set up as an apex development bank by the RBI in 1982 with the mandate to facilitate the flow of credit for the development of agriculture, small scale industries, cottage and village industries, handicrafts and other rural crafts and thereby to act as a “facilitator of rural prosperity”.

In recent years numerous reforms have been made in the Indian financial system. In 1999 India adopted Basel I guidelines as issued by Basel Committee on Banking Supervision and has also now adopted the Basel II norms to fortify the regulation, supervision, and risk management of the banking sector

### 2.2.3 The Microfinance Market

According to the Human Development Report, 2009 of the United Nations Development Programme (UNDP), 41.6 percent of India’s population, or 490 million people, live on less than the poverty benchmark of \$1.25 a day (at PPP). The proportion of population below the \$2 a day benchmark is 75.6 percent or (over 890 million people). Besides, while accurate information on this is not available, at least 60 percent of the population is said to be unbanked. The World Bank’s Financial Access Survey in two states of India in 2003 found that 59 percent of rural households in Uttar Pradesh and Andhra Pradesh (states) do not have accounts with the formal financial sector and 79 percent do not have access to credit form a formal source. It is not surprising, therefore, that over the past few years the Indian microfinance industry, both the bank-financed self help group programme and the microfinance sector served by NBFCs and NGO MFIs engaged in providing micro-credit services, has grown very substantially with a total of some 70 million credit accounts by March 2010. As a result, India today is said to be the world’s largest microfinance market having surpassed Bangladesh’s total of around 30 million accounts.

Keeping in mind, the huge surge in the demand for credit and other services, the Government of India (GoI) has expressed a strong and prolonged commitment to microfinance as a means of reducing poverty. The work of the Committee on Financial Inclusion (Rangarajan Committee) in 2008 discussed the nature and extent of financial exclusion and suggested suitable measures for increasing the availability of banking and other financial services such as insurance and remittances at an affordable cost to the low income population. The committee emphasised the need to improve the existing formal credit delivery mechanisms and the credit absorption capacity of marginal, sub-marginal and poor non-cultivator households.

One of the most important programmes in terms of numbers of people reached by microfinance is the Self Help Group (SHG) bank linkage programme. SHGs are village based, usually economically and socially homogeneous, groups of people who come together voluntarily to pool their resources and use them (initially) for micro-lending among themselves. Once the members are thought to have established a regular thrift and credit cycle, they are linked with banks under the NABARD promoted SHG-bank linkage programme (SBLP). The SBLP started as a pilot project in 1992 with 500 SHGs but grew very strongly during 2000-05 and then more slowly to reach a cumulative total of around 4.5 million SHGs linked to banks by March 2010. However, this figure entails some degree of retention of defunct groups. According to liberal estimates by the author's organisation (M-CRIL) the real figure is likely to be of the order of 4 million groups with membership of some 50 million people (mostly women). Given the quasi-regulatory status of NABARD and its association with the RBI, the public sector banks and RRBs took up the programme enthusiastically in the middle of the last decade (2002-07). However, the average amount of credit available per member never exceeded Rs 3,500 (around \$80) and there has been a declining interest in the programme as NABARD's support has waned over the past couple of years.

Resources committed to this programme by the government owned banking sector reached Rs 24,200 crore (\$5.2 billion) by March 2009. NABARD's support extended not just to the encouragement of the banking system to support SHGs but also to refinancing of bank lending. In the initial stages, around 2000-03, this support was critical in encouraging the banks to lend to SHGs; however, as support for the programme reached its peak, banks, encouraged by good reported repayment rates, no longer claimed refinance support and were

willing to commit their own resources. At this time (2002-07), the programme reported 30-50 percent growth rates. However, with the decline in portfolio quality and a reduction in support for the programme over the past couple of years the number of SHGs with outstanding loans has increased by just 7 percent in 2009-10 according to NABARD data. The latest information on portfolio quality, available for March 2008 indicates a loan default level of 3 percent in the SHG programme.

Other prominent government agencies lending to NGOs for on-lending to SHGs are SIDBI's Foundation for Microcredit (SFMC) and the 'National Credit Fund for Women' or '*Rashtriya Mahila Kosh*' (RMK). SFMC was launched in 1999 to provide a complete range of financial and non-financial services to MFIs retailing credit to individuals and joint liability groups as well as to SHGs. The RMK is a national level apex microfinance organisation providing microfinance services for women in India, which was set up in 1993 by Department of Women and Child Development (HRD Ministry).

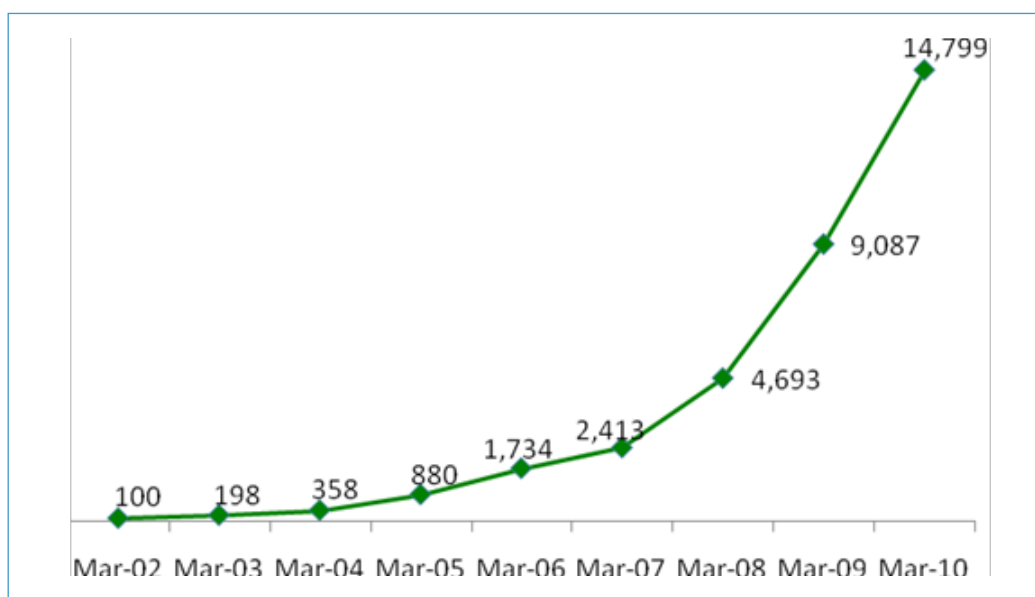
The cooperative movement in India (started in 1904) is both historically important and numerically extensive. The cooperative credit structure as depicted on the right of **Figure 2** differs in rural and urban areas. The urban system is comprised of urban cooperative banks (UCBs). The 1,721 Urban Cooperative Banks at end-March 2009, are generally regarded as poorly functioning institutions weakened by growing issues in governance and the regulator (the RBI) has, therefore, initiated a consolidation process. By and large, the UCBs are single town/city banks and are therefore, relatively small institutions serving a few thousand clients at most. These are concentrated in western India and are relatively unimportant in the rest of the country.

The rural cooperative structure with its three tiers, and 96,000 Primary Agricultural Credit Societies (PACS) at the base has an outreach that stretches to 80-90 percent of the villages in the country and is serviced by the network of District Central Cooperative Banks (DCCBs) supported by the State Cooperative Banks (SCBs) at the apex level. However, like their urban counterparts, the rural cooperative system (both PACS and DCCBs) has incurred substantial losses over the past several decades mainly due to financial mismanagement and inability to recover dues. The overall ratio of non-performing assets (NPAs) (bad debt) to total loan outstanding for all credit cooperatives is of the order of 26 percent and 88 of the 371 DCCBs incurred losses in financial year 2007-08. The Government of India is in the process of reviving this network through an Asian Development Bank (ADB) and World Bank funded \$2 billion programme of recapitalisation, training and systems support, implemented by NABARD. However, though on account of their outreach the PACS and DCCBs have considerable potential to make a real contribution to financial inclusion, in the politically charged environment in rural India the programme has relatively little prospect of long term success (See M-CRIL, 2009).

The total loan outstanding of the cooperative system on 31 March 2008 was Rs 233,014 crore (\$51.8 billion), or around 5 percent of the overall credit system in the country.

Overall, it is the independent MFIs – NGOs and NBFCs – that form the third part of the microfinance sector – that has been making the news. While many MFIs support SHGs, the largest MFIs essentially follow the methodology developed by the Grameen Bank of Bangladesh, based on individual lending but with group guarantees. This part of the sector has grown dramatically at around 90 percent per annum (in terms of portfolio) and over 60 percent per annum in terms of numbers of clients in recent years as shown in **Figure 3**. Its claimed outreach in excess of 25 million clients by March 2010 is based on substantial multiple lending to the same clients, however, M-CRIL estimates that the number of unique clients served by the sector is much lower, but still impressive, at 18 million. Of these, some 1.5 million clients are probably served by some 500 NGO-MFIs, while around 50 NBFCs serve around 16.5 million clients with the largest 5 accounting for two-thirds of that number (See M-CRIL, 2010). Over the past few years, the leading NBFC MFIs have emerged as highly profitable institutions with returns on assets

**Figure 3** CRILEX growth index for MFIs in India (31 March 2002 = 100)



to the order of 4-5 percent. These Indian MFIs have become the “darling” of the international social investment firmament to the extent that some 30 percent of all international equity deals in microfinance are reported to have taken place in India over the past 5 years.

Frustrated by regulatory restrictions on their efforts to offer deposit services to clients, the NBFC MFIs in particular, have increasingly bundled their credit products with insurance services. These too are restricted by regulation on insurance companies, but are provided by MFIs through agency or group insurance arrangement with large insurance companies. A substantial proportion of these policies – to the extent of two-thirds or more – are in reality just insurance-cover of the MFI’s loans, in case of death of the client; but increasingly such policies also cover lump sum payments to the family of the insured client. In smaller numbers, a few MFIs have also offered product, livestock and crop insurance in this way to help reduce the vulnerability of their clients.

In 1999, the Government of India encouraged commercial bank lending to microfinance by including wholesale lending to MFIs in the definition of “priority sector” for the purpose of determining the banks’ obligation to commit 40 percent of outstandings to specific development purposes. Around this time, the Small Industries Development Bank of India (SIDBI), a statutory development bank owned by the Government of India, established its microfinance wholesaling division, styled SFMC, and started to lend to MFIs in a big way. By March 2009, wholesale loans made by SIDBI alone crossed Rs 2,000 crore (\$445 million). Encouraged by SIDBI’s efforts and incentivised by the inclusion of wholesale lending to MFIs in the priority sector list, in early 2000s the leading private sector bank, ICICI Bank, also took up this business. It was closely followed by a number of foreign banks that faced challenges in meeting the RBI’s priority sector lending requirements

and later, by public sector commercial banks that began to feel left out of the MFI lending business. Since the NGO form of organisation does not have a legal owner, banks tend to prefer lending to NBFCs, leading to increasing transformations of NGO MFIs to NBFCs in their search for resources. By March 2010, Indian commercial banks had committed resources of the order of Rs 18,000 crore (\$4 billion) in loans for on-lending to micro-clients by MFIs with ICICI Bank alone accounting for \$1 billion.

However, increasing concerns about overheating in the Indian microfinance market – high growth rates of MFIs and multiple lending to microfinance clients leading to over-indebtedness – combined with emerging ethical issues related to promoter enrichment and malpractices in the NGO-NBFC transformation process have led to some re-thinking on the priority sector definition. A recent committee constituted by the RBI to consider the appropriateness of the definition of the priority sector recommended in early September 2010 that wholesale lending to MFIs be excluded from the definition from April 2012. If accepted, this recommendation would provide commercial banks and MFIs with a phase-out period from the priority sector. The net result is not likely to be a collapse of bank lending to MFIs but rather a reduction in overall volumes and an increase in cost, particularly for the smaller MFI borrowers. Thus, one of the key factors in enabling growth of MFIs would be significantly, but not terminally, curbed.

Given the social aspirations (if not achievements) of the Indian political economy, it is not surprising that the RBI has, for many years, tried to promote lending to smaller clients and to sectors with greater concentrations of low income people. The directed credit programmes of the government from the 1970s and 1980s gradually gave way in the 1990s to increasing obligations to report on small credit accounts. Thus, by March

2006, 45 percent of all loan accounts were in amounts less than Rs 25,000 (\$550) but aggregated to a minuscule proportion of the amount outstanding.

In an attempt to encourage the banking sector to downsize significantly, in early 2006, the RBI initiated a new experiment: the business correspondent model. Banks were encouraged to appoint NGOs of various types as their business correspondents so that outreach could, thereby, be extended to the village level and “last mile connectivity” with micro-clients established. However, in a bout of political correctness, the measure was throttled with the condition that business correspondents had to be paid by the banks out of their margins (currently of the order of 4 percent) and no additional charges could be imposed on clients. This was despite the well known fact that it is virtually impossible to deliver doorstep microfinance services at a cost less than 6-8 percent of outstanding portfolios. After nearly four years of experimentation yielding limited success, in November 2009, the limitation on charges paid by clients were removed. At the same time the nature of the entity to be engaged as the correspondent was expanded to include various types of retailers – grocers, medical stores – as well as retired army personnel and school teachers. The commercial banks are now in the process of launching new pilot programmes as they work out ways of making the business correspondent model fully operational.

#### 2.2.4 Regulation of Microfinance Institutions

As indicated by **Figure R2**, NGO MFIs are generally not financially regulated since they are not-for-profit organisations and regarded as small charitable institutions. Broadly, the NGO MFIs work for the upliftment of the poor and a majority of them are registered as societies under the Indian Societies Registration Act, 1860. This Act states that “a

*society can be formed for the promotion of literature, science or fine arts or the diffusion of useful knowledge/political education or for charitable purposes*”. Additionally, some MFIs are registered under the Indian Trust Act 1882, to operate as public charitable trusts or private, determinable trusts with specified beneficiaries/members. The acceptance of foreign deposits by NGO-MFIs registered as societies or trusts is also governed by the Ministry of Home Affairs under the Foreign Contribution (Regulation) Act 1976 (FCRA). The receipt of such grants is subject to onerous, but often routine, reporting requirements. Largely, Societies and Trusts are also exempted from the payment of tax due to the not-for-profit objectives of their operations. However, this non-taxable status is currently under threat as the Finance Ministry has classified any activity undertaken for direct economic benefit (as is the case with microfinance) and, therefore, generating a surplus as commercial and, therefore, taxable. The matter currently awaits the formulation of detailed rules but will almost certainly affect the extent to which NGO MFI earnings from microfinance can be recycled into their operations.

Most NGOs vary in size, mission, philosophy and approach and are structurally not suitable to carry out financial intermediation along with their core competence of social intermediation activities. Another category that must also adhere to FCRA regulations is the Section 25, not for profit, company registered under the Companies Act, 1956. Such companies are also not financially regulated as long as they do not accept public deposits, and do not pay any dividend to their members. In order to be classified as microfinance companies and stay outside the purview of regulation, their credit outstanding cannot exceed Rs 50,000 per business client and Rs 125,000 for housing credit.

Cooperative societies are based on the principle of mutual help, democratic decision making and open membership. The Mehta Bhansali Committee (1939) recommended that societies which have fulfilled the criteria of banking be allowed to function as banks. Hence under the Banking regulation Act (1949), the State Cooperative Banks (SCBs), District Central Cooperative Banks (DCCBs) and Primary (Urban) Cooperative Banks are recognised as cooperative banks. All cooperative banks are regulated by RBI and, under mandate from the RBI, supervised by NABARD. However, under state level cooperative laws, the administrative and management aspects of the cooperative banks, as well as all operations of societies are, in theory, supervised and facilitated by state governments through a state appointed Registrar of Cooperative Societies.

In 1995, highly progressive cooperative legislation titled Mutually Aided Cooperative Societies Act (MACS Act) was passed by the state of Andhra Pradesh to make the cooperative more operationally free, autonomous, self-reliant and free from state government interference in administrative matters. This was imperative since state cooperative acts did not provide a proper framework for the emergence of cooperatives as business enterprises owned, controlled and managed by their members for their own development. Similar acts have now been passed by 9 of the 28 states of India. However, the impact of this act has not been very pronounced as other forms of mutual cooperation (such as producer companies) have developed, while state governments have found other administrative means of exercising control over these cooperatives. Overall, the cooperative sector remains weak and moribund.

Self Help Groups (SHGs) are generally not registered. In the early 1990s, banks were allowed by the RBI to open accounts for SHGs which were neither registered nor regulated. RBI, in its mid-term review of Monetary and Credit Policy of November 2003 specified that the group dynamics of working of SHGs could be left to them and no formal regulations or structures should be imposed on them. However, if they have more than 20 members, the Companies Act requires they be registered as producer companies. In general, SHGs do not exceed the limit of 20 and in case they do, the groups usually register as societies.

In response to a couple of major instances of fraud by (non-microfinance) NBFCs in the 1990s, the RBI in 1996 announced the beginning of regulation and supervision of this hitherto ignored component of the financial sector. Minimum prudential and management norms were formulated and the estimated 45,000 NBFCs in existence at the time were required to register with the regulator. The registration process over the next few years resulted in the number of NBFCs being allowed to operate being cut down to around 7,000 by 2005, but has once more increased to over 12,700. As discussed earlier, partly in response to the commercial banks' willingness to lend to microfinance NBFCs, rather than NGOs, increasing numbers of MFIs started to transform into NBFCs from around 2005. Later, this process was further stimulated by the advent of, first, social equity funds and, more recently, private commercial equity funds willing to invest in such companies. As of now, there are around 50 NBFCs operating as MFIs. Mostly, these are transformed NGOs but there are also a few conventional NBFCs that have moved downmarket to provide microfinance services and, within the past 3-4 years, a growing number of microfinance start-ups. All the largest MFIs in India are NBFCs, with 23 of the largest 25 MFIs being

registered as such. Thus, NBFCs dominate the microfinance industry accounting for over 90 percent of both the microfinance portfolio and microfinance clients served.

Microfinance NBFCs, like all NBFCs are registered with and regulated by the RBI. There are no specific rules for microfinance NBFCs; all are required to conform to basic NBFC rules about

- minimum capital requirements (net worth of Rs 2 crore, (US\$450,000))
- capital adequacy: for systemically important NBFCs (assets >Rs100 crore, \$22 million) net worth must currently be >12 percent of risk weighted assets. From April 2011 this requirement will increase to 15 percent,
- deposit taking is only allowed by NBFCs with investment grade ratings from one of the four mainstream rating agencies operating in the country (only one microfinance NBFC presently qualifies), and
- there is also a variety of loan concentrations guidelines for NBFCs but largely these do not affect microfinance NBFCs on account of the small size of their loans.

In the context of concerns about the overheating of the microfinance industry it is not surprising that the microfinance NBFCs are attracting increasing interest from the regulator with more frequent supervision (now six monthly) and more detailed queries about portfolio quality, client protection and managerial remuneration, in particular.

There are no legal restrictions on the interest rates that NGOs, Cooperatives, SHGs can charge their borrowers. However, there is considerable debate, and much political interest, on what is the appropriate rate of interest, and an increasing concerns about the actions of, in particular, the microfinance NBFCs that dominate this sector. At various times, the state governments of Tamil

Nadu and Andhra Pradesh (where much of microfinance in India is concentrated) have threatened action against MFIs under the Usurious Money Lending Acts of those states. In each case, the RBI has intervened to point out that there is no federal restriction, and NBFCs, as federally regulated entities, are not covered by such laws. However, more recently (mid-September 2010), in the aftermath of questions about the ethics of microfinance promoters and their approach to client protection, the Government of India is said to have instructed government owned banks to ensure that MFIs they lend to do not charge more than a 24 percent effective rate of interest. This is at a time when the average yield of microfinance institutions has been calculated by M-CRIL to be around 28 percent and that of the leading ten MFIs in excess of 30 percent. What impact such an instruction will have in the context of the poverty rhetoric of the Indian political economy remains to be seen. It is potentially damaging for microfinance operations since many of the smaller MFIs will not be able to function with a 24 percent effective rate of interest but, if other more pressing issues occupy the government's attention, the efficacy of its application may not be significant.

