

# MICROFINANCE POLICY AND REGULATORY FRAMEWORK: EXPERIENCE AND PERSPECTIVE OF SOUTH ASIAN REGION – SRI LANKA, BANGLADESH, NEPAL AND INDIA

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## INTRODUCTION

The vital role played by 'finance' in an economy has been well-recognised and duly incorporated in financial policy frameworks. Finance, in its more popular usage, covers medium to large scale funding of both households and enterprises and is expected to help an economy to maintain its current output level by supplying working capital and expand its production capacity by supplying investment capital. Microfinance, its small and unseen brethren, too plays the same vital role and perhaps much more, with respect to its clientele. Microfinance, covering a wide array of services, viz., credit, deposit, money transfer, insurance, market information etc, keeps its clientele, the poorer segments of the society, afloat, helps them to gradually and progressively cross the poverty line and get them cohesively integrated into the rest of the society. In this manner, microfinance presents a potent instrument for alleviating poverty in the South Asian region.

The examination of the microfinance systems in the region reveals that the region still lacks a clearly defined and articulated microfinance policy. Microfinance has largely been left to itself, and the systems have sprung up almost automatically to meet the demands of this particular clientele. In this context, the numerous microfinance systems that are operating have stood the test of time and , therefore, could be considered more sustainable than formal

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financial systems regulated by authorities. At a very rudimentary and primitive level, the village money lender provides a host of microfinance services – credit, market information and social services – on simple and easy to follow procedures, but at appropriate prices. The widely held allegation against the village money-lender that he exploits his customers, trapping them in an ever moving vicious circle of poverty, paved the way for the creation of people based voluntary organizations. These organizations gradually evolved into small scale member based microfinance institutions (MFIs) which were set up at first at local or regional level. Some of them have since expanded vastly, covering a clientele spread throughout their respective countries, thereby becoming national players in microfinance.

The need for a clearly-announced microfinance policy has now become of paramount importance due to several reasons. First, after the failure of supply-driven and subsidy providing poverty alleviation programs, there was the necessity for trying out more sustainable poverty alleviation strategies. This gave rise to the development of a host of credit based poverty alleviation programs – microcredit, linkage banking, credit plus approach and finally, microfinance. Given the high incidence of poverty in South Asia<sup>1</sup>, microfinance need be recognized as an important element in poverty alleviation strategies. Second, microfinance institutions (MFIs) have now become an important part of the overall financial system, creating a systemic impact on it. This has generated supervisory and regulatory issues that have drawn the attention of authorities. The failure of any national level MFI would bring about the same social costs to the society as a formal financial institution. Consequently, as a precursor of the regulatory mechanism, microfinance policy need be explicitly incorporated into the national development strategies. Third, the national development of any country encompasses all the strata of the society and, therefore, a system that benefits a sizeable segment of the society cannot be overlooked. Fourth, along

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<sup>1</sup> A study by IFAD reveals that in South Asia, in 1998, about 40 percent of population lived below the poverty line. (See: IFAD (2002) p.3

with microfinance, the empowerment of the poor too takes place thereby elevating a section of the population hitherto neglected to the status of responsible citizens, capable of actively participating in the country's socio-political life. This is specifically valid in the case of women who emerge as the biggest beneficiaries of microfinance. On account of these reasons, time has now come for policy makers to explicitly recognize microfinance as an integral element in the overall economic policy framework to be pursued by countries.

This paper will present the experience and perspective of microfinance policy and MFI regulatory framework in four selected South Asian countries, viz., Sri Lanka, Bangladesh, Nepal and India. Part I of the paper will briefly evaluate the present state of microfinance policy and make the case for its explicit recognition as a tool for poverty alleviation. Part II will focus on the regulatory mechanism for MFIs and Part III will be devoted to the experience in the 4 selected countries under study. Part IV will present a summary and major conclusions that can be drawn from the study.