### 2.2.5 Regulation of Banks

In terms of volumes, if not in terms of the number of unique clients served, the commercial banks dominate the Indian financial system, accounting for over 90 percent of total financial assets. Keeping in mind, the relative importance of these institutions, they are subjected to stringent licensing criteria, prudential regulations and reporting norms.

Under the Banking Regulation Act, 1949, "banking" has been defined as '*accepting for the purpose of lending or investment, deposits of money from the public, repayable on demand or otherwise and withdrawal by*

*cheque, draft order or otherwise*. Section 22, of the act stipulates that a company intending to carry out its banking business must obtain a licence from the RBI, which is issued only after the “tests of entry” have been fulfilled. Such tests consist of minimum capital requirements, appropriate ownership structure, operating plans and controls, quality of management, ability of the bank to pay its present and future liabilities in full and whether the licensing of the bank would be in public interest. The licensing authority has the right to reject an application which does not meet the set standards.

The minimum capital requirements are set keeping in view the risks undertaken by banks and define the components of capital, bearing in mind its ability to absorb losses. In India, minimum capital requirements differ for different types of banks. In the case of commercial banks, the minimum capital requirement prescribed is Rs 200 crore (\$45 million), which must be augmented to Rs 300 crore (\$67 million), within three years of the commencement of business. Since the regulatory regime offers only full-fledged banking licenses and there is no concept of a small bank or a restricted banking license, the minimum capital requirements is quite high.

For state sponsored, regionally based Regional Rural Banks (RRBs), there are no authorised capital requirements since these were established as statutory entities under the guardianship of commercial banks. The aim was to combine the outreach of cooperatives with the large resource base of commercial banks and thereby improve financial inclusion in rural areas. The Local Area Banks (LABs), were conceived to provide a wide array of banking services in two to three contiguous districts with a minimum capital requirement of Rs 5 crore (\$1.1 million). However, as indicated above, only five of these received licences and the experiment is considered, by the regulator, to be a failure. The Urban

Cooperative Banks (UCBs), which are located in a single district/town, have a minimum capital requirement of Rs 10 lakh (\$22,000).

Until the late 1990s, the RBI imposed extensive interest rate ceilings on bank loans, particularly on lending to the priority sector. When these ceilings were removed the only limit that remained was a 12 percent ceiling on loans below Rs 25,000 (\$550) and 13.5 percent on loans below Rs 200,000 (\$4,500). LABs, RRBs and cooperative banks were not subject to these ceilings but RRBs, in particular, tended to be confined to the ceilings by administrative order as subsidiaries of the commercial banks. In 2006, these ceilings were made more flexible and each bank was required to limit the rate on small loans to its guideline prime lending rate. This meant that the interest rate on loans below Rs 200,000 fluctuated between 11.5-13.5 percent with foreign banks being at the upper end of the range. Most recently, from April 2010, all ceilings on interest rates have been abolished and banks are free to set rates on all loans on the basis of their own commercial considerations.

The Reserve Bank of India is solely responsible for regulation and supervision of banks under the Banking Regulation Act 1949. Section 35 of the Act empowers RBI to inspect the books of any banking company at any time. The supervisory functions of the RBI vis-a-vis the banks are carried out by the Department of Banking Supervision based on regulations formulated by the Department of Banking Operations and Development under the direction of the Board of Financial Services. Besides head office and controlling offices, some other specific branches are also inspected so as to ensure minimum coverage of advances. The Annual Financial Supervision focuses upon areas specified in the internationally adopted CAMEL model i.e. capital adequacy, asset quality, management,

earning, liquidity and systems and control. An off-site inspection is also undertaken to check the financial health of banks between two on-site inspections.

In the case of RRBs and rural cooperative banks, NABARD shares some of the supervisory functions with RBI and undertakes their inspection (portfolio check, off site surveillance) under the provisions of Banking Regulation Act 1949. Urban cooperative banks are supervised directly by the RBI. The supervision of NBFCs is undertaken by the Department of Non Banking Supervision (DNBS), which undertakes on-site (CAMEL) and off-site supervision.

One of the main indicators to check the financial health of financial institutions is the capital adequacy ratio (CAR), since bank capital acts as a buffer against the losses which a bank may incur. The minimum capital to risk weighted assets ratio was specified at 8 percent by the Basel Committee on Banking Supervision under Basel I, but has now been revised to 9 percent. The regulatory minimum CAR for UCBs is also 9 percent but presently no such norms exist either for rural cooperative banks or for RRBs.

The reporting requirements for commercial banks, local banks and regional rural banks are almost the same. Broadly, they involve preparation of consolidated financial statements and appointment of auditors for the audit of their accounts. Reporting requirements are most stringent for commercial banks, which are required to submit annual consolidated prudential returns, quarterly and monthly returns to the RBI. In the case of UCBs, three audited copies of accounts have to be submitted to RBI and published in local newspapers; however for the smaller UCBs, only the display of accounts in every office of the bank is sufficient.

## 2.2.6 Conclusions and recommendations

The overall policy framework in relation to microfinance and financial inclusion in India has moved well beyond the recommendations of GTFR, 1998 and achieved a high degree of liberalisation. The key achievements are:

- the growth and spread of the NBFC MFIs, now increasingly covering even the traditionally under-served northern part of the country;
- the wide coverage of rural areas by the network of cooperatives, cooperative banks and RRBs;
- the recently introduced liberal dispensation with respect to banks engaging business correspondents to achieve “last mile connectivity”;
- the abolition of all ceilings on interest rates and limitations on user charges for the provision of the business correspondent facility.

The key issues that need to be addressed are:

- matters of transparency, client protection and the suitability of products offered by NBFC MFIs to the needs of clients;
- the operational and prudential risks created by the high growth of NBFCs as their control systems become over-stretched and their managements pursue equity valuations rather than the needs of clients;
- severe governance and financial weaknesses of the cooperative banks and lack of professionalisation in the operations of RRBs;
- the development of business models for the provision of the business correspondent facility to remote rural clients (and many urban ones);
- facilitating regulatory framework for mobile banking that is yet to emerge.

Some of these issues can be resolved over time as MFIs compete with each other to offer better services and (perhaps) one or two collapse on account of the strain on their systems. More immediately, recent efforts to establish credit bureau facilities for both banks and MFIs will help in limiting over-indebtedness of clients and, thereby, improve client protection. Similarly, business models for the business correspondent facility are likely to emerge over time from the pilot programmes launched by commercial banks. In the meantime, some degree of sub-optimal utilisation of resources will occur as experiments are conducted and then abandoned. The key is for the government and regulator to keep an eye on the situation, take facilitating actions where necessary (such as in the establishment of credit bureaus) but refrain from setting the clock back by imposing interest rate limitations or abandoning the business correspondent model in a panic as a few inevitable failures occur in the short term. With the emergence of mobile banking as a possibility, there are considerable and exciting future prospects for increasing the outreach and utility of microfinance to low income clients.

## 2.3 Nepal

### 2.3.1 Introduction and Background

Nestled in the Himalayas, Nepal is a landlocked country (the nearest seacoast over 1,120 km away, in India) and one of the least developed economies of the world. Largely mountainous, only one-fourth of its total land area is in the terai – a 26-32 km wide and 1,500 km long fertile plain contiguous with India. The total arable land area is only 17 percent. However, Nepal is endowed with abundant water resources, having nine major rivers with an estimated potential of 83,000 MW of hydropower (2.3 percent of the world's potential), yet, with less than 1 percent of this potential having been harnessed till now.

Nepal is estimated to have a population of 29.2 million by end-2009 with a population growth rate in excess of 1.9 percent per annum and a population density of 198 persons per square kilometre. Roughly 30 percent of the country in the mountainous Himalayan region to the north has virtually no human habitation because of perpetual snow but the population density increases as the terrain descends into the hilly region and then the *terai*. The country is largely rural with around 17 percent of the population now living in urban areas.

Nepal continues to be one of the poorest countries in the world with a per capita income of \$447 at nominal rates (and \$1,049 at purchasing power parity), wide income disparities and poor access by a large section of the population to basic social services (according to the Asian Development Bank). It ranks 144 out of 180 countries covered, with a score of 0.553 on the Human Development Index of UNDP. Its average GNI per capita growth rate of 1.9 percent during the period 1990-2008 was lower than the earlier 2.4 percent growth rate partly on account of a

prolonged period of political instability that continues today. Its current GDP growth rate of 5.35 percent is significantly lower than that of its two large neighbours. The share of agriculture in national income has fallen from 50 percent in the late 1980s to around 40 percent now, while services contribute 41 percent of income with the remaining 19 percent provided by industry.

Traditionally, Nepal has had many programmes aimed at poverty alleviation, but with a very limited infrastructure base and limited resources, the outreach of the government is limited and the impact of these programmes on poverty greatly retarded by the state of virtual civil war that prevailed in the late 1990s and early 2000s. This situation has not been helped by the political instability prevailing since then. According to UN estimates, the population living below the international poverty line of \$1.25 per day at purchasing power parity amounts to 55.1 percent of the total. The proportion below

the \$2 a day norm is 77.6 percent, while that below a much more conservatively defined national poverty line is 30.9 percent. Real progress in tackling the resource constraints and skill deficiencies that lie behind economic deprivation must await the establishment of a stable government, hopefully now achieved (early in 2011).

As shown in **Table 2**, the number of financial institutions in Nepal has grown strongly over the past few years. During 2005-10, there was a virtual explosion in the establishment of all the four major categories of regulated institutions - A to D Class (as specified by the central bank/regulator, Nepal Rastra Bank, NRB); but the number of regulated Savings & Credit Cooperatives (SACCOs) and financial intermediary NGOs (FINGOs) remained the same. This is only because the central bank is no longer issuing licenses to such institutions (a matter that is discussed below) and does not indicate a slowdown in the proliferation of SACCOs and FINGOs throughout the country.

**Table 2** Growth of the regulated financial system

		<i>numbers</i>			
		1990	2000	2005	2010
A	Commercial banks	5	13	17	27
B	Development banks	2	7	26	79
C	Finance companies		45	60	79
D	Micro-credit development banks		7	11	18
Savings & credit cooperatives (licensed)			19	20	16
Financial intermediary NGOs (licensed)			7	47	45

Source: NRB, 2009. **Banking & Financial Statistics**, No.53, July

The number of cooperatives registered under the Cooperatives Act is reported to be nearly 9,000 but relatively few are actually involved in microfinance. The growth of deposits in the formal financial system averaged over 26 percent per annum during 2005-09 whereas loans grew by around 28 percent per annum during the same period compared to the 13 percent per annum average growth rate of GDP in nominal currency terms.

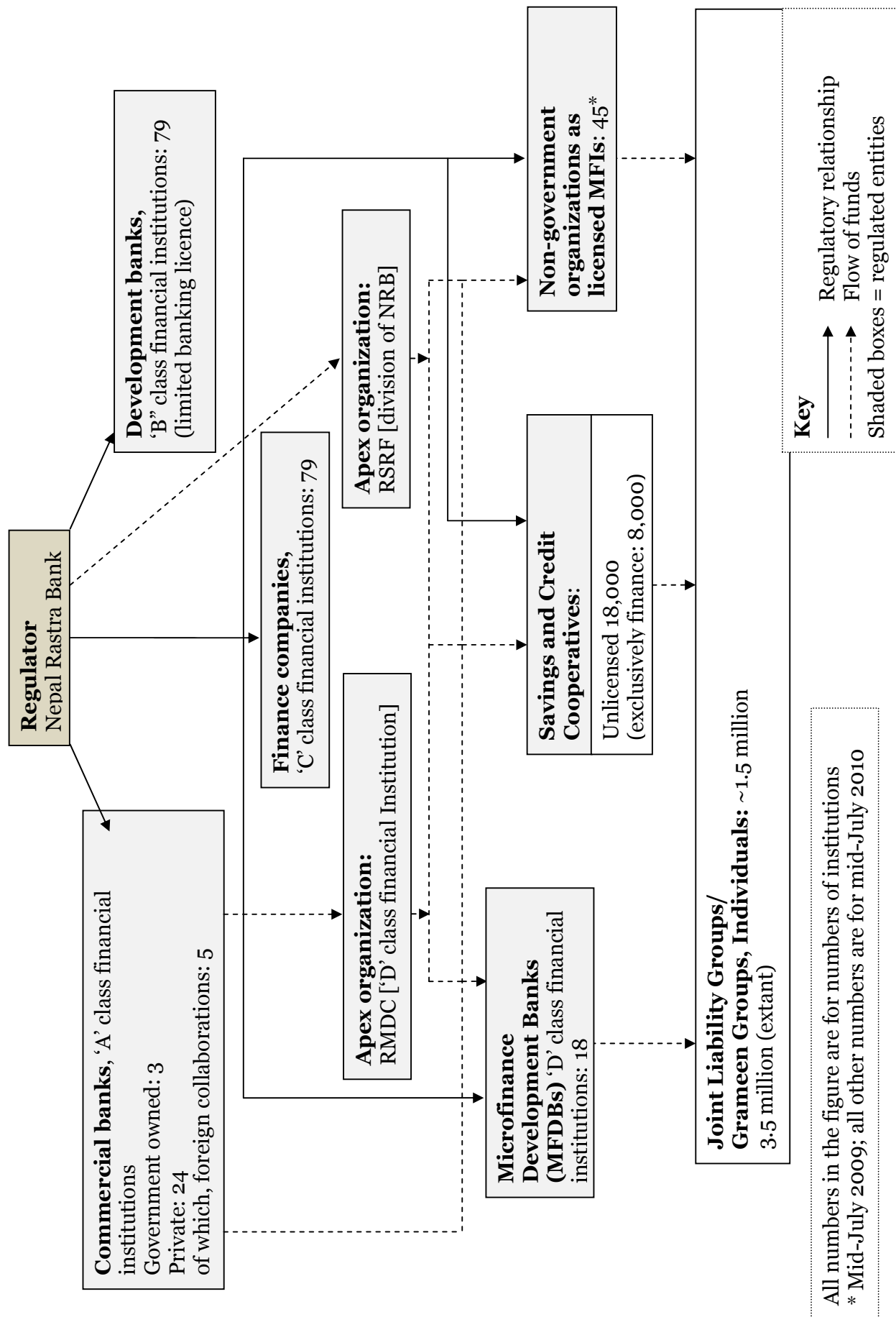
**Figure 4** provides a schematic presentation of the structure of the financial system. The system is dominated by the public sector, with two government owned commercial banks - Nepal Bank Limited and Rastriya Banijya Bank - along with the commercial branches of the Agricultural Development Bank of Nepal (ADB/N) accounting for 309 (41 percent) of the 752 bank branches in July 2009. However, unlike the mid-1990s when the public sector banks dominated the financial system with two-thirds of all loans and 55 percent of deposits, they now account for just 13 percent of loans outstanding and hold less than 20 percent of all deposits.

With the liberalisation of the financial sector during the 2000s, the 12 percent priority sector lending requirement was abolished, but the requirement for banks to hold 3 percent of the portfolio in loans to the 'deprived' sector (meant for the 'hard core' poor) continues. Development banks and finance companies are required to hold 2.5 percent and 2.0 percent respectively of their portfolios in loans to the deprived sector. A deprived sector loan is one provided on a group guarantee (i.e. without physical collateral); earlier up to a limit of NRs 60,000 (\$833), but now increased to Rs 90,000 (\$1,250) from financial year 2010-11 (mid-July to mid-July). Similarly, the limit for lending to microenterprises has been increased from Rs 150,000 (\$2,100) to Rs 200,000 (\$2,800)

but this should not exceed 33 percent of all deprived sector lending. There are also various limits for lending to women owned enterprises and to community owned enterprises, such as micro-hydro units and cold stores, included in the deprived sector requirement. Most importantly, the deprived sector lending requirement can no longer be fulfilled by making bulk deposits in microfinance institutions purely for the purpose of earning interest.

The central bank's commitment to microfinance is manifest in both the provision for the establishment of micro-credit development banks, and the growth of such banks as shown by the information in **Table 2**. From just 6 micro-credit banks (Microfinance Development Banks [MFDB], RMDC) and an apex fund in 2000, the number of such banks has now increased to 18. More incentives are also being provided for the establishment of commercial bank branches in districts with limited availability of banking services. These include the relaxation of minimum capital requirements for additional branches and eligibility for opening additional branches in the commercially vibrant Kathmandu valley, if branches are also opened simultaneously in limited access districts. Interest free loans of Rs 5-10 million are also to be provided by the central bank for opening branches in any of the 22 remote districts (out of 75 in the country). This will be reinforced by the policy to provide immediate licences to more institutions established to provide microfinance services in backward regions. In order to facilitate the regulation of the growing number of deposit taking small microfinance institutions, the establishment of a second tier institution (STI), for their regulation and supervision, has also been proposed.

The flow of funds to microfinance institutions – micro-credit development banks, financial intermediary NGOs and SACCOs is supported

**Figure 4** Structure of the financial system and microfinance delivery in Nepal

In 2001, a new apex institution was established for supporting small farmer cooperatives. In July 2009, the Sana Kisan Bikas Bank Limited (SKBBL) had outstandings of Rs 731 million (\$10.2 million), less than two-thirds of the \$15.8 million available to it. By April 2010 this had increased to Rs 1,105 million (\$15.3 million), and a coverage of over 200 small farmer cooperatives with reported outreach of over 150,000 farmers. It is sustainable but not highly profitable as an apex organisation.

The establishment of five RRDBs (regional rural development banks), also known as Grameen Bikas Banks, sponsored by the NRB constituted part of the Nepal Government's effort to pursue a poverty agenda. These public sector development banks were established in 1992 in the five development regions of the country and helped to promote the outreach of microfinance in the *terai* areas. Though none were financially successful, these banks helped to demonstrate the possibility of undertaking the provision of microfinance services through

the development bank model and led to the passing of the Development Banks Act, 1996. The first privately owned MFDB, Nirdhan Utthan Bank Limited, was established in the western region town of Butwal in 1999. Initially it was four of the main FINGOs that established development banks and, more recently, as discussed earlier, there has been a proliferation of such banks. Indeed, four of the five RRDBs have also now been privatised. Only the Far Western Grameen Bikas Bank remains in government ownership due to its dire financial state.

As **Table 3** shows, the outreach of the 13 retail MFDBs currently in operation (two are wholesale banks and three are establishing operations) exceeds 0.5 million loan clients with an average loan outstanding of Rs 19,400 (\$270) compared to the much lower outstanding of Rs 6,600 (\$92) for FINGOs and Rs 3,100 (\$43) for the nearly 800,000 cooperative borrowers. Discussion at the Nepal Microfinance Summit held in March 2010 suggests that microfinance in the country

**Table 3** Microfinance lending by major institutional types, July 2010

Type	Loan clients	Outstanding, in millions	
		Nepal Rs	US \$
<b>MFDBs</b>	504,000	9,795	136.0
<b>FINGOs</b>	363,000	2,401	33.3
<b>SACCOs</b>	786,000	2,214	30.7

by two apex funds, the Rural Microfinance Development Centre (RMDC) and, in a small way, by the Rural Self-Reliance Fund (RSRF), now being re-styled as the Microfinance Development Fund.

### 2.3.2 Arrangements for direct support

The Rural Microfinance Development Centre Limited (RMDC) was established in 1998 as an apex wholesale lending and promotional institution for microfinance in Nepal. It started operations in 2000 with the aim of supporting the provision of microfinance to at least 1.5 million low income families through 150 partner organisations. It was established with support from the Asian Development Bank (ADB) and is owned jointly by the NRB, commercial banks, Regional Rural Development Bank (RRDBs), Nirdhan Utthan Bank (the first MFDB to be established) and the Deposit and Credit Guarantee Corporation.

RMDC has become established as a well respected apex organisation and has made a significant contribution, particularly to capacity building, having provided training support to 206 microfinance partner organisations up to July 2010. Its lending activities have been undertaken in a fairly prudent and conservative way with under 60 percent of its total funds (of \$44 million) deployed in lending to 61 partner organisations at 6 percent interest, while around 33 percent are placed in investments (which, crucially, earn a higher rate of interest). As a result it had relatively high profitability with a nearly 3 percent return on assets in 2009-10 (compared to 2 percent in the previous year). It makes a moderate (10-20 percent) contribution to the microfinance funds available collectively to its main partner organisation types MFDB, SACCOs and FINGOs.

The Rural Self Reliance Fund (RSRF) has quite limited achievements that match its relatively modest resources. It was set up in 1991 to deploy seed capital received from the Government of Nepal, NRB and donor agencies to support the income generation activities of the rural poor through cooperatives, NGOs and other formal institutions, as well as to provide wholesale credit to MFDBs for on-lending to the “deprived sector”. Its initial corpus of Rs 20 million (\$280,000) was supplemented with Rs 100 million (\$1.39 million) in addition to seed capital provided by the NRB in 2001-02 and augmented by a policy of providing 5 percent of NRB’s annual profits. By July 2005, the funds available to RSRF had reached Rs 322 million (\$4.47) though only Rs 125 million (\$1.74 million) was deployed in loans to its 120 partner organisations (including 3 MFDBs) with an average outstanding loan size of just Rs 250,000 (\$3,500) per MFI.

Given that its funds are only a fraction of those available to RMDC, it is apparent that RSRF’s contribution to microfinance in Nepal is minuscule. Its portfolio at risk (PAR) in July 2005 was 5.4 percent but 20 percent of the portfolio in loans to SACCOS and FINGOs had a risk proportion in excess of 27 percent; 80 percent of its portfolio had been lent to MFDBs. With its yield of just 3.6 percent (8 percent interest, followed by a 6 percent on time payment rebate), the fund earned a surplus of 0.9 percent on assets in that year. However, its surplus is based largely on its overhead expenses being covered by the NRB. The RSRF have been in the doldrums since the middle of the decade, with a proposal to convert it into a more dynamic, autonomous entity styled as the Microfinance Development Fund still being discussed. By mid-July 2008, the Fund’s outstanding had shrunk to Rs 91 million, with an outreach at less than 15,000 families.

is now on a high growth trajectory with some concerns about multiple lending and over-indebtedness emerging in the traditionally well served *terai* areas of central and western Nepal as well as in some of the more easily accessible hill districts and in the Kathmandu valley.

### 2.3.3 Regulation of Microfinance Institutions

Nepal was the first country in South Asia to introduce specific regulations for the microfinance sector: the Development Banks Act, 1996 and the Financial Intermediary Societies Act (FISA), 1998 were both aimed at stimulating the growth of financial services in the rural, mostly unbanked areas of the country. Unfortunately, the attempt at introducing regulation to promote and facilitate microfinance was characterised more by confusion than clarity in its strategy towards poverty and financial inclusion. While the Development Banks Act was aimed at encouraging private sector initiative in financial inclusion, FISA came as a logical extension.

It was FISA that introduced the concept

of “limited banking licence” as a way to legitimise the ongoing financial services activities of NGOs registered as societies and of cooperatives. The limited banking licence gives its holder the right to provide microcredit services to low income families and to collect the savings of such families as member-deposits. However, from the start, FISA was more a source of confusion than promotion of inclusion. The Act said nothing about the collection of savings from non-borrowing members of the public and, indeed, contradicted the Cooperatives Act which is more liberal regarding membership and does not include income or account size limitations that are incorporated in FISA. This placed cooperatives that are limited banking licence holders in a legal limbo with regard to deposit taking. The main attraction of the limited banking licence for cooperatives was the stamp of legitimacy conferred by central bank supervision. At the same time, the stamp of assurance did not benefit NGOs since these institutions have not been particularly successful at raising voluntary deposits from members, let alone from the general public. It is for this reason that the number of cooperatives licensed under the act has

**Table 4** Minimum capital requirements for MFDBs and licensed Cooperatives

Area of operation	Nepal Rs in millions	US dollars million
<b>1 district</b>	2.5	0.035
<b>3 districts</b>	10	0.14
<b>10 districts</b>	20	0.28
<b>National</b>	100	2.22
...and cooperatives with limited banking licence		
<b>Municipality dist</b>	2.5	0.035
<b>Sub-metro' dist</b>	5	0.07
<b>Metro' district</b>	10	0.14

actually declined, from 35 at the peak in 1999-2000 to just 16 today. The number of licensed NGOs (FINGOs) has remained more or less steady, despite their failure to raise deposits from members, since access to preferential loans from RSRF and commercial banks is still an advantage. However, there has neither been a rush to obtain licences.

The original version of FISA included a clause that implied that the NRB would underwrite loans made to societies licensed under the Act. The clause was dropped in amendments made in 2003 after the NRB objected in the strongest terms. Ultimately, all financial legislation in Nepal was replaced in 2006 by one omnibus law called the Banks and Financial Institutions Act, 2006.

The minimum capital requirements for the establishment of commercial banks in Nepal is in the range Rs 250-500 million (\$3.5-7.0million) in equity depending on the location of the head office and the geographical coverage of their business. These are fairly liberal requirements and compare with a minimum requirement of \$65 million in India and \$117 million in Pakistan. For MFDBs the requirements are significantly lower as shown in **Table 4**. The capital requirement for operations at the national level has been reduced over the past few years from the earlier Rs 160 million (\$2.22 million). The earlier requirement for MFDBs

to limit deposit taking to borrowers has now been relaxed to enable them to mobilise deposits from the public.

RRDBs were established with an initial capital of Rs60 million (\$0.83 million). For SACCOs with limited banking licences, the requirements are much lower as shown in the table. Since NGO operations are not based on equity ownership, FINGOs are required to limit each loan to less than Rs 100,000 (\$1,400) per individual and must build a risk reserve fund through the allocation of 10 percent of their operating profits.

The capital adequacy norms for all financial institutions have, however, been tightened in keeping with Basel II norms, with banks now required to maintain their capital fund at 10 percent of their risk weighted assets with at least 6 percent being core (or Tier 1) capital. Other financial institutions must maintain a capital fund equal to at least 11 percent of their risk weighted capital and at least 5.5 percent core capital.

Liquidity ratios specified by NRB for microfinance institutions are set out in **Table 5**. Cooperatives also have to place 1 percent of their total deposits in an account with the NRB.

The loan loss provisioning norms for financial institutions range from 1 percent to 100 percent depending on the quality and ageing of the loan. Good loans (less than 3 months

**Table 5** Liquidity & cash reserve ratios\*

Institutions	Liquidity ratio	Cash reserve
MFDBs	4 percent	2 percent
SACCOs	7 percent	2 percent
FINGOs	Not specified	

\* as a proportion of deposits

overdue) must be provisioned at 1 percent, weak (3-6 months overdue) at 25 percent, doubtful (6-12 months overdue) at 50 percent and bad loans (more than 12 months overdue) at 100 percent.

Over the years, group guarantees have become accepted in Nepal as loan collateral for poverty lending. Even commercial banks involved in group lending have accepted these as a collateral substitute. In addition, the Development Banks Act specifically recognises joint liability of the group as sufficient collateral for low income families up to a specified loan amount (Rs 60,000, \$850) given to them. For microenterprises, unsecured loans can be up to a level of Rs 150,000 (\$2,100).

NGOs and cooperatives with limited banking licences as well as microfinance banks, as Class D financial institutions, are all obliged to submit data on their financial operations to NRB. By separate instructions issued from time to time NRB asks such institutions to submit financial information and data relating to:

- Loan terms and conditions
- Interest rates
- Deposit terms, maturity and other conditions
- Liquidity parameters
- Financial statements
- Operational information – portfolio and outreach
- Loan repayment and arrears rates.

Various returns are required to be submitted on a weekly, monthly and annual basis. The NRB's supervision department has been responsible for the inspection of regulated microfinance institutions until now, but

since July 2010, this responsibility has been transferred to the Microfinance Promotion and Supervision Department of the Bank. The Supervision Department was unable to provide the resources necessary to undertake an adequate number of inspections and the purpose of the transfer is to increase the frequency and quality of supervision by staffs that are better able to understand issues in MFI operations. The aim is to increase frequency from once in 2-3 years to at least every 18 months. In the long run, the plan is to transfer all microfinance responsibilities to the proposed Second Tier Institution. A note proposing the creation of such an institution has recently been submitted by NRB to the government.

There are no interest rate caps on micro-lending in Nepal. Interest rates can be fixed by the Board of Directors of the respective MFIs. However, decisions regarding changes and procedures have to be informed compulsorily to the NRB within a few days of making them and information on effective interest rates have to be published in the local media at least once a year. However, in a country that has recently undergone a Maoist insurgency and is still in political turmoil while a viable political solution is found, it is inevitable that there is informal political pressure on MFIs to limit their interest rates. By and large, effective interest rates in microfinance in Nepal (less than 25 percent) are amongst the lowest in the world.

### 2.3.4 Conclusions and recommendations

The overall policy framework in relation to microfinance and financial inclusion in Nepal has, for a number of years, been progressive and liberal. As in the case of most of the other countries, microfinance regulation in Nepal has actually moved beyond the recommendations of GTFR, 1998.

In recent years, with the privatisation of RRDBs and reduction in minimum capital requirements for MFDBs operating at the national level, it has become even more liberal. The key features are:

- a fast growing microfinance sector stimulated by the liberal dispensation for the establishment of microfinance development banks that are able to offer deposit as well as credit facilities;
- continuation and strengthening of the deprived sector lending requirement which promotes the flow of funds from commercial banks to MFIs;
- the existence of a successful apex organisation (RMDC) that has been able to provide capacity building support as well as on-lending resources to MFIs;
- a relatively liberal regime of prudential regulation and supervision as well as the removal of all controls on interest rates.

The key issues that need to be addressed are:

- the age old concern about the development of a model for the provision of microfinance services in the hills of Nepal – this has been much talked about but not adequately addressed in terms of significant pilot experiments with alternative models; though RMDC is now actively encouraging hill microfinance;
- a growing concern about multiple lending and over-indebtedness as well as mission drift to lending to non-poor clients that could cause an India-style crisis in the country in the not-too-distant future; and

- the plan to convert the relatively unsuccessful RSRF into a larger Microfinance Development Fund rather than strengthening and expanding the successful operations of RMDC as an apex institution;
- the plan to establish a Second Tier Institution outside the central bank for the promotion and supervision of microfinance, since this would effectively separate the NRB from microfinance issues removing a large proportion of the people from participation in the mainstream financial system; it is not clear how the concern about the lack of supervisory experience and capacity in relation to microfinance will be addressed better by the Second Tier Institution than it is by the central bank.

The resolution of some of these issues is related to the political economy of the country. With the political arrangements in turmoil, there are attempts to concentrate power within government-controlled microfinance vehicles. What is needed is a decisive approach to mainstreaming the financial needs of the large proportion of the population of Nepal who are potential microfinance clients rather than separating their needs out into special purpose vehicles. A mainstream approach will be beneficial also in encouraging MFIs to direct their attention away from the terai, saturated with financial services and substantially affected by the problems of multiple lending and consequent over-indebtedness, increasingly towards the hill regions as increasing resources are devoted to the needs of this less developed part of the country.

## 2.4 Pakistan

### 2.4.1 Introduction and Background

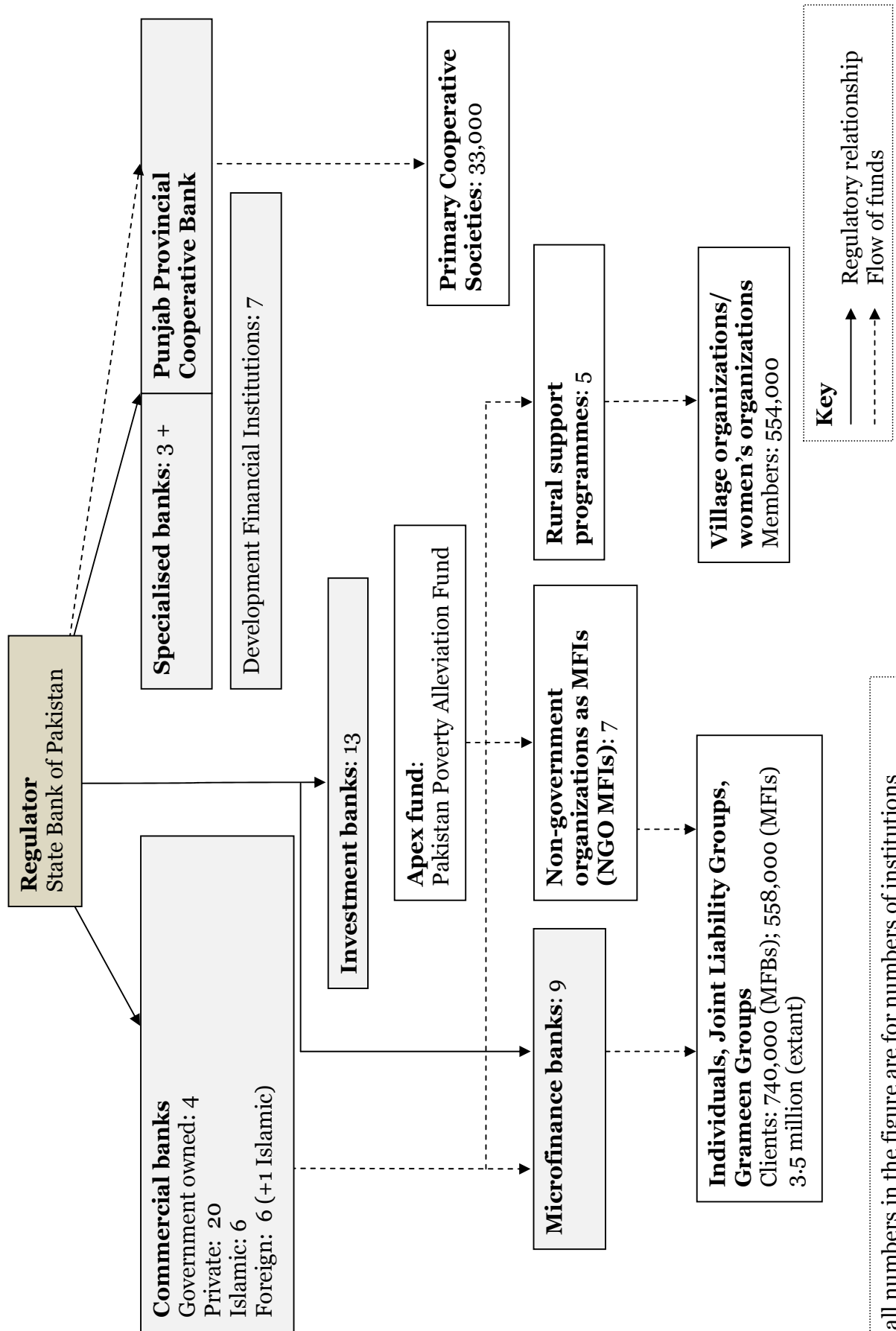
With a population of 174 million (July 2009), Pakistan is the seventh most populous country in the world, with about one-third of this population concentrated in urban areas. It is on the northwest side of the South Asian subcontinent with India to the south and east, China and Tajikistan to the north, Afghanistan to the northwest and Iran to the west. The population growth rate was estimated to be 2.2 percent per annum in 2008 with a total fertility rate of 3.43 children born per woman. The population density of 216 persons per square kilometre is lower than that of other South Asian countries, except Nepal.

GNI per capita was \$1,020 in 2009, slightly below that of India and well below Sri Lanka and most countries of Southeast Asia. Pakistan's economic growth was in the 5-8 percent range during 2003-08 but is estimated at 2.7 percent for 2009. There has been a marginal shift in the structure of production in the past decade with the share of agriculture declining from 26 percent in 1995 to 21 percent, while the share of services has increased from 50 percent to 55 percent. Reflecting its relatively moderate growth rate compared to other Asian countries, Pakistan's performance in terms of human development is disappointing. Its score of 0.572 using 2007 data places it 141 amongst 182 countries, just above Nepal and Bangladesh but lower than India at 0.612. It has a relatively high fertility rate and its infant mortality rate (88 per 1,000 births), adult literacy rate and school enrolments continue to be at lower levels than those of some South Asian countries.

International estimates of poverty placed the proportion of population below the national poverty line rate at 32-35 percent in 1999, though the government claimed at the time that just 23.1 percent were below it. According

to World Bank estimates, this poverty rate fell to 17.2 percent by 2007-08. The incidence of poverty in urban areas is said to be some 5 percent below the national average and in rural areas around 3 percent above. Using the international poverty thresholds, 60.2 percent of the population lives on less than \$2 a day according to UN estimates with 22.6 percent below \$1. By this measure, Pakistan is significantly better off than both Bangladesh and India that have around 75-80 percent below \$2 a day and 40-45 percent below the \$1 poverty threshold. In recent times, the government has pledged increased expenditures on both health and education in order to improve the human development levels of its population. However, with growing issues of terrorism compounded by the resource constraints arising from the recent floods affecting around 25 percent of the land area of the country, this is going to be a major challenge. The problem is further compounded by the chronic instability of the political system in Pakistan.

**Figure 5** provides a schematic presentation of the structure of the financial system in Pakistan. With the deregulation of the financial system, mainly since 1991-92, there has been a proliferation of financial institutions in Pakistan, but the past few years have seen a series of mergers and acquisitions along with the establishment of some new Islamic banking institutions. The number of operating commercial banks is currently 40, boosted by 6 of the special category Islamic banks, but still below the peak of 45 in 1995. With a wave of mergers and acquisitions having taken place over the past decade, the concentration ratio of the top 5 banks has declined from 63 percent of assets in 2000 to 52 percent of assets in calendar year 2007. A number of medium sized banks have merged in recent years partly to satisfy the greatly increased minimum capital requirements and adequacy ratios specified under the Basel-II

**Figure 5** Structure of the financial system and microfinance delivery in Pakistan

was, in fact, a reduction in the numbers of clients in late 2008 before some small growth in borrower numbers was recorded again in 2009. In the quarter ending 30 June 2009, the number of borrowers increased by 3 percent, and portfolio by 8 percent.

Ever since the promulgation of the MIO, microfinance has been regarded by the Government of Pakistan as an activity of national importance and the SBP has, from time to time, announced measures of liberalisation for MFBs and promotion for microfinance generally. Relatively recently, in February 2007, the SBP developed a national strategy for microfinance entitled “Expanding Microfinance Outreach”. The strategy presents a diagnostic assessment of the sector and identifies the factors that lie behind the relatively low microfinance outreach in the country. The strategy has specified outreach goals and recommended some initiatives for strengthening the capacity of the sector.

One of the initiatives identified was to use the vast network of branches of the Pakistan Post Office to reach remote rural areas in a cost effective manner. This was taken up by the First Microfinance Bank (FMFB) which has completed its pilot programme. As part of the programme to encourage new technologies, the Tameer Microfinance Bank Ltd. (TMFB) was issued a licence under the Branchless Banking Guidelines to initiate a branchless banking project in association with Telenor, one of the leading mobile phone companies in Pakistan and a major shareholder of the bank. Similarly international microfinance NGOs like ASA and BRAC, with extensive knowledge and experience of fast growth and widespread operations were encouraged to operate in Pakistan. Both organisations started operations in 2007.

### 2.4.2 Arrangements for direct support

The Pakistan Poverty Alleviation Fund (PPAF) is the lead apex organisation of the country, wholesaling funds to civil society organisations with partnerships based on rigorous criteria. It was established in 1999 as a public-private partnership. It provides debt financing for microcredit and enterprise development and grant funding for small scale infrastructure, water, housing, health, education, social safety nets, training, social mobilisation and institutional capacity building for the delivery of services. Over the past decade, it has established itself as an organisation that enjoys significant clout among partners. It has been financed by funds from numerous international and bilateral donors, principally the World Bank, International Fund for Agricultural Development (IFAD) and KfW<sup>2</sup>. Its total resources by April 2010 amounted to some \$1,070 million.