#### ***PART I - PRESENT STATE OF MICROFINANCE POLICY***

Microfinance is expected to cater to a specific clientele, the poor, who are normally defined very broadly as those incapable of meeting even the day today basic requirements needed for a decent human life. This group is not homogeneous but depicts a wide diversity. Those who are at the bottom of the pyramid constituting the poorest of the poor in abject poverty differ significantly from those at the top who are closer to the poverty line. This lower group is normally identified as the lower 50 percent of the poverty group for convenience. The existence of significant differences between the top half and the bottom half has made even the microfinance practitioners skeptic of the capability of microfinance to provide an effective tool for alleviating poverty among those in the bottom half. Fernando (2004a) has succinctly presented the views of microfinance practitioners on the issue as ranging from extreme pessimism to extreme optimism. Those in the extreme pessimism believe that

microfinance cannot reach the bottom half on a sustainable basis, since their problems are compounded not by a lack of '*financing*', but by other structural issues such as poor infrastructural facilities, lack of market access and imperfect information. Hence, the crucial issue has been two-fold: the poorest of the poor who do not have intention to service microcredit and, even if they have intention to do so, are incapable of generating a sufficient income stream to repay their loans. As a result, it is inevitable that they default loans, making MFIs vulnerable to a high loan delinquency ratio. Hence, frequent and periodical demands for loan forgiveness and the rescue of MFIs by tax payers are on the card, making the whole microfinance system unsustainable in the long run.

Those in the optimism camp believe the exact opposite. Their optimism on the capability of microfinance in reaching the bottom half effectively is based on the assumption that there is an effective demand for microfinance services from this target group. Hence, MFIs could reach them effectively, and given the proper pre-requisites such as a conducive credit culture, market based practices and empowerment of the target group, the microfinance system would be sustainable in the long-run. Their argument has been strengthened by the ground level results that MFIs may have succeeded in introducing successful microfinance schemes for the benefit of this group.

Fernando (2004a) has also identified a mid-camp which believes that microfinance can outreach the bottom half to a limited extent. According to this camp, it is futile to believe that microfinance can salvage all the poor in the poverty group. While the top half can be served effectively by microfinance, its ability to produce miracles for the bottom half is suspect. Hence, they argue that the search for building effective models for serving all the categories of the poor alike must be continued and microfinance for this purpose should be used having known its limitations.

The corollary of the presence of such wide differences among microfinance practitioners about its capability has been the relegation of

microfinance policy to a very negligible status in national development agendas. Both politicians and policy makers, while admitting that poverty alleviation is the topmost priority of the society, do concentrate on other strategies for attaining the desired objective. These strategies focus on setting macroeconomic policy at right levels and toward right direction to induce a higher growth and elevating the poor through trickle-down process, on the one hand, and, providing hand-outs to them to sustain a minimum consumption level, on the other. The World Bank sponsored poverty reduction strategies do concentrate on the former to a large extent. While these strategies do not totally dismiss the provision of hand-outs to the poor, they emphasise on the need for proper targeting to cross the poverty line within a given time-frame. Microfinance is hardly mentioned as an effective strategy in this policy framework.

The non-recognition of microfinance as an effective policy tool has also been prompted by the prevailing socio-political conditions in many developing countries. This refers to the relative bargaining power of different groups in the society, viz., the rich, the middle class and the poor. While the rich are quite capable of protecting their own interest against adverse external shocks, the middle class which is vulnerable to external shocks is now emerging as a powerful force in these countries. The bargaining power of this class in the extant socio-political scenario is placed well-above that of the poor segments, the main beneficiaries of microfinance systems. The superiority of the bargaining power of the middle class emanates from its higher level of education, asset base, social networks and connections and access to information than that of the poor. They are continuously being heard by both the politicians and policy makers who are sympathetic to their case. The media too, continue to present their case cogently and strongly. They have also organized themselves as benefit promoting pressure groups such as trade associations, welfare societies and social clubs etc. Hence, it is natural that the prevailing policy framework in these countries is biased toward the middle class to a large extent. It is ironic

that the rich too indirectly benefit from the policy packages favouring the middle classes and therefore, they too give their tacit approval to such policies.

The poor, on the other hand, are without such social networks, connections and associations to be heard continuously by the policy makers concerned. Their hand to mouth living style precludes them from devoting time for their own concerns. Their access to useful market information is inadequate. Even if they have access to such information, they do not possess the necessary skills to process such information and gain advantage. They are very rarely organized as social clubs or associations to exert pressure on the policy makers. Since the market base of the media is made up principally of the middle class, no sufficient coverage is given by the media to the problems faced by the poor. Hence, the poor are not strong enough to make themselves heard by policy makers. The corollary has been very clear: the relegation of microfinance to an unimportant status in the national economic development policy frameworks.

It may be useful to consider in greater detail the case put forward by pessimists against microfinance as being unable to outreach the bottom half of the poor. As Robinson (2001) pointed out, those in abject poverty are incapable of using microcredit to their advantage, because their enterprises are hindered by a lack of infrastructural facilities and inadequate market access. Hence, their use of credit would not generate a sufficient income for them to service the microcredit effectively. Having thus identified the issue, she has come up with a solution which appears to be contrary to the accepted principles of mainstream microfinance practitioners. She claims that the poorest of the poor should not be the responsibility of the financial system, but the ministries of labour, health, social welfare, etc. The governmental subsidy programs implemented by these ministries should be supplemented, she claims, by donors and private charities. A similar sentiment has been expressed by de Haan and Lipton (1998), when they too found fault with microfinance practitioners for mistaking the lubricant (credit) for the engine (feasible and profitable activities). Their message is that microfinance should not be expected

to deliver things which it cannot do and it is advisable that its limitations are properly understood. The failure to do so would be that the microcredit borrowers would end up in an inescapable debt trap.

This pessimism over microfinance and the suggested solution have a basic flaw. It has narrowly defined microfinance to mean only microcredit. Hence, it assumes that, in the absence of other conducive conditions, the poor would not be able to generate a sufficient income stream to service their debt. Microfinance is much more than microcredit. It concerns itself with such key areas as empowerment of the poor, market developments and access, use of information profitably etc, in addition to the provision of miscellaneous financial services. Given the wider coverage of microfinance, the poor are in a position to derive benefits from microfinance, if an effective social mobilization and empowerment process precedes its delivery to the poor. Furthermore, the suggested solution involving the provision of hand-outs to the poor by the government, donors and charities is not sustainable: on one side, these organizations would sooner or later run into resource constraints; on the other, the dependency syndrome which it creates in the minds of the poor would generate moral hazard practices, thereby putting them into innumerable miseries once the subsidies are withdrawn. Hence, any viable and sustainable solution to the problem of the poor should contain, as an integral element, the empowerment and social mobilization of the poor so that they could take care of their affairs by themselves.

This microfinance policy thrust necessarily involves a process through which the poor are taken through in order to make an attitudinal change in them. The need for the attitudinal change arises from the premise that it is not poverty which is disastrous, but the culture of poverty which is widely prevalent among them. Poverty is an ailment which can be successfully cured. But, if someone suffers from the ailment known as culture of poverty, no medication would be effective in curing him. The main symptoms of a person suffering from the culture of poverty are as follows: he is fatalistic or ready to blame others for

his suffering; he sees only the problems and not the opportunities created by such problems; he is lazy and does not want to move away from his home; his personal habits are socially contemptible; he shirks his responsibility for the family and he does not want to be a participating citizen. For microfinance to work in any society, a change in this behavioural pattern is a must.

The required change was termed by Maclelland (1961) as the inculcation of the need for achievement (n-ach) in the minds of the people. He identified three basic psychological needs that contribute to prosperity and economic growth: need for power (or n-pow) representing the '*concern with the control of means of influencing a person*', need for affiliation (or n-aff) concerning the desire to establish, maintain and restore an affective relationship with another person or simply having a friendship and need for achievement (or n-ach) manifesting the desire to take challenge and attain success. The first two are concerned with a person's relationship with the rest of the society, while the last relates to his personal success for which he expects appreciation and recognition by the society. According to Maclelland, all the three needs are learned rather than inborn. Hence, it is possible to cultivate them in the minds of people through a successful and effective learning program.

Maclelland found that, in societies which are characterized by high n-ach in people on a widespread basis, the economic growth was faster and sustainable. This is because of the following relationship he found in the societies examined by him.