During 2008-09, PPAF disbursed Rs 6.3 billion (\$74 million) to 48 partner organisations for microcredit. Its partner organisations are reported to have a 50 percent share of the microcredit market in Pakistan. During the year PPAF funds alone accounted for 22 percent of all disbursements to the order of Rs 28 billion (\$335 million); 24 percent of its ultimate borrowers were based in urban areas and 76 percent in rural. The urban portfolio is predominantly deployed in loans to women unlike its rural portfolio. Of the 1.37 million loans facilitated by it, 339,000 were to women in 2008-09. In terms of institutional types, its close relationship with the Rural Support Programmes (RSPs) has been loosened in recent years with their share in total funds declining from 92 percent in 2000-01 to just 32 percent in 2008-09. MFBs now account for 44 percent of the total and NGOs for 22 percent. Over time, it has

2 German Development Bank [note: does not use the full form any more]

norms. Overall, the net domestic assets of the banking sector have grown by 15-17 percent per annum – significantly higher than the trend rate of inflation of 10 percent though this has increased to more than 15 percent over the past few years.

Nevertheless, the World Bank's Access to Finance Survey of 2008 showed that just 12 percent of the adult population has no access to formal financial services and 56 percent has no access to financial services of any kind. In order to promote financial inclusion, the State Bank of Pakistan (SBP), the central bank, has a Development Finance Group specifically charged with the responsibility of developing initiatives that broaden access to underserved and marginalised sections of the economy. These include initiatives for promoting finance for agriculture (via the mainstream commercial banking system), for housing and infrastructure, small and medium enterprise (SME) finance and microfinance.

The scheme of requiring the state-owned commercial banks to lend to the agricultural sector continues. With the closure of the Federal Bank of Cooperatives and all the provincial cooperative banks, excepting one in Punjab in 2002, there is also an indicative target for domestic private commercial banks to lend to agriculture. In 2008-09, 93 percent of the target was achieved overall but the private sector was markedly reluctant, achieving just 80 percent of a target, which was only 20 percent of the total, despite accounting for nearly 50 percent of the assets of the banking sector. The remaining cooperative bank, in Punjab, serves its 33,000 member cooperatives as well as individual farmers but, since 2007, no longer receives any direct funding from the State Bank of Pakistan. The village level cooperatives continue to be dominated by elites and

tend not to provide loans to the poor. The bank itself has serious portfolio quality and management issues and relies on support from the provincial government of Punjab for its continued existence. Nevertheless, the SBP has launched a number of initiatives for the promotion of agricultural credit. These include a crop loan insurance scheme, guidelines on the Islamic financing of agriculture and a handbook of best practices for agricultural and rural finance.

The government and central bank have made a substantial commitment to microfinance over the past decade with the promulgation of the Microfinance Institutions Ordinance (MIO) in 2001 and with continued efforts to promote the growth of microfinance lending, both by commercial and microfinance banks (MFBs). Support to commercial banks in undertaking microfinance includes encouragement to open both standalone microfinance branches and establishing microfinance units at existing branches, as well as training for staff in providing microfinance services. The extent to which these measures have yielded results is not clear as there seems to be no microfinance-specific reporting by the commercial banks.

Microfinance in Pakistan has an increasingly developed framework for operations but still quite low outreach. The microfinance sector as a whole reported 1.8 million active borrowers at the end of June 2009, with 50 percent women. However, these were spread over the 7 operational microfinance banks at that time, as well as the around 15 NGOs actively engaged in providing microfinance services. The high growth of some of the leading institutions had led to some signs of over-heating, locally in the Lahore area, and as a result, there has been a mixed growth performance over the past 2 years. There

been able to reduce the grants given by it for operational and capital costs from 26 percent of on-lending funds in 2000-01 to just 5 percent now. PPAF has played an important role in the growth of the sector but it has not been as dominant as a source of funds for microfinance as PKSF in Bangladesh.

In addition to the actions outlined at the end of the previous section, the SBP also entered into a partnership with the Department for International Development (DFID) of the UK for a £50million Financial Inclusion Programme (FIP) to be implemented by the former. The aim of one of the components under FIP was to develop the microfinance sector's capacity to reach 3 million microfinance users by the end of 2010 and 5 million by 2015. The aim was to transform the sector from a subsidy-based activity undertaken by informal institutions to a market-based financial services industry with formal, regulated institutions. Financial inclusion will also be supported through improved remittance systems, expansion of SME and rural financing.

The most important interventions under the programme are:

1. **Microfinance Credit Guarantee Facility** of £10 million aimed at mitigating the risks perceived by commercial lenders about lending to the microfinance sector. It provides a partial guarantee resulting in a credit enhancement that enables the banks to develop their own sense of the risks involved in microfinance.
2. **Institutional Strengthening Fund** of £10 million to strengthen the human resource base, improve governance, introduce new products and delivery systems hinging on technology and refining

the strategic direction of microfinance institutions. The idea is to make microfinance institutions in Pakistan more competitive and increase the depth and breadth of microfinance services in the country.

The remaining £30 million is to be used for an SME Guarantee Fund, a capacity building fund for the State Bank and an innovation challenge fund.

3. **Improving Access to Financial Services Fund** of \$20 million under an Asian Development Bank sponsored facility to support institutional capacity building initiatives of the stakeholders – financial service providers, training of government and regulatory authorities and literacy programmes for clients and potential clients to improve access to and utilisation of finance.

The Pakistan Microfinance Network (PMN) evolved from an informal effort of several Pakistani participants of the first Microfinance Summit in 1997. It received its first grant support from the Aga Khan Network in 1999 and was formally registered as a not-for-profit company in 2001. It is a network of organisations engaged in providing microfinance services and dedicated to increasing the outreach and sustainability of the sector in Pakistan. PMN is today the most active and credible of national microfinance networks in South Asia. It has been instrumental in fostering awareness about microfinance amongst policymakers in Pakistan and is regularly consulted by the government and central bank when taking decisions affecting the microfinance framework, and has played a significant part in shaping those decisions. It has launched comprehensive capacity building initiatives

using expert CGAP-certified trainers from the region. Its proactive approach to establishing an information hub has enabled the development of benchmarks and standards for the microfinance sector in Pakistan which has bolstered the cause of transparency in microfinance internationally, as well as within the country.

The creation of the microfinance bank as an institution in Pakistan was an exciting development not just for microfinance in the country but for south Asia as a whole. It was only the second country in south Asia (after Nepal) to make a specific provision for deposit services for microfinance clients, in addition to credit. As discussed above, it was also supposed to enable microfinance in Pakistan to reach 3 million clients by the end of 2010. In practice, the 7 operational MFBs had 700,000 clients by the end of 2009, less than 40 percent of the total of 1.8 million persons served by microfinance institutions. Essentially, apart from the first two, Khushhali Bank and First MF Bank, the other MFBs were run more like conventional banks, than as microfinance entities, targeting urban microenterprises rather than groups of women micro-borrowers, typical of microfinance in South Asia, and thus did not make much of an impact in terms of client numbers. Overall, MFBs have less than 25 percent exposure to

women clients. Their deployment of funds in microfinance loans has been around 50 percent compared to the 70-80 percent typical of MFIs, and their operating expense ratios around 40-50 percent are also higher than normal. As a model, the MFB is yet to establish its role and market niche in the overall financial system. Recent events in Pakistan, including the Lahore delinquency crisis of 2009 and ongoing issues in the economic environment, have caused a setback to the growth of the microfinance industry in general and microfinance banks, in particular.

### 2.4.3 Regulation of microfinance institutions

The microfinance industry in Pakistan was fortunate in the acceptance of the activity as a key part of the government's poverty reduction efforts. This happened as early as 2001, with a new (military) government attempting to gain acceptance from the people of the country. A new, dynamic Governor of the central bank was able to pick up the cues and introduce both the institutional framework and specific prudential regulation sought by MFIs in other parts of South Asia as a means of legitimacy and integration with the overall financial system.

**Table 6** Minimum capital requirements for MF

Area of operation	Pakistan Rs in millions	US dollars Millions
District	100	1.18
Regional (5 districts)	150	1.76
Provincial	250	2.94
National	500	5.88

The intent behind the introduction of the microfinance bank into the institutional framework has already been discussed. Its design was about as promotional as could be expected. The minimum capital requirements for the establishment of commercial banks in Pakistan is now Rs 6 billion (\$70million) and rising to Rs 10 billion (\$118 million) by the end of 2010 in equity as part of the Basel II norms. These are fairly stringent requirements compared with the minimum requirement of \$65 million for commercial banks in India, and the much lower requirements in other parts of South Asia.

For MFBs the minimum capital requirements are fairly stringent as shown in **Table 6**. This is partly to ensure that the licence is not misused as telecom companies and other private parties look at MFBs for their branchless banking operations. The capital requirement for operations at the national level is Rs 500 million (\$5.88 million) while district level operations can be started for just Rs 100 million (under \$1.2 million). These requirements are more than 2.5 times the minimum capital requirements for microfinance banks in Nepal. At least 51 percent of the capital of these banks must be held by sponsors whose shareholding cannot be transferred, or in any way committed without the permission of the central bank.

Such banks cannot extend loans in excess of Rs 150,000 (\$1,765) with 80 percent of the loan portfolio within the limit of Rs 100,000 (\$1,175). The MFBs are also required to ensure that the indebtedness of their borrowers from other institutions – NGOs, cooperatives, commercial banks – does not exceed Rs 150,000 (\$1,765). They are now also required to report to a credit bureau. As the Pakistan Microfinance Review, 2009 reports, “A number of regulatory amendments were introduced by the SBP in 2009. As per

these changes, MFBs can extend micro loans up to PKR 150,000 (USD 1,765) as general purpose loans, and PKR 500,000 (USD 5,880) as housing loans. Borrowers’ annual income conditions have also been relaxed from PKR 150,000 to PKR 300,000 (USD 1,765–3,530) for general loans and PKR 600,000 (USD 7,060) for housing loans to allow room for the graduation of microfinance clients.”

The capital adequacy requirement is for the MFB to maintain capital equivalent to at least 15 percent of its risk weighed assets. Contingent liabilities during the first 3 years are not allowed to exceed three times the bank’s equity and thereafter should not be more than 5 times equity. In addition, in order to meet obligations to depositors, MFBs are required to maintain a cash reserve equivalent to 5 percent of their demand and time liabilities in a current account with the central bank and a further 10 percent in liquid assets – cash, gold, unencumbered approved securities. It must also establish a Depositors’ Protection Fund to which it credits not less than 5 percent of its annual profits after taxes. As an additional measure of prudence there is the requirement of a statutory reserve to which it must credit 20 percent of the bank’s annual profit after taxes until the reserve equals the bank’s equity and 5 percent of the profit thereafter.

The loan loss provisioning norms consist of a general provision of 1.5 percent on all outstanding loans while sub-standard loans (30-90 days overdue) have to be provisioned at 25 percent, doubtful loans (90-180 days overdue) at 50 percent and “loss” loans (more than 180 days overdue) have to be provisioned at 100 percent. All MFBs have to have a restructuring/rescheduling policy and non-performing loans must be written off one month after being classified as “loss”.

As an additional means of oversight, the law specifies that all MFBs will get a credit rating within 3 years of first being established or within one year of the commencement deposit mobilisation and will ensure that the validity of the rating is maintained by obtaining annual ratings thereafter. Ratings can be by any agency on the SBP's approved panel or an international microfinance rating agency (with prior approval of the central bank).

No such rules apply to NGO MFIs and RSPs since these operate under civil society rules not designed for the provision of financial services. Each set its own rules based more on a concern for its public reputation and fiduciary responsibility to its funders and donors rather than specifically to the government or the public.

MFBs are required by the SBP under the Microfinance Institutions Ordinance to submit

1. A biweekly Statement of Affairs containing the major heads of assets and liabilities at the close of business on alternate Saturdays
2. A quarterly Report of Condition containing full financial statements – balance sheet and profit and loss account along with an:
  - Aging schedule of non-performing loans
  - Summary of fixed and other assets
  - Summary of disbursements and recoveries
  - Details of deposits by type and ownership
  - Details of borrowings
  - Details of income earned and expenses incurred
  - Staff employed
  - Number and location of branches

There are no limits or caps on lending and deposit rates for MFBs or other microfinance institutions in Pakistan. However, MFBs are required to educate their clients about the cost structure and terms and conditions of their loans and deposits, make complete disclosures in contract documents signed with their clients and require their field officers to read out the terms to their clients. Important terms and conditions must also be displayed in the windows of their branches (there is also discussion of the possibility of making a client protection cell mandatory for MFBs). This is a complete disclosure system that could potentially lead to improving financial literacy and better protection for microfinance clients. This is followed only partially in practice, but is said to be improving as loan officers become more accustomed to the transparent functioning this entails. These requirements also put pressure on NGO MFIs and RSPs to improve their implementation practices, thus leading to greater transparency in microfinance. There is now also discussion on the possibility of introducing uniform regulation for microfinance NGOs that currently operate under five different regulatory spaces.

The SBP's Microfinance Department is responsible for the inspection of MFBs. As an activity taken up by a central bank charged with responsibility for the country's financial system, the microfinance department is not regarded by employees as the most favoured department to be in since it does not provide significant opportunities for understanding or being involved in the more sophisticated elements of modern financial engineering. There is some degree of discomfort in working with institutions designed apparently to work with people who are seen as "inherently risky". However, with support from SDC and

under the DFID sponsored capacity building programme, the SBP is gradually building up the microfinance expertise of its staff with training programmes at home and exposure visits to MFIs in other countries. Ranked fifth by the Economist Intelligence Unit's report, **Global Microscope**, on the microfinance business environment in 2010, Pakistan's regulatory framework is regarded very highly.

#### 2.4.4 Conclusions and recommendations

As a serious piece of legislation intended to legitimise microfinance and enable the provision of microfinance services by formal, regulated institutions, the Microfinance Institutions Ordinance, 2001 is perhaps the best example of its type in South Asia. Thus, Pakistan also has not only fully implemented the measures encapsulated in GTFR, 1998, it has moved well beyond those ideas. While microfinance in Pakistan has grown significantly over the past few years, however, the experience with the establishment and performance of microfinance banks in the country has been mixed. The key developments of the microfinance industry and the contributions of the policy framework in the country are:

- an environment of legitimacy for microfinance as a part of the wider financial system rather than as a component of a social welfare/poverty reduction strategy that marginalises the activity;
- reasonably fast growth in the overall outreach of microfinance institutions in Pakistan with the aggregate number of clients served growing at an average of 33 percent per annum in recent years followed by a hiccup in 2009 before resuming some growth in 2010;

- the existence of a successful apex organisation (PPAF) that has been able to establish itself as a credible microfinance support organisation within the institutional arrangement of a public-private partnership and provide on-lending resources to MFIs;
- the establishment of an active, respected microfinance networking organisation providing significant advocacy and standard setting services while supporting appropriate capacity building initiatives for the industry;
- a well designed framework for the establishment of formal microfinance institutions (MFBs) along with a reasonably prudent regime of regulation and supervision;
- a central bank that is highly supportive of an interest rate regime that is free of political controls but is transparent and applied in a framework of consumer protection and responsibility to clients.

The key issues that need to be addressed are:

- the limited effectiveness of the government and central bank's attempts to promote lending to agriculture in general and the failure of the system of village level cooperatives in particular;
- the limited success of the microfinance banks to fulfil the promise of operating in a dynamic, innovative and poverty focussed framework;
- hence the inability to achieve the outreach target of 3 million clients by end-December 2010, envisaged by the MIO, which is likely to be missed by as much as 30 percent;
- despite this relatively low achievement, the emergence of over-indebtedness in limited geographical areas resulting in a damaging delinquency crisis for at least one large player in 2009.

The resolution of some of these issues is a challenge within the overall troubled political framework of the country. A concerted effort is required by the central bank to understand the incentives and disincentives of the dynamic operation of the MFBs. A similar effort is needed from PMN to focus the energies of its member organisations on product innovation to serve the real needs of microfinance clients, and to limit their own cost of operations. Achievements in these areas would help establish microfinance in Pakistan as the most effective part of the poverty reduction framework in the country.

## 2.5 Philippines

### 2.5.1 Introduction

The Philippines experienced major demographic and socio-economic changes since the completion of the GTFR study in 1998. The population has increased from 68.6 million in 1995 to an estimated 88.6 million in 2007 (ADB, 2008, p.115). With rapid urbanisation, the share of rural population has decreased from 41.5 percent in 1995 to 36.5 percent in 2006.

Although there has been some progress in poverty reduction in the Philippines, the record has been patchy, and estimates on poverty differ widely. According to ADB (2008, p.128), the proportion of the population living below \$2 a day has declined from 52.5 percent in 1995 to 45.2 percent in 2006.

The structure of the economy has also changed between 1995 and 2009. The share of agriculture in GDP has declined from 21.6 percent in 1995 to about 14.1 percent in 2005. Agricultural employment in total employment has declined from 44.1 percent in 1995 to 37.1 percent in 2005, indicating an acute problem of low productivity in the agricultural sector and lack of adequate productive employment

opportunities in other sectors of the economy, and this lack of productive employment is the root cause of persistent poverty.

Inflation has not been a major issue during the past 12 years, with the average annual inflation rate being 5.4 percent during 2003-2009, although the rate was unusually high at 9.3 percent in 2009.

A major feature of the Philippine economy is the large inflow of remittances from Filipinos working overseas. In 2009, according to the Banko Sentral ng Pilipinas (BSP), the overseas workers remitted over \$15.1 billion to the Philippines.

The country has also experienced a fundamental change in its communication environment during the last decade with the entry of mobile phone operators into the market. The number of mobile phone subscribers has increased dramatically from about 1.0 million in 1997 to over 71.0 million in 2009. Most low income households have access to a mobile phone, as a result.

These socio-economic and demographic factors, particularly urbanisation, persistent poverty at high levels, lack of productive employment opportunities, high penetration of mobile phone technology, and large inflows of remittances have significantly affected the microfinance sector.

### 2.5.2 Overview of the Financial System

The formal financial system in the Philippines consists of banks and non-bank financial institutions (NBFIs). Banks are financial institutions regulated and supervised by the Banko Sentral ng Pilipinas. They are categorised into universal and commercial banks, thrift banks, and rural and cooperative banks. Non-bank Financial Institutions (NBFIs), on the other hand, are entities that are engaged in financial services but may or may not have quasi-banking functions. These

include the investment houses, financing companies, investment companies, securities dealers/brokers, fund managers, lending investors, pension funds, pawnshops, credit card companies, venture capital corporations, and non-stock savings and loan associations.

At the end of June 2010, there were 38 universal and commercial banks, 74 thrift banks, 661 rural and cooperative banks, and 6,471 NBFIs. The banks and NBFIs are licensed and regulated by the BSP.

The informal financial system is comprised of moneylenders, trader lenders, input suppliers, and savings clubs such as the Rotating Savings

and Credit Associations (ROSCA), which are not registered with any authorised registering entity.

Aside from banks and informal providers, there are credit and multi-purpose cooperatives and NGO-MFIs that are not considered part of the statistics of the Philippine Financial System but are considered significant players, especially in microfinance. There are around 500 NGOs engaged in microfinance and more than 4,000 credit cooperatives that are legally permitted to offer loans and take deposits from members.

**Table 7** Snapshot of Microfinance In the Banking Sector (as of 30 September 2009)

	No. of Banks	Amount (In Millions)	No. of Borrowers
Microfinance Oriented Rural Banks	5	958.12	174,874
Microfinance Oriented Thrift Banks	3	218.36	55,580
Sub-total	8	1,176.48	230,454
Microfinance Engaged Rural Banks	162	3,957.97	567,099
Microfinance Engaged Cooperative Banks	25	769.38	79,750
Microfinance Engaged Thrift Banks	19	516.88	17,552
Sub-total	206	5,244.24	664,401
<b>Grand Total</b>	<b>214</b>	<b>6,420.71</b>	<b>894,855</b>
<i>Note: Universal/Commercial banks that have exposure to retail microfinance institutions on a wholesale basis are not included in the above table.</i>			
<i>Source: BSP.2009 Year End Report on Microfinance and Financial Inclusion Initiatives</i>			

The basic structure of the formal financial system, however, remains the same as what prevailed at the time of the GTFR with the exception of two major developments: the entry of new microfinance-oriented banks and the emergence and the rapid growth of mobile banking.