It is therefore necessary to inculcate n-ach in the poor in order to break them away from the traits of the culture of poverty.



The analysis so far suggests that the microfinance policy has not been given its due recognition in national development agendas due to its own failure to address the basic issue of changing the poor into a successful microentrepreneur. Hence, it is necessary to introduce microfinance as a comprehensive package to change the poor into a modern man blessed with high n-ach and capable of taking care of his own affairs as a responsible citizen of the society.

**PART II - REGULATORY FRAMEWORK OF MICROFINANCE  
INSTITUTIONS (MFIs)**

A salient feature of MFIs has been that they have sprung up spontaneously to meet a market demand similar to the creation of microbusinesses. These institutions which have been set-up at first as small village based voluntary associations to cater to each other's needs have gone through an evolutionary process to become sometimes national level MFIs. Despite varying sizes, MFIs handle other people's money and, therefore, the viability and solvency of these institutions have become a crucial issue in MFI policy frameworks. Given the fact that they function as depositories for the most vulnerable groups at the bottom of the income pyramid, a failure of an MFI may entail greater social costs from a welfare point of view than that of a higher level lending institution.

The policy response to the need for establishing a regulatory mechanism for MFIs has basically taken three approaches:

- (a) Allowing MFIs to self-regulate and bringing them under strict market discipline;
- (b) Regulating only large MFIs which have a systemic impact on the entire financial system or the microfinance market;
- (c) Bringing all MFIs into a regulatory net so as to establish a viable microfinance system.

Each of those approaches have their own merits and demerits and therefore a country should choose very carefully the most appropriate system, since both regulation and non-regulation entail differing costs on the society.

(a) ***Self Regulation and Market Discipline***

Self regulation requires MFIs to follow and adopt internal control, good governance and proper disclosure systems so that the sustainability of MFIs would be ensured through self motivation. Hence, in the long-run, it is the self regulation that ultimately preserves the viability of an MFI. This is because, however much external regulation is employed, without internal stability, an MFI would not be able to survive in a hostile market environment.

The following are the important elements of self-regulation of MFIs:

- (a) Adoption of proper internal control systems to prevent, detect and deter fraudulent behaviour on the part of MFI employees. It is equally important to maintain strict discipline among employees as a deterrent to fraudulent behaviour.
- (b) Practising self-restraint in the behaviour by clearly pre-announcing the policy of an MFI.
- (c) Commitment to continuous improvement of the management quality so that an MFI would gain capability of withstanding adverse external shocks and going through difficult periods.
- (d) Team-work should be promoted in order to capitalize on the full potential of workers and thereby ensure the sustainability of its actions.
- (e) Installation of good management information systems so as to procure timely data for making informed decisions, giving advance warning of impending disasters and preventing adverse developments within the organization.

The self-regulation should be coupled with a policy of subjecting MFIs to market discipline to realize the best results for the system. The market discipline would help an organization to develop itself on a sustainable basis, solidify its operations and attain the necessary resilience to withstand or absorb adverse external shocks. Since the market discipline operates on the basis of rewarding well doers and punishing ill-doers, it requires to automatically close-down MFIs that fail to maintain the required market norms. It is however of interest to assess the welfare cost of such automatic closing of ill-performing MFIs.

The continuation of an ill-performing MFI with outside support would generate two basic economic issues: moral hazard problem and adverse selection problem. The presence of either of these problems is injurious to the long-term well-being of a viable MFI system. The automatic closing of an MFI resolves both problems simultaneously. It reminds MFIs that they should stand on their own (elimination of moral hazard) and that they cannot expect to gain by forming MFIs to receive public funds (absence of adverse selection). The MFIs that could continue to pass the tests of the market are efficient, viable and sustainable. Hence, the welfare gains to the society by subjecting MFIs to market discipline are substantial.

The loss to the society would be the loss of the financial savings of the poor who would have been indoctrinated into savings habits by a microfinance program. The resultant loss of confidence of the participants in the microfinance systems in general and MFIs in particular would adversely affect the success of microfinance based poverty alleviation programs. This is, however, a short-term impact and could be eliminated through an effective insurance system.

In view of the net welfare gains involved, it is best that MFIs are allowed to be self-regulated and subject to market discipline in order to maintain their liquidity, stability and solvency in the long run. Any external regulatory mechanism could only supplement this main pillar of ensuring the long-term sustainability of MFIs.

(b) ***Regulation Through External Bodies***

The response of the authorities who are skeptic of the virtues of self-regulation and market discipline has been to bring MFIs under the umbrella of a governmental regulatory mechanism. The coverage of the regulation varies from regulating only the large MFIs with a systemic impact at one end to all MFIs that form the MFI net of the country at the other. Since all MFIs have their origin as non-governmental organizations (NGOs) and NGOs do not have an equity ownership, the management of an MFI has the incentive to abuse its powers to work for a self-fulfilling objective either individually or as a collective group. This apparent deficiency in the NGO evolved MFI model has made the authorities cautious of allowing such MFIs to handle other people's money, specifically, the poor people's money. Hence, as the production of a public good, attempts have been made to maintain their stability and solvency by introducing a regulatory mechanism for MFIs.

Whatever the scope of regulation, MFIs could be regulated by authorities by adopting two methods.

1. ***Establishment of a Government Regulatory Authority to Regulate MFIs***

In this method, a separate authority to be established by the government would regulate and supervise MFIs which are brought within its purview. In view of the high cost involved and the need for minimizing the burden on tax payers, the authorities sometimes choose to regulate only the large and national level MFIs which could exert a systemic impact on the financial system. In other options, the regulatory arm could be extended to all MFIs so that the government takes responsibility for maintaining a stable, viable and solvent MFI system for the benefit of the poor.

The establishment of a separate governmental authority for regulating MFIs is justified on the following grounds:

- (i) The need for a distinctive regulatory approach for MFIs, in view of the significant difference between MFIs and higher level financial institutions;
- (ii) The recognition of the need for having a lighter regulatory structure for MFIs which are fledgling institutions and vulnerable to market vicissitudes;
- (iii) The need for preventing the normal banking supervisory authorities from being overstretched by having to regulate a large number of MFIs as well.

When a separate regulatory authority is established for MFIs, such authority, adopting a system of differential regulatory methods, should be given full powers to approve or disapprove MFIs, call for information, examine books and other records and issue directives, guidelines and regulations to MFIs.

## **2. Outsourcing the Supervisory Work of MFIs to Outside Bodies**

In view of the large number of MFIs operating in a country, it is neither practicable nor cost-effective for a single regulatory authority to attempt at covering all MFIs. To minimize the costs, but at the same time, maintain the required efficacy, the supervisory work could be outsourced to other organizations such as accounting and audit firms, whenever there is evidence to suggest an impending crisis in the MFI system. In addition to the cost minimization, this method has the following merits:

- (i) The ability to engage specialists who are specifically competent and skilled in the products, affairs, operations and businesses of MFIs;
- (ii) The flexibility of resorting to supervision whenever the need arises, thereby avoiding a continuous and regular supervision;
- (iii) The possibility of effecting the required supervision through a lean body at the center

To facilitate the adoption of this method, it is necessary to prepare the guidelines, benchmarks, norms and internal control systems in detail so that the outsourced supervisors could follow a uniform method of supervision. It is also advisable to introduce a separate accounting and auditing standards system for MFIs, since such standards applicable to normal financial institutions may be too stringent and prohibitive for MFIs.

The regulatory mechanisms of MFIs should, of necessity, be based on both self regulation and market discipline and external oversight by a supervisory and regulatory authority. The two approaches are complementary to each other. Hence, in the absence of either approach, the other cannot deliver the required results.