### 2.5.3 Overview of the Microfinance Sector

The microfinance landscape of the Philippines has changed significantly since the completion of the GTFR and has become more commercialised. First, a new breed of institutions (microfinance banks and microfinance-oriented banks) has emerged in the market. Microfinance banks are those whose total loan portfolios are 100 percent microfinance while microfinance-oriented banks are those that have at least 50 percent of microfinance loans in their gross loan portfolio. Second, the scope of services provided by the sector has broadened. Third, delivery modalities have changed with the increasing integration of new technology into operations, primarily the use of mobile phones for small-sized financial transactions. Fourth, a small number of NGO-MFIs have significantly increased their outreach and market share and are operating on a more commercial basis. Fifth, government financial institutions (GFIs) have moved out of retail microfinance to focus on wholesaling of funds for MFIs. Sixth, commercially oriented meso-level institutions have emerged to provide support services for microfinance development. These changes and developments have contributed to a substantial increase in the number of clients served by the sector in the past 12 years.

GTFR had noted that rural banks, (only a small number were engaged in microfinance - McGuire et. al 1998, p.237), are well-positioned to provide microfinance services, although they serve slightly better-off people

in rural areas; and particularly recognised the point made by a World Bank study that highlighted the potential of rural banks for microfinance without setting up alternative institutions. According to the BSP, by the end of the 1990s only about 55 banks were engaged in microfinance. By the end of September 2009, as shown in **Table 7**, there were 214 banks (largely dominated by rural banks) with microfinance operations. These banks were reaching more than 894,855 borrowers. In 2009, 55 Philippines MFIs reporting to the Microfinance Information Exchange (MIX) Market had 1.92 million active borrowers, a combined gross loan portfolio of \$365 million and \$222 million in client deposits. The industry's current total outreach is estimated to be around 7.0 million borrowers.

As in most other countries, a small number of NGO-MFIs in the Philippines have also increased their outreach dramatically in recent years. These MFIs include the Center for Agriculture and Rural Development, Inc. (CARD NGO), Tulay sa Pag-unlad Inc. (TSPI), and TayTay sa Kauswagan Inc. (TSKI). The number of active borrowers of CARD NGO has increased from 10,812 in 2000 to 497,441 in 2009, while TSPI's number has increased from 25,939 to 226,930 in the same period. TSKI had 161,299 active borrowers in its books in 2009 ([www.mixmarket.org](http://www.mixmarket.org)). The number of borrowers reached by the sector as a whole has grown by 40 percent between 2005 and 2008 and the size of the outstanding loan portfolio has doubled (Asia Focus, 2010, p.2). The NGO-MFIs, as a whole, have a larger market share than other types of MFIs both in terms of number of clients served, and the amount of the loan portfolio.

The industry has also become more commercialised in the past 12 years. The increased involvement of the rural banks in the sector is one indication of this. The

increased reliance of leading NGO-MFIs on commercial sources of funds is another. The NGO-MFIs also adopt market-based pricing policies to serve their clients. According to ADB (2007, p.3), MFI interest rates to clients are normally more than 40 percent per year.

While commercial banks were not engaged in microfinance at the time of the GTFR, this has begun to change in recent years with some commercial banks providing loans to MFIs. A more recent approach of commercial banks includes acquisition of rural banks to begin retail microfinance operations. The Rizal Commercial Banking Corporation, for example, acquired a rural bank in February 2009 and entered the sector through the rural bank's branch network. The Asia United Bank has also acquired a rural bank to take advantage of its microfinance network. The Bank of the Philippines Islands, which was the first private sector commercial bank to engage in wholesale microfinance lending, has recently established a thrift bank devoted to branchless banking for microfinance.

The entry of mobile phone companies into the microfinance industry and the growth of mobile phone-based banking is perhaps the most dramatic development since the GTFR. Two such companies have been operating mobile phone-based payments and money transfer schemes (G-Cash by Globe Telecom and Smart Money by Smart Communications). These two operators had an estimated 3.7 million active mobile payment/transfer users in 2009 (CGAP, 2010, p.5). An increasing number of rural banks are also using mobile phone-based systems to disburse loans and collect of repayments.

The growth of the micro-insurance sub-sector is another major change in recent years, although hard data are not readily available on the actual outreach. CARD-MBA (Mutual Benefit Association), an important player in this sub-sector, had insured over 4.4

million individuals by August 2009 (CARD, 2009). A new micro insurance company – MicroEnsure Philippines, has been established by MicroEnsure, a global micro insurance company, to tap the market potential in micro insurance. A number of mainstream insurance companies have also begun to offer micro insurance products recently (Llanto et. al. 2009, p.41).

At the time of the GTFR, meso-level institutions supporting microfinance in the Philippines were limited and such support was primarily donor-dependent and donor-driven. This has changed in the past 12 years. A plethora of private institutions, such as the Asian Institute of Management, provide academic and technical training in and business development services for microfinance. Even support and services provided by the industry associations such as the Microfinance Council of the Philippines (MCPI) and Rural Bankers Association of the Philippines (RBAP) have become increasingly commercial.

#### 2.5.4 Microfinance Policy

At the time of completion of the GTFR, the Philippines had an overarching national microfinance strategy formulated by the National Credit Council (NCC) in early 1997. The strategy was “*unusually explicit in situating microfinance within the broader financial system,*” and “*according it a key role in poverty alleviation*” (McGuire et. al. 1998, p. 235). However, the strategy is mostly oriented toward micro credit, with very little discussion of the implications for deposit services (Gardiol et. al. 2006, p.15).

In line with the strategy, the Government took a number of initiatives to improve the broader policy environment for sustainable microfinance. In 1998, the Agriculture and Fisheries Modernisation Act was passed, calling for the rationalisation of all agricultural

related credit programmes of the Government (Charitonenko, 2003, p. 32). In 1999, the Executive Order (EO) 138, considered as the main pillar of the government's microfinance policy, reaffirmed the market-oriented policies for microfinance development and directed the transfer of all direct credit programmes, not just agricultural credit programmes, from government line agencies to government financial institutions (GFIs), for wholesale lending to MFIs. The EO 138 also directed discontinuance of interest rate subsidies and the use of private MFIs to deliver retail services. The EO was a bold policy initiative in a context, as explained in the GTFR, where subsidised credit programmes were rampant, hindering development of sustainable microfinance. The EO was in line with most of the recommendations of the GTFR.

The government articulated its continued commitment to microfinance development in the Medium-Term Philippine Development Plan 2004-2010 by recognising it as an important tool for poverty reduction (ADB, 2007, p.4). The broader government policies also recognised the importance of commercialisation in the microfinance sector to achieving poverty reduction. This is clearly evident from not only the absence of interest rate ceilings on micro credit but also efforts to impose such ceilings in a global context where micro credit interest rates have become a major issue, and interest rate ceilings are becoming more common (CGAP, 2004; Fernando, 2006).

The Government policies also emphasised the importance of improving overall performance of MFIs and monitoring their performance on a systematic basis. For this purpose, NCC, in association with the BSP and a number of other organisations, finalised a set of performance standards, (known as the PESO standard which stands for portfolio quality, efficiency, sustainability, and outreach) based

on international best practices in evaluating financial institutions engaged in microfinance. These standards can be used by MFIs across the banking, NGO and cooperative sectors.

However, the EO 138 was repealed and replaced by EO 588 issued in August 2006 which revived the government administered subsidised credit programmes in the country. This shattered the faith of the microfinance community in government policy, at least for some time. The microfinance community suspected this policy reversal as a politically motivated measure and expressed its fear that this would undermine sustainable microfinance, with a number of funding agencies, such as the ADB and US-AID, joining this group. The Government responded to these concerns by issuing EO 588-A, the focus of which was on providing microfinance to areas unserved by private sector MFIs. It identified 47 of the poorest municipalities for possible government intervention. However, the EO 588 served as a reminder that political economic issues of finance for the poor remain alive.

The government policy also increased the emphasis on working in close collaboration with the private sector industry stakeholders, including industry associations such as the Rural Bankers Association of the Philippines (RBAP) and the Microfinance Council of the Philippines (MCPI). The policy also paid a great deal of emphasis on improving coordination among different government agencies involved in policymaking and regulation for microfinance. Many of these government and private sector agencies have worked together, with guidance from the NCC and the BSP, to improve performance standards for MFIs. In July 2004, the government relocated the Cooperative Development Authority (CDA) from President's Office to the Department

of Finance (DOF), giving DOF the authority to oversee CDA policies and directions. Meanwhile the Securities and Exchange Commission (SEC) has been encouraged to improve non-prudential regulation and supervision of NGO-MFIs. The National Anti-Poverty Commission (NAPC) established a Microfinance Unit (MFU) as a separate unit within the NAPC to work toward further improvement of the enabling policy environment for microfinance. The increased emphasis on consumer protection and financial education, two areas that were not part of the public discourse at the time of the GTFR, was another important change in government microfinance policy. The latter is in line with the recent global trends in microfinance policy (Alliance for Financial Inclusion. 2010).

The government also made progress on resolving the issue of taxation for NGO-MFIs. In 2006, BSP and NCC assisted the Bureau of Internal Revenue (BIR) to identify the key issues on taxation of MFIs. With the BIR issuing a circular clarifying the taxation norms for NGO-MFIs in November 2007, after consulting with the Philippine Council of NGOs Certification (ADB.2007, p.8).

Although it was not introduced with the primary motive of assisting the microfinance industry, the Credit Information System Act of 2008 could also be considered a positive development in the microfinance industry environment. This law created the Credit Information Corporation (CIC) to receive and consolidate basic data on credit history and financial condition of borrowers. And the operations of the CIC are expected to help MFIs, among others, to make better credit decisions and reduce credit risks.

There has also been a clear shift in government policy in the past 12 years from directed credit schemes through the banking system to promoting market-based wholesale financial facilities for private sector MFIs from specialised microfinance institutions

such as the People's Credit and Finance Corporation (PCFC) and the state-owned development banks such as the Land Bank of the Philippines. Under this policy PCFC has become a major wholesaler of funds to MFIs, providing funds at market-based interest rates. This policy shift is also clearly evident in the Barangay Micro Business Enterprise (BMBE) Act of 2002. The shift appears to have led to a decline in directed retail credit.

However, mandatory allocation of bank credit for certain specified sectors continue in an otherwise liberal policy environment. For example, the mandatory credit allocation for agriculture under the agri-agra law enacted in 1975 remains at 25 percent for all banks. The government is in the process of tightening the rules through a new law by scrapping alternative compliance by the banks to the mandated lending to agriculture. Under the Magna Carta for Micro, Small and Medium Enterprises, banks are required to set aside at least 8 percent of their loan portfolio for micro and small enterprises.

### 2.5.5 Regulatory Framework for Microfinance

The Philippines is one of the two Asian developing countries (the other being Cambodia) that achieved remarkable progress in microfinance policy and regulation since the completion of the GTFR in 1998. In 2009, the Economic Intelligence Unit's First Annual Global Microfinance Index ranked the Philippines (along with Cambodia) first out of 55 countries in the developing world for its microfinance regulatory framework. The study which measured the state of the regulatory framework, investment climate for microfinance, and institutional development, ranked the Philippines third overall, next to Peru and Bolivia (BSP. 2009, p.70). The Philippines' commitment to pro-actively accommodate the evolving needs of a growing and increasingly diverse sector is illustrated by the innovative approach taken to create regulatory space for mobile phone banking in recent years.

However, the microfinance regulation of BSP has not been equally supportive of small savings mobilisation by banks. For example, as Gardiol et al (2006, p.16) point out, BSP's prohibition of off-site deposit collection by banks in 1999 reduced the ability of rural banks to mobilise savings, especially in less densely populated areas. They reckon that more openness to innovative practices would help regulated institutions to capture more small deposits.

#### 2.5.6 Regulation of Banks in Microfinance

As noted in the GTFR, the Philippines had a legal framework supportive to the establishment of formal, small-scale banks conducive to offering commercial microfinance. Although these banks were regulated and supervised by the BSP, there was no regulatory framework for microfinance in the banking sector. It is in this context that the National Microfinance Strategy highlighted the importance of having appropriate regulation and supervision for microfinance.

BSP, accordingly, developed a microfinance-friendly regulatory framework using the provisions of the General Banking Law of 2000. This law, through its sections 40, 43 and 44 mandated the BSP to recognise microfinance as a legitimate banking activity and to set the rules and regulations for its practice within the banking sector (Charitonenko, 2003, p.33). To carry out this mandate systematically BSP institutionalised microfinance within its organisational structure and defined its commitment to microfinance in three ways: (i) providing an enabling policy and regulatory environment; (ii) increasing the capacity of the BSP and banking sector with respect to microfinance; and (iii) promoting and advocating the development of sound and sustainable microfinance operations.

BSP also built its own capacity for regulating and supervising microfinance operations. It provided training to its supervisory staff on the supervision of microfinance operations of banks, created a group of Inclusive Finance Advocacy Staff, and established the Supervisory Data Center (SDC). In 2006, the capture and reporting of data for microfinance was centralised within SDC (Bedson ed. 2009, p.15). To effectively supervise and examine banks engaged in microfinance, the Microfinance Examination Group was created in BSP in August 2006.

BSP spelled out its regulatory measures for microfinance in line with the changing market conditions and the industry needs in terms of over 18 circulars issued since 2001 ([www.bsp.gov.ph](http://www.bsp.gov.ph)). The initial microfinance-focused circulars issued by the BSP facilitated the basic institutional mechanisms and defined the broader boundaries and rules of engagement for banks in microfinance. For example, the Circular 272 issued in January 2001 established guidelines on “micro-financing loans” and recognised cash-flow based lending as a peculiar feature of microfinance. Circular 273 partially lifted the moratorium on establishment of new banks as long as the new banks are microfinance oriented. In 2005, branching guidelines were revised to allow qualified microfinance oriented banks and microfinance oriented branches of regular banks to establish branches anywhere in the Philippines.

The Circulars issued later, from about 2006, responded to the changing market in microfinance, including those brought about by the integration of new technology, illustrating the BSP's flexible and dynamic approach to microfinance regulation. Circular 683 issued in February 2010 allowed thrift, rural and cooperative banks, subject to certain rules and regulations, to sell, market, and service approved micro insurance products, increasing the potential network for distribution of micro-insurance. BSP regulations also supported product

diversification in the microfinance sector by approving housing microfinance loan products (Circular 678 issued in January 2010) and micro-agricultural loans (Circular 680 issued in February 2010). The BSP regulation allowed microfinance banks to take risk and innovate based on their capacity to manage risks effectively and efficiently. The risk-based supervision approach used by BSP in its supervision also facilitates MFIs with adequate risk management systems to grow faster than those institutions without such systems. In addition, the use of this approach allows BSP to focus its attention on MFIs with potentially higher risk.

### 2.5.7 Regulation of Branchless Banking

The most remarkable development in microfinance regulation in the last decade is the emergence of a framework for branchless banking. Branchless banking has grown in Brazil, Kenya, South Africa and the Philippines in the past 10 years (CGAP.2008). Brazil's growth is based on a system of banking correspondents (agents) who use point of sales (POS) devices (Kumar. 2005). In the Philippines, South Africa and Kenya, branchless banking has grown through mobile phone-based systems (CGAP.2010; 2008).

The dazzling growth in the number of mobile phone subscribers in the Philippines has created vast opportunities for branchless banking (Jimenez and Roman, undated). According to the International Telecommunication Union, approximately 75 percent of the population in the country are mobile phone subscribers (CGAP 2010, p. 3). Filipinos use mobile phones for SMSs and send about one billion messages a day.

BSP's approach to accommodate mobile phone banking has been cautious and progressive.

The ability to manage technology-related risks of mobile banking by all parties involved was a major focus in the approach. Unlike central banks in many other Asian developing countries, BSP has allowed both bank-based (Smart Money) and nonbank-based (G-Cash) models of mobile banking to thrive in the country. In the bank-based model, banks have been permitted to outsource a range of activities to the mobile operator, Smart Communications. In the non-bank-based model, a subsidiary of the mobile operator (Globe Telecom) offers virtual stored-value accounts enabling mobile phone customers to make payments and money transfers. Within this overall framework, Smart money was launched in 2003 and G-Cash was launched in 2004. The country's two mobile network operators (MNOs) now offer the functional equivalent of small-scale transaction banking to an estimated 3.7 million customers (CGAP. 2010, p.5; 2008, p.1).

To enable G-Cash to operate, BSP required Globe Telecom to establish a subsidiary. BSP regulated this subsidiary, G-Xchange Inc (GXI), as a "remittance agent". However, BSP initially adopted a very restrictive regulatory policy on banks' and non-banks' use of agents. BSP regulations do not allow banks to outsource their inherent banking functions, which effectively include all transactions related to deposit-based accounts. Banks are also not allowed to outsource "Know Your Customer" (KYC) responsibilities to third parties. Non-banks are allowed to use remittance agents only for distribution of payments and for KYC.

BSP's regulatory framework on mobile banking evolved and took shape through a series of circulars related to mobile banking issued over time. These circulars and their main content are presented in **Table 8**.

**Table 8** BSP Circulars Related to Mobile Banking

Circular Number & Date	Main Content
240 (5 May 2000)	<ul style="list-style-type: none"> <li>Requires banks to seek prior Bangko Sentral ng Pilipinas approval to provide electronic banking services.</li> <li>Applicant banks must prove that they have an adequate risk management process to assess, control and monitor any risks arising from the proposed electronic banking activities.</li> </ul>
268 (5 December 2000)	<ul style="list-style-type: none"> <li>Specifies the duties and responsibilities of banks when outsourcing banking functions.</li> <li>Lists banking functions which cannot be outsourced.</li> <li>Provides information on the penalties involved for violating provisions.</li> </ul>
269 (21 December 2000)	<ul style="list-style-type: none"> <li>Stipulates updated guidelines concerning electronic banking service provision.</li> <li>Covers compliance processes for e-banking along topics such as services, finances, procedures, approvals, security, and sanctions.</li> </ul>
471 (24 January 2005)	<ul style="list-style-type: none"> <li>Governs the registration (by BSP) and operations (legal compliance, Anti-Money Laundering Council training) of foreign exchange dealers/money changers and remittance agents</li> </ul>
511 (3 February 2006)	<ul style="list-style-type: none"> <li>Focussed on guidelines on technology risk management</li> <li>Outlines the primary risk related to the bank's use of technology</li> <li>Also describes a risk management process on how banks should manage these risks</li> </ul>
542 (1 September 2006)	<ul style="list-style-type: none"> <li>Focussed on consumer protection for electronic banking and prescribed rules and regulations for consumer protection</li> </ul>
649 (9 March 2009)	<ul style="list-style-type: none"> <li>Gave more clarity to e-money transactions</li> <li>Provides guidelines on the issuance of e-money and the operations of electronic money issuers (EMI) in the Philippines.</li> <li>Emphasises that e-money issued by banks is not considered to be a deposit (therefore e-money does not qualify for deposit insurance)</li> </ul>

Not all regulations were enabling, however. Some rules of BSP restricted the early growth of mobile banking. For example, the rule that required remittance agents to send their officers and personnel directly involved in cash operations for training by the BSP's Anti-Money Laundering Council (AMLC) constrained the growth in the number of agents. There were no more than 5,000 registered cash-in, cash-out agents in the country until 2009. Since 2008, AMLC has permitted GXI and Smart to conduct its own AML training. And in January 2010, the BSP permitted GXI mass registration through one application. With this relaxation of regulation, GXI has immediately registered 15,000 new remittance agents (CGAP.2010, p.8). Smart is also in the process of getting a mass registration approved.

BSP did not rush to regulate mobile banking. For example, circular 649, defining e-money, was only issued after observing Smart Money and G-Cash for several years. BSP also built its own capacity to regulate and supervise mobile banking. In 2005, BSP created the Core Information Technology Supervisory Group to address electronic banking issues and supervise institutions engaged in providing e-banking services.

#### 2.5.8 Regulation of Financial Cooperatives

The regulation and supervision of cooperatives has been the responsibility of the Cooperative Development Authority (CDA). The CDA is also charged with a developmental role for cooperatives (McGuire et al. 1998, p. 238). In practice, the CDA's approach to cooperatives focused on "promotion and proliferation" rather than "regulation and supervision". This approach has changed

substantially in recent years owing to government's policy emphasis on regulation of financial cooperatives. This policy aims at transforming CDA from a cooperative promoter to a cooperative regulator. The policy appears to approximate the CGAP's guiding principle related to regulation and supervision of financial cooperatives which recommend their prudential supervision by a specialised financial authority. However, it is essential to build CDA's capacity for effective regulation and supervision. The government has obtained technical assistance from ADB and US-AID for this purpose. CDA is now in the process of creating a separate supervision and examination unit to carry out regulation and supervision of financial cooperatives on a more systematic basis.

Following the initiatives of the NCC, a Standard Chart of Accounts (SCA) and a Manual of Accounts have been formulated. The approved SCA approximates that employed by the banking sector. The CDA issued a circular requiring all cooperatives engaged in savings and credit activities to use the SCA by January 2003 (Charitonenko, 2003, pp.36-37). Following the adoption of the SCA, the CDA also adopted the COOP-PESOS as the performance standards for cooperatives engaged in savings and credit services. CDA also updated the SCA in response to the latest International Accounting Standards requirements (ADB.2007, p.8).

CDA, in late 2007, issued a Manual of Rules and Regulations (MRR) that established prudential rules and regulations for cooperatives engaged in savings and credit operations and provided guidelines for complying with the provisions of CDA regulations on sound microfinance operations. The original Cooperative Code of the Philippines has also been amended to introduce the Cooperative Code of 2008.

At the time of the GTFR, regulation and supervision of financial cooperatives did not exist in practice. When compared with that situation, the recent initiatives represent a major shift.

### 2.5.9 Regulation of NGO-MFIs

Non-government organisations (NGOs) are classified as ‘non-stock, non-profit’ organisations and required to register with the SEC. This applies to NGO-MFIs as well. However, as noted in GTFR (McGuire et al. 1998, P.245), they are not closely supervised by the SEC, but are required to file audited annual financial statements with it. Because NGO-MFIs are not permitted to accept deposits from the public, prudential regulation and supervision of these institutions is not required in theory. More importantly, since the existing legal framework allows space for transformation of NGOs into regulated financial institutions, there is also no need for a separate legal framework for NGO-MFIs. The absence of efforts to prudentially regulate NGO-MFIs in the context of the Philippines seems to fall in line with the CGAP’s (2003) Guiding Principles on Regulation and Supervision of Microfinance. However, the growth of some NGO-MFIs into relatively large-scale financial institutions and their increasing involvement in deposit mobilisation beyond compulsory deposits suggests the need for more attention to this issue.

It appears that the government has changed the policy and regulation concerning NGO-MFIs in recent years. This is reflected in a recent memorandum circular issued by the SEC. This circular (Memorandum Circular No. 2) focused on microfinance operations of NGOs, requiring NGOs providing microfinance services to disclose this information to SEC. It is difficult to conclude whether this could be the first step toward building a regulatory framework for NGO-MFIs in the country, or not.

The Philippines, however, continues its previous policy of self-regulation for NGO-MFIs. This is the approach recommended in the GTFR. To strengthen self-regulation, the Philippines has focused on improving performance standards for these institutions and increasing their adoption by MFIs. This approach has been implemented by the NCC and the BSP in partnership with the People’s Credit and Finance Corporation (PCFC) and the MCPI. Second tier organisations such as the Land Bank of the Philippines and the PCFC also maintain some credit supervisory authority over NGO-MFIs that borrow from them (Bedson ed. 2008, p. 15). MCPI plays a role in providing self-regulatory oversight of its member NGO-MFIs. MCPI has been tracking performance of its member organisations since 2000 and has improved its systems and procedures significantly in the last decade. MCPI uses the tools and analytical methods from the Microfinance Information Exchange (MIX).

While these efforts related to NGO-MFIs are commendable, they do not address the fundamental issue in financial services for the poor, namely the issue of mobilisation of deposits by the NGO-MFIs. The legal situation concerning the mobilisation of deposits from members still remains unclear. The case for public deposit mobilisation by NGO-MFIs, however, is weak in the Philippines for at least four reasons: (i) There exists a legal and regulatory framework that allows transformation of NGO-MFIs into regulated banking institutions; (ii) there is a tiered minimum capital requirement system for the purpose with relatively modest amounts for rural banks and thrift banks; (iii) BSP has relaxed branch opening rules allowing microfinance oriented rural and other banks to open branches anywhere in the country; (iv) It may not be possible to cover public deposits of NGO-MFIs under the Philippine Deposit Insurance Corporation’s deposit insurance programme.

### 2.5.10 Policy and Regulatory Framework for Micro insurance

Policy and regulation of micro-insurance was not a subject of importance in the microfinance community in the 1990s, and the GTFR study did not include micro-insurance policy and regulatory issues. However, in recent years micro-insurance has attracted increasing attention of policy makers, practitioners and funding agencies.

The Philippines is one of the few Asian developing countries that has made progress on policy and regulation for micro-insurance. The government has allowed lower capital requirements for underwriting micro-insurance policies. Institutional flexibility was permitted by providing legal space in the existing insurance regulatory framework for mutual benefit associations (MBAs) to operate as non-profit insurance service providers. CARD-MBA was thus registered with the SEC in 1999 and licensed by the Insurance Commission in May 2001. Other existing micro insurance MBAs include ASKI-MBA, RBT MBA, and Kasagana-ka MBA. Over 4.5 million households have gained access to formal insurance from micro-insurance MBAs as a result of the regulatory space created for them by the government.

In 2006, the Insurance Commission declared the month of January of every year as “Micro-insurance Month” to promote micro-insurance. The Commission also issued what has been described as a “groundbreaking circular” defining what micro-insurance is and its minimum features (Llanto et al., 2009, pp.29-30). The Circular set the parameters on how to design insurance products best suited for the poor and disadvantaged sectors by focusing on affordability, accessibility and simplicity (Llanto et al, p.30). Through its Circular 9-2006, the Commission reduced the

guarantee fund for new and existing MBAs wholly engaged in providing micro-insurance (Micro insurance MBAs) from Pesos 125 million (USD 3 million) to Pesos 5 million (USD 122,000).

The NCC in coordination with the Insurance Commission initiated the formulation of a National Strategy to develop the insurance market for the poor. The Strategy was launched in January 2010 together with a Regulatory Framework for Micro insurance. The thrust of the Strategy is providing access to insurance to the poor. It emphasises the establishment of an appropriate policy and regulatory environment for safe and sound provision of micro insurance for the poor by the private sector. The Strategy also recognises the importance of insurance education for the poor.

The Regulatory Framework for Micro insurance aims to encourage, enhance and facilitate the safe and sound provision of micro insurance products and services by the private sector. The Framework mandates MFIs’ transition to formal micro-insurance services within a year. The Government also reduced the tax on life insurance premiums from 5 percent of the total premiums collected to 2 percent to make life insurance products more affordable to the poor. In addition, the Government has taken a number of other initiatives such as measures to improve performance standards, demand-driven product development and insurance literacy of the low-income people. These measures as a whole are expected to make a significant contribution to the development of the micro-insurance market in the country.

### 2.5.11 Summary and Recommendations

The Microfinance industry in the Philippines has firmly established itself in the financial system over the past decade. Institutional diversity and the outreach in the industry have increased. The micro-insurance sub-sector has expanded in recent years through mainstream insurance companies and MBAs.

The impressive progress in policy and regulation has underpinned this growth, expansion and commercialisation. The policy reversal introduced through the repeal of the EO 138 has been corrected to some extent and does not appear to have threatened the sustainability of the industry, contrary to the fears expressed by most observers at the time of the repeal. With this exception, most of the recommendations made in the GTFR have been implemented. The continued absence of interest rate ceilings on micro credit, including attempts to introduce ceilings, and the rationalisation of most government directed credit programmes are clear evidence of the policy makers' commitment to operate in line with the international good practices.

BSP has played a dominant role in the microfinance industry development in the country. BSP's regulations responded to the evolving needs of a growing and increasingly diverse sector. The regulations in particular helped rural banks to increase their market penetration in the microfinance sector. BSP also supported the process of convergence of telecommunication and finance through regulatory accommodation of mobile phone-based branchless banking. The microfinance regulatory activities of the BSP have been carried out within the existing financial sector laws, in line with the CGAP's Guiding Principles on Regulation and Supervision of Microfinance. Overall, the Philippines appear to have got the regulatory framework right, to a large extent.

However, BSP needs to make its regulation more supportive of small deposit mobilisation by rural and other banks with operations in rural areas. It has to consider relaxing restrictions on off-site deposit collection by banks and examine the potential disincentives of its rediscounting facilities on rural deposit mobilisation (Gardiol et al. 2005). In general BSP has paid more attention to micro credit than micro savings.

GTFR recommended that NGO-MFIs probably be permitted to handle voluntary savings while satisfying agreed standards of accounting and reporting. Although this has not been implemented, many NGO-MFIs continue to mobilise compulsory and voluntary deposits from their members. In line with the views expressed in the GTFR, no major effort has been made to bring NGO-MFIs under a separate regulatory system. Furthermore, unlike in most other countries, there has been no pressure from NGO-MFIs to introduce a separate legal and regulatory framework for microfinance. Self-regulatory measures have been improved, as suggested in the GTFR, through second tier institutions and the MCPI.

BSP has continued to support the integration of microfinance with the mainstream financial system. The mainstream commercial banks have begun their engagement in the microfinance industry for retail lending and deposit mobilisation. This is evident from the increasing trend in acquisition of rural banks by commercial banks.

There remain a number of challenges in policy and regulation. Incorporating financial inclusion as a core objective of the regulation and supervision that currently focuses on the stability of the financial system and the protection of the depositors is an overarching challenge.

A more daunting challenge for the BSP is to move from the currently restrictive mobile banking system, focused largely on payments and money transfers, to a system that facilitates financial intermediation. The experience in Kenya suggests that this is feasible. The Equity Bank in Kenya in partnership with Safaricom (mobile operator behind M-PESA) recently began to offer a full, interest bearing savings account, M-KESHO. This account, linked to M-PESA, has no limits on account balances. The account holders can transact at any time, at over 17,000 retail outlets that accept M-PESA. However, in the Philippines e-money is not considered a deposit and hence interest cannot be paid on e-money. The regulators in the Philippines have to deal with these issues in framing regulations for a mobile phone-based financial intermediation system.

Overall, the BSP has followed good practices in microfinance regulation, operating mostly within the boundaries of the existing General Banking Law instead of a MFI-specific separate legal and regulatory framework. The track record of the BSP suggests that it will face up to the remaining and new challenges even more effectively and innovatively in developing a financial system that would ensure not only financial stability and protection of depositors' funds, but also financial inclusion.

The government should further reinforce its efforts to strengthen the CDA to significantly improve its capacity and performance in regulation and supervision of financial co-operatives providing microfinance services. This is particularly urgent and important because poor people's deposits in these co-operatives are not covered under any deposit insurance scheme. In addition, the Government should clarify its policy on deposit mobilisation by NGO-MFIs and seriously implement its stated policies on this matter. However, it is important that these policies are formulated through comprehensive consultation with NGO-MFIs, BSP and other stakeholders. Further, the government should continue to pursue its liberal policy framework on NGO-MFIs not involved in mobilisation of public deposits.

## 2.6 Sri Lanka

### 2.6.1 Introduction

Since the completion of the GTFR, Sri Lanka has experienced many significant socio-economic changes. The population increased only modestly from 18.1 million in 1995 to 20.4 million in 2009 (ADB. 2008; CBSL, 2009); and the economy continued to perform negatively, affected mainly by the prolonged internal conflict in the North and East, which finally ended in May 2009. The restoration of peace provides greater opportunities to improve broad-based socio-economic development encompassing the population in the North and East. Even with the internal conflict, the economy demonstrated a high degree of resilience and maintained reasonable growth rates during much of the period. The growth rate averaged 6.3 percent per annum during 1997- 2006 (World Bank. 2008, p. 15). As a result of sustained growth, per capita income more than doubled from \$700 in 1995 to \$1,599 in 2007, though much of the growth was concentrated to the Western Province.

Inflation accelerated since early 2006 and peaked in 2008 at an annual average rate of 22.6 percent. In 2009, it declined sharply to 3.4 percent (CBSL. 2009, p.81). The rise in inflation in 2008 was partly a result of rising world market prices for food and oil.

The structure of the economy has changed to some extent. The share of agriculture in the GDP has declined from 18.4 percent in 1997 to 11.7 percent in 2007, while that of service sector has increased. The share of agricultural in total employment has also declined to 30.7 percent in 2005 (ADB. 2008). This wide gap between employment figures and its share in the GDP reflect the productivity problems in this sector, and the lack of productive employment opportunities outside it.

Sri Lanka has also made progress in poverty reduction. According to the Central Bank of Sri Lanka (CBSL), poverty declined from 28.8 percent in 1995/96 to 15.2 percent in 2006/07 (CBSL. 2009). However, the poverty in the estate sector has increased from 30 percent in 2002 to 32 percent. The World Bank estimates (2005) indicated that 34 percent of the population live on or less than \$2 a day.

As in most other South Asian countries, Sri Lanka has also experienced a significant growth in the inflow of remittances in recent years. The amount of remittances increased from \$1.92 billion in 2005 to \$3.3 billion in 2009 (CBSL.2009, Table 82). The number of mobile phone subscribers has increased tenfold in the last five years to reach 15.0 million at the end of March 2010. This indicates a penetration rate of 75 percent. As it is in other countries such as Bangladesh, India and the Philippines, these twin developments – growth in remittances and mobile phone use, create tremendous opportunities for banks and MFIs to improve financial services for the poor and unbanked low-income people.

### 2.6.2 Overview of the Financial System

The financial system in Sri Lanka is characterised by a great deal of diversity. The institutions in the system include, in addition to the CBSL, commercial banks, specialised banks, finance companies, insurance companies, cooperative rural banks (CRBs), community-based financial cooperatives, Samurdhi Banking Societies (SBSs) and microfinance NGOs (GTZ/BWTP. 2008). The commercial banks and specialised banks at the end of 2009 had 5,703 branches and other outlets scattered throughout the country. The branch network of the two state-owned commercial banks, Bank of Ceylon and the People's Bank, extensively cover most rural areas. The state-owned National Savings Bank (NSB) is a major player in the savings sector.

Finance companies also play an increasingly bigger role in the financial system. There were 35 registered finance companies at the end of June 2009.

The CRBs have 1,805 branches, and the official number of thrift and credit cooperative societies (TCCSs) is close to 8,500, though only less than half of these are operational. The network of SBSs consisted of 1,048 member-owned societies. The actual number of active NGO-MFIs is unknown and considered to be over 1,200. But, according to CBSL sources, most of these are small and reach less than 3,000 clients each. The tsunami disaster in December 2004 led to the establishment of many new NGO microfinance programmes during 2005- 2007.

### 2.6.3 Overview of the Microfinance Sector

As in the case with other countries covered in the GTFR, Sri Lanka's microfinance sector has witnessed significant changes in the past 12 years. Notable changes in the microfinance landscape in the post-GFTR period include the commencement of business by the SANASA Development Bank (SDB) in 1998, entry of some finance companies, particularly the Lanka Orix Leasing Microcredit Company (LOMC), into the microfinance industry, entry of BRAC Bangladesh to provide microfinance in Sri Lanka through BRAC Sri Lanka and the merger of six Regional Development Banks (RDBs) into a single RDB in July 2010. The entry of Berendina Microfinance Limited into the industry is also an important development. The December 2004 tsunami also led to changes within the industry. Many subsidised microcredit programmes were introduced to channel credit to the tsunami affected poor people and microenterprises. However, many of these programmes had disappeared by the end of 2008.

The sector has also become more diversified. Its diversity and salient features are described in detail in a number of reports published by the GTZ-ProMis Project office in Colombo (GTZ, 2009a;2009b) and in a GTZ/BWTP joint publication on the microfinance industry in Sri Lanka (GTZ/BWTP. 2008a) which has been updated in 2010.

The most striking feature is the dominance of state-sponsored microfinance. SBSs have grown to become a major player. The microfinance operations of RDBs, People's Bank (PB), Bank of Ceylon (BOC) and the National Savings Bank (NSB) further increase the role of state-sponsored microfinance. However, reliable data on their microfinance operations are not available. PB's People's Fast microfinance loans are offered by its network of 324 branches, most of which are located in rural areas. BOC's involvement is more in mobilisation of small savings than in microcredit. NSB's savings deposit facilities are used extensively by many low income households.

The relatively high importance of community-based microfinance is another major characteristic of the Sri Lankan industry. CRBs and TCCSs are major players in this category. NGO-MFIs and other providers are estimated to reach about 1.0 million clients. BRAC Sri Lanka reaches about 100,000 clients and its growth to this level within a short period of about five years suggests that efficient providers still have room to increase their outreach.

As shown in **Table 9**, the industry outreach may be estimated in the range of 9.3 million to 11.0 million clients or 2.2 million – 2.7 million households. These numbers include an unknown number of non-poor clients and households. But still, they suggests that the

microfinance market penetration in Sri Lanka is extremely high, most probably over 70 percent, when compared with the estimated number of 1.7 million poor households in the country. To put Sri Lanka in the global context, the market penetration in Bangladesh has been estimated around 62 percent by the World Bank in 2005 (World Bank. 2006, p.24).

**Table 9** Microfinance Outreach in Sri Lanka

Institution	Number of Clients	Remarks	Deposit Portfolio (Rs)
Co-operative Rural Banks (CRBs)	4 – 5 million	Mostly depositors	103.9 billion
Samurdhi Banking Societies (SBSs)	3.5 – 4.0 million	Borrowers and depositors	41.1 billion
Regional Development Bank	0.8 - 1.0 million	Mostly borrowers	n.a.
Sarvodaya Shramadana Societies (SSSs)	500,000	Depositors and have many borrowers too	3.63 billion
BRAC Sri Lanka	100,000	Borrowers	-
Thrift & Credit Co-op Societies (TCCSs)	100,000	Borrowers and depositors	4.4 billion
Other MFIs*	300,000	Borrowers	-
<b>Total</b>	<b>9.3 – 11.0 million</b>	<b>Borrowers and depositors</b>	<b>153.03 billion</b> (\$ 1.4 billion)
Estimated Number of Households	2.2 – 2.7 million		

\*Does not cover commercial banks. But these banks mobilise significant amounts of small savings.

Source: CBSL (2009); GTZ/BWTP (2010)

The extraordinarily high amount of savings mobilised by inadequately regulated or unregulated MFIs outside the commercial banking system is another feature. The amount exceeds Rs 153 billion or \$ 1.4 billion (See **Table 9**) and indicates a more than three-fold increase over the Rs 47 billion estimated for 2004 (Duflos et. al 2006, p.9). This is not surprising given the strong savings culture in the country. The state-owned and private commercial banks also play an important role in mobilisation of micro-deposits because they are a relatively cheaper source of funds. According to one commentator, Sampath Bank, a major private sector commercial bank, mobilises a significant amount of small savings.

Sarvodaya Economic Enterprises Development Services (SEEDS) reported \$26.3 million (about Rs 2.9 billion) deposits at the end of March 2010 while Sarvodaya Shramadana Societies (SSSs) of SEEDS have mobilised a large amount of deposits, although there is no legal charter for both SEEDS and SSSs to mobilise deposits. Many small-scale NGO-MFIs have also been mobilising deposits without a legal charter (Duflos et al. 2006).