**PART III - THE EXPERIENCE OF SOUTH-ASIAN REGION IN MFI  
REGULATION<sup>2</sup>**

The regulatory approach adopted by South-Asian countries towards MFIs varies from formal supervision and regulation, as in the case of Nepal, to allowing MFIs to be self-regulated in a free market environment, as in the case of Sri Lanka, Bangladesh and India. The lack of a proper regulatory and supervisory machinery for MFIs in the latter category of countries has in no way resulted in or led to any failure of the MFI system in those countries. In fact, some MFIs in Bangladesh such as Grameen Bank and BRAC have become international models for well-run MFIs. Fernando (2004b) notes that in India, SHARE Microfinance Ltd, an MFI, has managed to elevate itself as a regulated financial institution (RFI) by registering with the Reserve Bank of India as a non-bank finance company. At the same time, in Nepal where a formal supervisory and regulatory mechanism for MFIs exists, two MFIs, viz., Nirdhan Utthan Bank and DEPROSC Bikas Bank, have been elevated to the status of specialized banks. In Sri Lanka too, one MFI operating as an MFI under the co-operative laws, has

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<sup>2</sup> This section heavily draws on ADB(2000), Wijewardena (2001), Mortuza(2001), Shresta (2001) and Fernando (2004b)

been successful in establishing its own specialized bank under the name of SANASA Development Bank. The available evidence, therefore, suggests that, for the evolution and performances of MFIs, the presence of a formal regulatory mechanism is immaterial. Yet, the growth of the MFI sector is so fast and its outreach is so wide-spread, that the financial authorities cannot be oblivious to the potential risks and dangers associated with a problem MFI sector.

The sections below will outline the current status of the regulatory and supervisory mechanism over MFIs in 4 selected South Asian countries, viz., Sri Lanka, Bangladesh, Nepal and India.

a) **Sri Lanka**

MFIs have been established in Sri Lanka under different statutes.<sup>3</sup> Hence, any regulatory oversight is exercised on MFIs under the relevant provisions the statutes concerned. These provisions do not extend beyond the reporting requirements under which the MFI concerned should file its audited final accounts with the respective government authority. These authorities too, in view of the staff shortage and resource constraints, do not make any attempt at monitoring the operations of these MFIs. The usual treatment of such accounts by the authorities concerned has been the filing away in the plethora of files and documents of the bureaucracy without even an index for subsequent retrieval. No evidence has even surfaced about the policing of these organizations by the authorities concerned.

The absence of a formal regulatory and supervisory mechanism for MFIs in Sri Lanka has been prompted by several reasons. First, MFIs are still at a very primitive stage of development and have been set up to cater to their own members. Though accepting deposits from the public is illegal for them, unless

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<sup>3</sup> Co-operatives are set-up under the Co-operative Development Act, and the relevant reporting authority is the Commissioner of Co-operative Developments. In the case of both societies which are set up under the Societies Ordinance and People's Companies which are set up under the Companies Act, the reporting authority is the Registrar of Companies.

they are registered with the Central Bank as a registered finance company under the Finance Companies Act, to promote an MFI system, the Central Bank has been permitting them to accept deposits only from their members. Since the MFIs have not matured enough, it has been considered that formal regulation of MFIs would deliver a severe blow to the development and evolution of an MFI system in the country. Second, MFIs constitute only a negligible portion of the entire financial system. Hence, they do not pose a potential systemic risk and, therefore, any attempt at regulating and supervising them formally would not be cost-effective. Third, perhaps the authorities would have been guided by the dictum that if something operates well, one should not try to intervene in it and, in the process, cause it to malfunction. When applied to MFIs, this means that MFIs operate well in the country and, therefore, there is no necessity for disturbing the same through regulation and supervision. Fourth, the larger type MFIs are being accredited by donors for receiving donor assistance, since they have been maintaining, on their own, the minimum standards needed for such accreditation. This self-regulation which is viable and sustainable in the long run, is the best way of ensuring the stability, viability and solvency of MFIs. On account of these reasons, no need has arisen in Sri Lanka for introducing a formal regulatory and supervisory mechanism for MFIs.

ADB (2000) notes that registration with an authority has never been an issue for MFIs to operate in Sri Lanka. Whether an MFI is registered or not, there is no prohibition for it to lend money to members of public. In the absence of usury laws, there has not been any control over the interest rates charged by MFIs. In fact, MFIs have been charging higher interest rates than the normal market lending rates, reflecting the high risk factor involved in lending.<sup>4</sup>

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<sup>4</sup> For instance, Isuru Development Societies which are made up of beneficiaries of the Small Farmers and the Landless Credit Project implemented by the Central Bank charge a lending rate of 36 percent per annum, when the prevailing market rates range between 15 to 20 percent per annum.