The private commercial banks play only a marginal role in microcredit, although their role is bigger in microsavings. Hatton National Bank's microfinance programme reaches about 15,000 micro-entrepreneurs and the outstanding loan portfolio is about Rs 2.0 billion. As a recent study noted, for many formal financial institutions, *"their entry into microfinance is more a Corporate Social Responsibility activity or a image building activity"* (GTZ/BWTP. 2010, p.14). It seems this is more accurate about their microcredit operations than about microsavings. At least two factors seem to explain this: transaction costs in microcredit remain high for commercial banks; business case for commercial banks' engagement in microsavings is greater and as regulated

financial institutions, they have a competitive advantage in microsavings mobilisation over unregulated MFIs.

The SANASA Development Bank (SDB), a specialised bank with a focus on cooperatives and microfinance, has made impressive progress in the last few years and established itself firmly within the formal financial system. SDB had a loan portfolio of \$93.2 million, 190,427 active borrowers, a deposit portfolio of \$95.1 million and 289,655 depositors at the end of 2009 ([www.mixmarket.org](http://www.mixmarket.org)). SDB was ranked No. 2 in the 2009 Mix Global 100 composite ranking of MFIs by the Microfinance Information Exchange (MIX).

The micro-insurance sub-sector has also grown in the past 12 years. However, non-availability of reliable data on the sub-sector does not permit discussion of its major features.

It is important to note that new technology-based branchless banking has not taken root in Sri Lanka. Some banks and MFIs rely on post offices and even fuel stations to reach clients but the country lacks mobile phone-based branchless banking for low income households. Overall the integration of new technology into the industry at customer interface level remains uncomfortably low despite the fact that over 43 percent of urban and 38 percent of rural low-income households have a mobile phone, inflows of remittances are frequent to these households and transaction costs are an important issue for both service providers and the clients. Most clients seek more convenient, cheaper, and safer ways to access financial services.

It is widely agreed that governance, transparency, operations, management, and financial viability vary substantially across most community-based MFIs and NGO-MFIs. And most do not follow international good practices in their operations (Duflos et al. 2006; GTZ. 2009a).

The Lanka Microfinance Practitioners' Association (LMPA), established in 2006 aims at improving the policy, legal and regulatory environment for microfinance and the performance of its member MFIs through lobbying, advocacy and member capacity building. During 2009-2010, the organisational improvement made to LMPA has made it a more active and productive meso-level institution. However, its ability to play a major role in microfinance development in the country is constrained by the lack of resources and limited membership. Its membership consists mostly of NGO-MFIs and majority of the members are small-scale operators.

#### 2.6.4 Microfinance Policy

At the time of the GTFR there was no national microfinance policy in Sri Lanka. This continues to be the situation to-date. Even without a national policy, Sri Lanka's policy makers have recognised microfinance as an important tool for poverty reduction. And multitudes of poverty reduction initiatives have adopted, and continue to adopt, widely different approaches to microfinance development. Most efforts and approaches paid little attention to building sustainable systems (Charitonenko and Silva, 2002, pp.13-14). Credit is too often politicised through interest rate subsidies (Duflos et al. 2006, p.1), and provision of subsidised credit continues (CBSL, 2009, pp.185-186).

Charitonenko and Silva (2002) argued that government policy of providing subsidised credit through state-owned banks and state-sponsored programmes crowd-out private sector operations and discourage commercialisation of the industry. Most practitioners still agree with this assertion. A CGAP study in 2005 (Duflos et al. 2006) also confirmed this. However, the use of subsidised interest rates by the government

to ensure outreach to low-income households seems to have gained more popularity in recent years. This is reflected in the subsidised interest rates charged under the Japan International Cooperation Agency-funded Poverty Alleviation Microfinance Programme II which commenced its operations in January 2009 and many other government-sponsored microcredit programmes.

In early 2009, the National Development Trust Fund (NDTF), state-owned apex body that provides wholesale funds to MFIs even introduced a interest rate cap of 15 percent per annum (on declining balance basis) for its partner organisations to which it lends, at 7 percent. Although most major MFIs stopped borrowing from the NDTF in response, the NDTF has not changed this policy.

While government interventions in microfinance markets have become even more pervasive, the absence of a microfinance development policy that is in line with international good practices has made it difficult to improve the quality of different interventions and their implementation. More importantly this seems to have prevented a coherent approach to build a sustainable financial system that works for the poor.

The Mahinda Chintana, the government's overarching policy document, stated the need for the development of a national policy and strategy for the sector in consultation with the industry stakeholders. The Mahinda Chintana admitted that *"the absence of a unique policy and supervisory framework has allowed the proliferation of fundamentally unsustainable MFIs, which weakens governance, diminishes the institutional autonomy, exacerbates the lack of enforcement of financial prudence and does not provide for transformation of MFIs and NGOs into depository institutions or regularise their savings activities"* (quoted in GTZ/BWTP, 2009b, p.24).

Accordingly, the Mahinda Chintana argued for a national policy and a strategy to build a flourishing and strong microfinance sector over the next decade. In addition, it endorsed establishment of a regulatory and supervisory mechanism for MFIs and reform of government sponsored MFIs such as SBSs and CRBs and the apex body, National Development Trust Fund (NDTF).

The CBSL (2009, p. 74) also noted that *“creation of microbusinesses through microfinancing programmes is a major strategy under the safety ropes programmes in alleviating poverty.”* According to Ratwatte (2010), who held the position of the Secretary to the Treasury a number of years ago under a previous administration, *“Finance Ministry officials have made it very clear that no subsidised credit will be available in the future for the microfinance industry.”*

However, there has been little progress in translating most of these policy statements into practice until recently. A draft microfinance act was prepared in 2004 but it did not see the light of the day, even after many revisions. A new draft Act has been issued in August 2010 for public comments. Some institutional changes have been made: 6 RDBs were merged to form a single RDB; and it was announced that the NDTF would be closed and its assets would be transferred to the Sri Lanka Savings Bank. Many microfinance practitioners and other commentators are of the view that the latter will have a negative impact on the growth of most small-scale NGO-MFIs. Policy on foreign equity investments in microfinance remains restrictive.

The current President's 2010 election manifesto, commonly known as the Mahinda Chintana 2, made reference to several initiatives that would be taken to expand the access to finance for low-income households, but has not specifically mentioned

microfinance. It endorsed subsidised credit for Samurdhi recipient families, interest free loans up to Rs 100,000 in the first year and thereafter at a concessionary interest rate of 6 percent. A number of other measures have also been mentioned to expand financial services for low-income and marginalised groups. Most involve subsidies and deviate from international good practices.

The policy measures of the new government seem to emphasise on two areas. One is the need for a law to regulate and supervise MFIs. The other is the importance of continuing interest rate subsidies to ensure credit outreach to the low-income people. The latter is not consistent with the previously articulated intention to build a *“strong microfinance sector in the next decade.”* The current status concerning policy, however, makes abundantly clear that Sri Lanka is in dire need of a unique national policy on microfinance and financial inclusion.

#### 2.6.5 Regulatory Framework for Microfinance

The regulatory framework for microfinance has changed little since the completion of the GTFR. The CBSL continues to regulate and supervise the commercial banks, specialised banks including the Regional Development Bank established under the Pradeshiya Sanwardana Bank Act No. 41 of 2008, finance companies and other non-bank financial institutions licensed by it. The SBSs are regulated and supervised by the Samurdhi Authority of Sri Lanka in terms of the Samurdhi Authority Act No. 30 of 1995. CRBs and TCCSs are regulated and supervised by provincial-level commissioners and district officers (Duflos et. al. 2006, p.26). At national level, the responsibility is with the Department of Cooperative Development (DCD). The insurance Board of Sri Lanka regulates and supervises the insurance companies.

The current regulatory framework is deficient and inadequate. First, the regulatory and supervisory system is fragmented. This is a result of the effort to regulate institutions rather than microfinance activities. And this is not a good practice (CGAP. 2003).

Second is the unevenness in application and varying quality of regulatory standards across different types of institutions; there being no uniform standard (GTZ/BWTP. 2010, p. 14). Loan classification, provisioning for loan losses and many other regulations concerning microcredit vary from one type of institutions to another. This has made the playing field highly uneven.

Third is the inadequacy of regulations for each type of institutions. The regulators for CRBs, TCCSs and SBSs are insufficiently staffed and resourced, to effectively regulate and supervise a large number of institutions. Charitonenko and Silva pointed out in 2002 that *“an inadequate regulatory framework for cooperatives puts their clients’ savings at risk and hampers commercialisation of the cooperative network”* (p. 31). A CGAP study in 2005 (Duflos et al. 2006, p. 26) also noted that *“this lack of supervision poses great risk for the whole financial system”*. This is a more acute problem today because the amount of client savings in cooperatives has increased dramatically since 2005. A systemic failure in CRBs, for example, could affect more than 4 million people, one-fourth of the population, in the country. As with the CRBs, the TCCSs are subject to minimal supervision. Although the GTFR recommended that the government should not permit TCCSs to accept deposits from the general public in their own right (McGuire et al. 1998, p.281), the TCCSs, as a whole, now have over Rs 4.4 billion deposits in their books. The DCD was not equipped to provide prudent regulatory oversight at the time of the GTFR. Nor is it adequately equipped now to effectively exercise this task.

The establishment of SDB has resulted in an improvement in the operations of TCCSs. To qualify as an agent for SDB, a primary society must follow sound business practices. This provides an incentive for TCCSs to improve their management. However, this is inadequate to ensure safety and soundness of many TCCSs.

SBSs are also not regulated effectively. However, the overall risk profile of SBSs as a whole seems to have changed recently. At the end of June 2007, SBSs’ deposits were more than twice its loans. At the end of 2009, the deposits were about Rs 13 billion less than the outstanding loans. Still this does not negate the need for effective regulation of SBSs.

In CRBs and SBSs, small size of individual institutions does not mean that their financial problems may not spread across the system. Since both systems involve large numbers of people, their problems could also lead to major political instability. The political case for regulation of these organisations seems much stronger than the economic case.

Lack of a supportive legal and regulatory framework for NGO-MFIs is another issue. The NGO-MFIs in Sri Lanka are still unregulated and unsupervised as it was at the time of the GTFR. According to law, NGOs are not allowed to mobilise deposits without a license from the CBSL, issued under the Banking Act or the Finance Companies Act. However, this prohibition has not been applied in practice. Even government agencies and microfinance projects such as the NDTF and the Small Farmers and Landless Credit Project implemented by the CBSL have actively encouraged NGOs to mobilise savings.

The government made an effort during 2004-2006 to introduce a microfinance act and regulate MFIs under a rural finance project funded by the Asian Development Bank. These did not lead to the expected outcomes.

Prudential regulation of these institutions is not necessary in theory because they do not have a legal charter to mobilise deposits. However, because many NGO-MFIs mobilise deposits, regulation appears necessary.

#### 2.6.6 The Draft Microfinance Act

The government has recently drafted a new Microfinance Act to establish a Microfinance Regulatory and Supervisory Authority (MRSA) and released it for comments from the public. According to this draft Act, the MRSA will be responsible for licensing, registering, regulating and supervising companies, NGOs, societies and cooperative societies engaged in microfinance business. The draft Act defines microfinance business as *“acceptance of deposits and providing of financial accommodation in any form and other financial services mainly to low income persons and micro enterprises.”* The Act envisages permitting licensed and registered MFIs to accept public deposits and carry out a range of financial and non-financial services ([www.cbsl.gov.lk](http://www.cbsl.gov.lk)). The CBSL has announced that the Act would come into effect in 2011.

One of the objectives of the MRSA would be to ensure that microfinance business is carried out by licensed/registered MFIs in a *“transparent, professional and prudent manner with a view to safeguard the interests of the depositors and the customers.”*

The commercial banks, registered finance companies, SBSs and Farmers’ Organisations established under the Agrarian Development Act No. 46 of 2000 are exempted from the provisions of the Act. However, the Act leaves room for the Monetary Board of the CBSL to *“set principles or standards to the regulators of microfinance business.”* Thus it is possible to apply a set of uniform regulations across NGO-MFIs, SBSs, CRBs, TCCSs, and Farmers’ Organisations involved in the microfinance business.

The Act introduces a tiered structure, with different capital requirements for MFIs based on their scale and operational area. The registered MFIs will be allowed to operate in a single administrative district or a Divisional Secretary’s Division. An important restriction, the rationale for which is not clear, is that a company limited by guarantee is not eligible to apply for a license to operate at national level. This prevents SEEDS, the largest NGO-MFI and a number of other NGO-MFIs, from applying for a license to operate at national level.

The Act needs improvements in a number of areas. The Act does not differentiate prudential regulation from non-prudential. It seems that institutions that need only registration do not require prudential regulation. There are some unclear or grey areas, uncovered issues and provisions that may adversely affect the industry’s development. Whether companies limited by guarantee are eligible to apply for a license to operate at levels less than the national level is not very clearly spelled out in the Draft Act.

The provisions that allow MRSA to give directions on the maximum rates of interest payable on deposits and the rates that may be charged on loans given by licensed/registered MFIs may create problems if the rates determined by MRSA do not enable MFIs to operate on a sustainable basis. Whether the licensed and registered MFIs are allowed access to foreign debt and equity is also not very clear. Since licensed/registered MFIs are not exempted from the provisions of the Money Lending Ordinance, they will not be able to obtain foreign equity investments into their business. This part of the Act does not appear to be forward looking in a global environment where many equity investors are seeking investment opportunities to fund MFI growth and MFIs may need such investments.

Sri Lanka has the previous disturbing experience of a draft Act which did not progress to enactment after several years of deliberations and many revisions. It is not known how long this draft act will take to become a law and the MRSA is established (GTZ/BWTP. 2010, p.15).

A number of microfinance experts in the country have described the Act as an important piece of legislation, despite its drawbacks. The Act needs clarity on a number of issues and needs to be made forward looking. Making space to enable integration of new technology to improve access to finance through branchless banking is also important.

A recent World Bank report noted (2006, p. 96) that *“it has become fashionable in South Asia for the microfinance sector and governments to draft, consider, and adopt special microfinance regulations.”* Does Sri Lanka’s draft Act represent another example? Most microfinance experts in the country would say no to this question. Sri Lanka needed a well crafted regulation and this draft could be developed to meet that requirement. The other issue is whether the new Act will further increase the fragmentation in the regulatory framework? That is unlikely. The draft Act, as noted earlier, provides space for the Monetary Board of CBSL to enforce uniform standards to a range of microfinance regulators not directly covered by the Act and hence has the potential to substantially reduce, if not eliminate, fragmentation in the prevailing framework. The draft is focused on regulating microfinance business across a range of MFIs. In a broader sense the draft Act is in line with some of the guiding principles of regulation and supervision of microfinance specified by CGAP (2003).

The draft Act, if it becomes a law, will shake-up the industry and lead to many changes in the microfinance landscape. A few NGO-MFIs are likely to become national level licensed operators and will be compelled to improve their governance, transparency and operations. Many small, unsustainable NGO-MFIs will disappear from the industry. A more competitive institutional structure is likely to emerge. Many commercial banks may find it difficult to compete with national level licensed MFIs in the retail microfinance market, particularly in rural areas unless they use new technology extensively to reach the low income people.

A prominent microfinance expert in the country has noted that MRSA *“could very well be a game changer in the battle against poverty and marginalisation”* in the country. However, it would be unfortunate if MRSA adopts a poverty-focused approach to regulation. The main goal should be to improve access to finance in a safe and sound manner. Much will depend on how quickly MRSA would be able to establish itself as a strong regulator with adequate resources including non-political, competent professionals and the extent to which it will adopt a forward looking approach to microfinance regulation.

#### 2.6.7 Regulatory Framework for Branchless Banking

Sri Lanka’s branchless banking is still in its infancy and does not include an extensive system similar to what is seen in countries like Brazil, Kenya and the Philippines (CGAP.2010; 2008; Kumar.2005). However, some regulated banks in Sri Lanka have been using agents to perform limited banking functions for many years. The interest in such agent banking has been reinforced in recent

years with the emerging new technology. For example, Hatton National Bank (HNB) has partnered with the government post offices to offer a range of financial services utilising a smart card (Bedson ed. 2008. p.68). CBSL regulates this type of agent banking within its existing banking regulatory framework.

Nevertheless, CBSL, in August 2010, released the draft guidelines for mobile payments ([www.cbsl.gov.lk](http://www.cbsl.gov.lk)). The guidelines propose two models. The first one is a customer account based system tied into a customer account at a licensed bank or a finance company registered by the CBSL. The second is a custodian account based system operated by non-bank service providers (NBSPs) licensed under the regulations to operate as mobile payment service providers. Under this system, NBSPs may open e-money accounts for each customer and issue e-money by accepting physical money from the customer. Such NBSPs are required to maintain custodian account(s) with a licensed commercial bank and shall maintain in the custodian accounts the cumulative sum collected from all mobile account holders at all times. This is similar to what Banko Sentral ng Pilipinas (central bank of the Philippines) has for G-CASH operated by GXI, a subsidiary of the Globe Telecom.

The guidelines are extensive and cover definition of e-money, risk management, responsibilities concerning cash-in cash-out agents, customer education and many other aspects. The guidelines define e-money as *“monetary value stored in devices for mobile payments.”* Banks or NBSPs are barred

from paying interest on mobile money. This essentially means that there is no possibility to use the system to offer interest bearing savings accounts, something that Equity Bank in Kenya does in its M-Kesho accounts in partnership with Safaricom, a mobile network operator. Although there are limitations, such as this, the effort to introduce a regulatory system is a very positive development.

#### 2.6.8 Summary and Recommendations

Sri Lanka's microfinance sector has grown substantially in the past 12 years. The industry reaches over 2 million households with primarily deposit and loan services. With this vast outreach, Sri Lanka's microfinance market has penetration, may be, over 70 percent - probably the highest in the world. The industry however is dominated by community-based MFIs and state-sponsored institutions. These institutions mobilise a large amount of savings from low income households promoting domestic financial intermediation. However, these community-based MFIs are unregulated or insufficiently regulated and supervised. And this MFI system does not have an appropriate framework to address any systemic failures. Hence the entire system poses significant risk. The weak and fragmentary regulation and supervision is thus a major issue in the sector.

The absence of a coherent national policy on microfinance and financial inclusion is another issue of importance. This has contributed to the continuation of unsustainable approaches to microfinance and a plethora of subsidised and scattered microfinance programmes. It is widely accepted that governance, transparency, operations, management and financial viability vary substantially across MFIs. Policies in the past have not been consistent; this characteristic is seen in the current policy measures as well. A well-designed national policy would be necessary to provide broader directions to the industry and address many issues in the sector in an effective manner in line with international good practices.

Although the microfinance outreach is extensive in the country, the role of private banks has been limited. GTFR recommended that it is necessary to have some mechanism to enable small banks to be licensed. However, the circumstances have changed: the case for such small banks appears to be weak in the current context. Commercial banks face increasing opportunities to play a more dynamic role through partnerships with other institutions and new technology supports such approaches. What Sri Lanka needs is better banks, not more banks, and innovative partnerships between existing banks and other institutions particularly community-based MFIs, to reach the unserved and the underserved.

The release of the draft Microfinance Act for public comments is a positive development and the government is in the process of moving forward on regulation. The draft guidelines on mobile payments also suggest that CBSL is keen to create greater opportunities for financial institutions to harness new technology for financial inclusion.

The draft Microfinance Act has many positive aspects; however, it also requires improvements in a number of areas. The Act should be made sufficiently forward looking by allowing space for integration of new and emerging technology that would facilitate branchless banking and financial inclusion.

The future of the microfinance industry, and financial inclusion would critically depend on the extent to which the proposed MRSA would be made a strong regulator with adequate resources to function effectively and independently. This is an enormous challenge. As a recent World Bank study (2006, p. 97) emphasised, *“there is no example in the world of special regulatory bodies for microfinance having been particularly successful.”*

### 3. CONCLUSION

Since the completion of the GTFR in 1998, modern microfinance industry has evolved dramatically, and the industry landscape has changed substantially with remarkable diversity being witnessed.

Today, microfinance banks, traditional commercial banks with microfinance operations, non-bank finance companies, self-help-groups (SHGs) linked to commercial banks, co-operatives and community-based financial institutions dedicated to providing microfinance services to the poor, operate side by side in most countries, with the microfinance NGOs that were dominant players in the 1990s. A range of innovative partnerships between financial institutions and other institutions have also emerged and begun to take root, geared to serve low-income clients. In some countries of the region, notably the Philippines, mobile network operators have also entered the financial service industry to serve the low-income segments, among others, and have contributed to the convergence of financial service and telecommunication industries. Policy makers in most Asian countries recognise the fact that technology, mobile phones in particular, could play an increasingly important role in expanding access to finance for the poor and low-income households. The widespread use of mobile phones by poor households, among others, has opened new opportunities for branchless banking, especially for the poor. These changes have major implications for policy and regulation.

Since the late 1990s, the industry outreach in the region has increased from a couple of million poor clients to over 100 million by the end of 2010. And the region today, as a whole, accounts for over 70 percent of the global outreach. According to rough estimates, the industry currently reaches around 25-30 percent of the potential market in the region, not an insignificant proportion; while in Bangladesh and Sri Lanka, the market penetration rate exceeds 60 percent. In India alone, SHGs, non-bank finance companies (NBFCs) and non-government MFIs have over 70 million credit accounts by the end of March 2010. But owing to a lack of reliable data that cover the region comprehensively, these numbers may not depict the exact picture of the outreach, though it is certain that the industry has shown significant growth in the last twelve years. This is particularly true for India, Bangladesh and Sri Lanka in South Asia and the Philippines in the East Asia region.

With this rapid growth, a small number of MFIs in the region have grown dramatically to become industry giants, and with this trend, a significant concentration is observed in the industry. In Bangladesh, for example, the Grameen Bank and two other licensed MFIs (BRAC and the Association for Social Advancement or ASA) account for over 70 percent of the total outreach in that country. In India, while 50 NBFCs serve about 16.5 million clients, the largest 5 NBFCs account for nearly two-thirds of that number. There are both positive and negative aspects of this trend. On the positive side, these large-scale MFIs have greater potential to mobilise resources in the market, realise economies of scale and scope, and provide services more efficiently. Also, they are better positioned to

reduce risks of geographical concentration. The negative aspect is that they tend to command excessive market power and reduce market competition. The larger MFIs on the other hand are more vulnerable to political risks. Thus, the emergence of a handful of giant MFIs in the industry has made policies promoting competitive markets more imperative than before.

The increased numbers of self-sufficient or financially viable MFIs have been another improvement in recent years. Some of these MFIs have become leading financial institutions in their own countries. In many countries in the region, regulated microfinance institutions now play a major role, including both Bangladesh and India. Some MFIs, such as the Grameen Bank in Bangladesh, have become true financial intermediaries, with increased reliance on domestic resources, including public deposits. But in India, the current regulations have prevented microfinance NBFCs from similarly becoming financial intermediaries. However, in virtually every developing country, perhaps with the exception of Sri Lanka, the existing supply of savings services falls far short of the demand from poor and low-income people. Thus, the increased role being played by MFIs in deposit mobilisation and the still large gap between the demand for and the supply of savings services tend to suggest that more attention is needed to improve policies for savings services, and regulatory frameworks to ensure the safety of poor people's hard-earned savings in financial institutions.

The integration of new information and communication technology (ICT), primarily mobile telephony, into the industry has reinforced growth trends in some countries, such as the Philippines; it has also strengthened the private sector interests in the industry. The commercialisation of microfinance has also increased rapidly in

the last decade, leading to private sector investments that have grown substantially to reduce the dominance of donor capital. The reliance of MFIs on public deposits for their resource requirements has also increased. Both the integration of new ICT and the rapid commercialisation have tremendous implications for policy and regulatory framework. The regulation needs to respond in a manner that would reinforce these developments, while containing possible risks associated with these evolutions. Once again, it is clear that the industry growth in the last twelve years have further increased the importance of getting the framework right.

Amidst these developments a heated debate has emerged, and continues, about the potential of microfinance for poverty reduction, and its actual contribution to this noble objective. One school of thought is of the opinion that microfinance has inherently limited capacity to make any significant dent in the poverty problem, and that creation of productive employment is essential to achieve this objective. They further argue that microfinance is not capable of creating productive employment on any large scale; therefore, the time has come to move the policy focus more toward the comprehensive new paradigm of "inclusive finance." The other school of thought meanwhile emphasises the need to learn from the past experiences and pay more attention to increasing the poverty reducing capabilities of microfinance, and strengthening the social performance of microfinance institutions. Currently, the industry seems to be progressing along these twin paths: on one hand, inclusive finance has gained wider currency in recent years in part because of the increasing recognition of the view that exclusive focus of financial services for just the poor is not good policy for poverty reduction; on the other, many MFIs have begun to pay more systematic attention to social performance by integrating

key social dimensions into their mission and strategic management objectives with the assistance from a growing number of meso-level and global organisations. The crisis of over-indebtedness in a number of countries, particularly in (Southern) India, created by the astonishingly high growth rates pursued to make MFIs more attractive to commercial investors have underscored the importance of giving more emphasis to the social dimensions of microfinance. More importantly, the over-indebtedness problem, and widely reported and debated malpractices of some major MFIs in India, and the growing notion that many MFIs appear to behave just like traditional “loan sharks” seem to have put increasing pressure on policy makers to put in place restrictive regulatory regimes as knee-jerk reactions to these problems.

In recent years, particularly 2010, a number of countries in the region have chosen restrictive policies to address these issues that have cropped up with the unsustainably high growth rates, and rapid commercialisation of the industry. Breaking away from its traditional liberal interest rate policy on microcredit, Bangladesh imposed an interest rate ceiling on microcredit at 27 percent per annum (on a declining balance basis) in November 2010 and directed MFIs to shift the system of interest rate charge to declining balance method from the widely used flat rate system. Also, MFIs have been directed to recover loan instalments on a monthly, rather than weekly basis. The industry practitioners fear that such regulatory measures would retard the growth of the industry. Similarly in India, the state government of Andhra Pradesh proclaimed an Ordinance in mid-October 2010 with a view to protecting women self-help-groups from exploitation by the microfinance industry in the State. A reputed senior policy maker at the central government has described the ordinance as “draconian.” The same policy maker predicted that if this

Ordinance is implemented as it stands, it will lead to the collapse of the microfinance sector there, a view shared by many practitioners in the country. A sub-committee appointed by the RBI to investigate the proximate causes of the crisis and to suggest solutions has also made a number of recommendations including imposition of specific limits on the effective interest rates that MFIs could charge. It is clear that such measures will have negative impact on the industry growth. According to some commentators, these negative developments suggest that microfinance has become an activity that is now dependent on the mercy of regulators and politicians, who are more likely to get things wrong than getting them right. While this interpretation may seem reasonable, the same developments also tend to suggest the validity, and the continued importance, of getting the framework right. Twelve years on, the key message of the GTFR remains valid.

There seems to be no dispute about this key message. But how to achieve this in a manner that would reinforce the positive progresses in the industry while adequately addressing the issues related to the negative ramifications remains a complex issue. There are guiding principles on regulation formally adopted by donor members of the Consultative Group to Assist the Poor (CGAP), and consensus guidelines based on these principles, expected to provide guidance to national authorities as well. Yet, the experience to-date seems to suggest that many developing countries in the region are still struggling to get the framework right because political economic factors seem to overshadow the economic factors.

A major factor behind this struggle is an over reliance on the poverty-focused approach to regulation, rather than an approach that focuses on financial stability, consumer protection and financial inclusion. The regulators’ main concern has been to put

in place an extensive set of rules to ensure poverty-focus of the services provided by MFIs. For this purpose, they tend to make a concerted effort at limiting, and directing the scope of services, and impose ceilings on loan size and interest rates, among other things. Mixing non-prudential concerns with important prudential issues and overburdening regulatory bodies with implementation of these non-prudential regulatory measures also reflect this poverty-focus. These efforts further weaken the inadequately-resourced regulatory institutions and reduce their overall effectiveness in achieving the core objectives of prudential regulation. The poverty-focused approach to regulation has also increased fragmentation of the financial systems in most countries. Striking a right balance among multiple objectives of financial stability, consumer protection and financial inclusion is not an easy task by any means, but this remains one of the major challenges in every developing country in the region.

Thus, despite some improvements in policies on regulation, a wide gap between the theory and the practice continue to exist in most countries. This gap and the complexities in the new landscape of microfinance compels the policy makers and the development community to reinforce their efforts to seek more effective ways to address the need for regulatory regimes and a supervisory system that would ensure sustainable growth of the industry and help build more inclusive financial systems.

Broadly, two institutional approaches are being used for regulation and supervision of microfinance in the region, as it is elsewhere: one is to carry out this activity by the central bank, while the other is to create dedicated separate institutions for the purpose. Pakistan and the Philippines have chosen the first, while Bangladesh has adopted the second

approach with the establishment of the Microcredit Regulatory Authority in 2006. Sri Lanka is also on its way to adopt the latter approach after debating the issue for many years. In India indications tend to suggest that the central bank may not take on this responsibility. It appears that the central bank in Nepal too is keen to hand over this function to a separate institution. While it is true that there are no examples in the world of a successful special regulatory body for microfinance, it does not necessarily mean that such bodies are unlikely to be effective and successful; though the fact that the field of regulation and supervision of microfinance being still relatively new, building such institutions to become strong regulators can pose a serious challenge. Besides, newly created regulatory institutions will obviously lack experience, and may be subject to serious teething problems, among other things.

The country experience and developments discussed in this update of GTFR show that regulation and supervision issues and challenges tend to vary across the countries reviewed. Given the diversity of the countries, and the fact that these are at different stages of financial sector development and evolution, this is understandable. However, some issues and challenges appear to be common. For example, fragmentation of regulatory system is shared by many countries. Inadequate regulation and supervision of deposit taking activities of NGO-MFIs is another such issue. Poor regulation of the co-operative and other community-based financial institutions that are engaged in deposit taking from non-members is another issue. Most countries have yet to put in place effective regulatory measures to ensure safety of poor people's deposits, not only in co-operatives, but also in other microfinance institutions. Even some major microfinance institutions in the region remain inadequately regulated and supervised. A case in point is the Grameen

Bank in Bangladesh. Lack of enabling policy and regulation for the development of microinsurance has also emerged as a major issue in most countries, although some, notably India and the Philippines, have made an effort to address this issue.

In most countries, perhaps with the exception of Bangladesh, a major failure in the microfinance sector is still unlikely to directly threaten the stability of the overall financial system. However, effective regulation and supervision of microfinance is still essential in all countries with evolving microfinance industries. A case for regulation also stems from political economic considerations because of the sheer number of people served by these institutions. If a major microfinance institution fails, it is likely to create unwieldy political problems that could threaten the stability of the entire financial system. Thus, the political economic case for regulation needs to be clearly understood and should not be overlooked.

An urgent need to broaden the scope of policies to address consumer protection issues is widely recognised in many countries in the region. This need has also arisen partly with the rapid growth of the industry and the increased level of commercialisation. Many microfinance institutions have come under fire for not being price-transparent. Some MFIs have even been accused of charging exploitative interest rates, intentionally providing inadequate information to their clients and use of abusive collection practices. The lack of transparency and clear-cut measures to protect consumers has reinforced the process of politicisation of microfinance sector issues. In a number of countries, including India and Pakistan, politicisation

has led to serious crisis in the industry and begun to retard its sustainable growth. And the policy makers in India and Bangladesh have put in place restrictive regulation with a stated objective of protecting the consumers. These responses, primarily driven by political considerations, do not seem to address the core issue of effectively protecting the consumers. Nor do they improve financial inclusion.

Thus the policy and regulation in the region which showed an improvement until about 2005, has begun to see significant setbacks in recent years in the two countries with the largest microfinance sectors. Other countries have not yet witnessed similar major setbacks, although in the near future Sri Lanka is likely to move from the relatively liberal framework to a more restrictive regime with the enactment of the proposed Act on microfinance regulation. In the meantime, based on the current situation, it may be reasonable to conclude that Pakistan, Nepal and the Philippines will continue to move towards more liberal environments through improvements in the existing policy and regulation. India and Bangladesh are likely to have more restrictive policy and regulatory framework. Of all countries in the region, the Philippines will most likely continue to be the country with the most liberal framework for microfinance and financial inclusion. There is an opportunity for other countries to learn a great deal from the experience of the Philippines. In general, cross-country learning will be most valuable for all countries interested in improving the policy and regulatory framework.

### 3.1 Some Recommendations

The review of the developments in the microfinance industry in the countries covered in this update and the current issues and trends in the industry provide a basis for making a number of recommendations related to the policy and regulatory framework.

Although microfinance has a role to play in poverty reduction, it is essential to recognise that this is a very limited role. It is also important to adopt a more comprehensive financial inclusion approach to achieve greater impact on poverty reduction, and this means moving away from the exclusive focus on financial services for the poor. Microfinance within such an approach might be an important entry point for financial inclusion of the poor, but it is not just the poor who remain financially excluded. For example, many small and medium enterprise operators and small farmers who could create productive employment opportunities for the poor, to enable them to get out of poverty, remain financially excluded.

The adoption of a comprehensive financial inclusion approach requires a clear national policy framework and a strategy on financial inclusion, formulated through a broad consultative process and a thorough diagnostic of the status of financial exclusion issues in the respective countries of the region. Some countries, such as the Philippines and Pakistan, have already embraced the financial inclusion approach. The policy makers in India have also emphasised the importance of a more comprehensive approach to financial inclusion and taken a number of measures to improve financial inclusion. Bangladesh Bank too has introduced a number of initiatives for financial inclusion, but the country lacks a coherent policy and a well-designed strategy.

In general, a comprehensive policy and a strategy on financial inclusion should focus on promoting sustainable services through a range of private sector institutions. Countries where public resources are used to provide interest rate subsidies should reconsider these programmes and policies with a view to reducing market distortions and reallocate the resources to build financial infrastructure for financial inclusion. The experience in most countries suggests that interest rate subsidies have not worked for the benefit of the poor. And, “smart subsidies” have a better role to play in developing inclusive financial systems.

Most Asian countries, particularly those in South Asia, should review their interest rate policies for the microfinance sector with a view to adopting more liberal policies that would allow MFIs to take pricing decisions without restrictions. However, government policies should clearly articulate the requirement that MFIs and other financial institutions need to strictly adhere to the core principles of transparent pricing.

Recognising the rapid evolution of the microfinance industry, dramatic transformation of the landscape of the industry and new opportunities created by convergence of new information and communication technology and financial service industry, virtually all developing countries in the region need to thoroughly examine the existing regulation affecting financial inclusion to identify how they can be adapted and improved to achieve the objectives of financial inclusion. Regulations related to branching, use of agents to deliver financial services to the excluded people and those in remote areas, know-your-customer requirements and those on opening of new accounts in most countries need adaptations to be in line with the requirements for

financial inclusion. In general, regulatory framework should: (i) open up opportunities for sustainable expansion through a diverse range of institutions; (ii) allow adequate room for product and service diversity; (iii) create a conducive environment, in particular for savings mobilisation by a wider range of institutions; (iv) create sufficient space for integration of existing and emerging new ICT into the financial services industry to accelerate the process of financial inclusion; and (v) include measures to improve price transparency and ensure consumer protection.

This update also recommends strengthening of regulation of financial cooperatives. The cooperatives are a dominant source of financial services for the poor and low-income households in Sri Lanka. In India there are a large number of financial cooperatives which are expected to provide financial services to low-income people. The Philippines also have cooperatives with a mandate to serve low-income clients. Credit co-operatives have begun to, according to some sources, mushroom in Bangladesh. But none of these

countries have adequate regulation and supervision of the financial cooperatives.

The governments must also invest adequate resources to improve the capacity of regulatory institutions. This is particularly important in countries such as Bangladesh where new and separate institutions have been established for microfinance regulation. Even in countries such as Pakistan where the regulatory responsibility lie with the central bank, allocation and use of adequate resources to develop the regulatory capacity is required. To build inclusive financial systems on the basis of the remarkable achievements of the microfinance industry to-date, developing countries in Asia need not only right policies but also strong regulatory institutions that can respond to the rapidly changing market. And, it should specially avoid reverting to restrictive policy and regulatory framework, a disturbing trend that is emerging in some of the countries where the problem of over-indebtedness has put pressure on the politicians and policy makers to respond.

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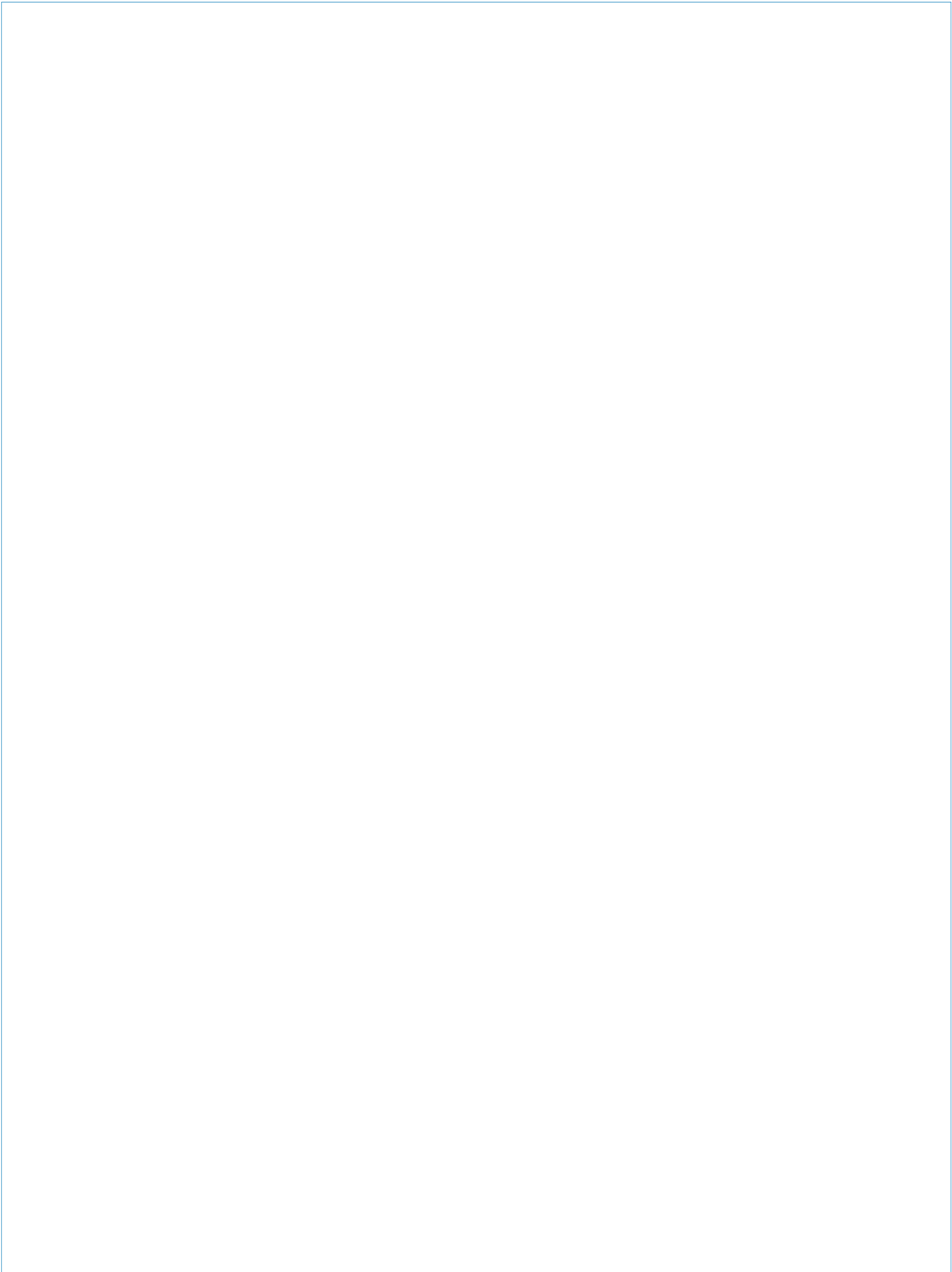
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## NOTES

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