The official stand with regard to the introduction of a supervisory and regulatory mechanism for MFIs in Sri Lanka has been summarized by ADB (2000) as follows:

*A senior CBSL supervisor of non-bank financial institutions felt it would be a long time, given present priorities and resources, before MFIs would come to the attention of central bank regulators, if they were simply to confine themselves to collecting member deposits, and remained relatively small operators. There is currently too much for CBSL to do in the regulated financial sector. The volume of savings involved is an important consideration, however, which may explain the cautionary reference to Samurdhi in the 1997 (Central Bank) annual report. (p301)*

b) **Bangladesh**

According to ADB(2000), there are no specific regulatory provisions in Bangladesh relating to MFIs that go beyond the simple administrative and accounting requirements of the laws related to charities, trusts, co-operatives and non-profit companies. Even the significantly large MFIs such as the Grameen Bank and Palli Karma Sahayak Foundation (PKSF) have evolved on their own without being subject to a regulatory mechanism. The reporting requirements of all these MFIs to the Bangladesh Bank have been only for statistical purposes, and not for any prudential regulation.

In the absence of a formal regulatory mechanism, MFIs have resorted to self-regulatory systems in order to maintain their status. Mortuza (2001) reports that MFIs have their respective mechanisms of self-regulation that might not be adequate in terms of qualified standards. But, it does not necessarily call for external regulatory measures. Since external regulation is only one element in a well managed MFI system and all the other requirements fall within the rubric of self-regulation, Mortuza (2001) recommends that self-regulation should be

strengthened. For this purpose, it is necessary to introduce an appropriate code of norms/conduct and institutional transformation options through an apex body of NGOs such as the Association of Development Agencies in Bangladesh (ADAB) and Credit and Development Forum (CDF).

In order to establish a well-functioning solvent and sustainable MFI system in Bangladesh, Mortuza (2001) further recommends that the self-regulation should incorporate the following elements of code of norms/conduct and require all MFIs to abide by them through the influence of the apex bodies of MFIs.

- (i) A strong and capable Board of Directors that establishes sound programs of intervention, financial and risk management policies and holds the management accountable for implementing such policies effectively.
- (ii) Developing a standard accounting system for MFIs with the required degree of transparency.
- (iii) Effective internal control and an intensive and extensive internal audit function to confirm that the approved policies are followed and procedures are effective.
- (iv) Development of an effective mechanism for the protection of savers.
- (v) Introduction of an efficient management information system.
- (vi) Development of effective financial and operational performance standards.
- (vii) High quality external auditing by those auditors who are knowledgeable and competent in microfinance as an objective check on internal systems to protect against fraud and mismanagement, and
- (viii) Introduction of strategic monitoring and financial performance standards.

The emphasis on developing and sustaining MFIs through self-regulation and associated code of norms/conduct would be a model for other countries to follow, since it was Bangladesh which provided the role-model of MFI systems to the rest of the world.

c) **Nepal**

Unlike other countries in the South-Asian region, Nepal chose to introduce formal supervision and regulation of MFIs. The Financial Intermediary Societies Act (FISA) of 1998 has empowered the Nepal Rashtra Bank(NRB) to be the licensing, regulatory and monitoring agency for MFIs. Accordingly, NRB has been empowered to:

- (i) call for information, data or other documents from MFIs in order to regulate and supervise them;
- (ii) approve or disapprove the interest rates charged by MFIs;
- (iii) issue, cancel or renew licenses to MFIs;
- (iv) recover the loans on-lent in the case of closed down MFIs;
- (v) prescribe the level of administrative expenses of MFIs;
- (vi) issue directives on the operations of MFIs;
- (vii) prescribe suitable accounting systems for MFIs.

According to ADB(2000), NRB has issued directives to MFIs on the following matters:

- (i) Limiting the loans to less than NRs 100,000 (US\$ 1440) per individual;
- (ii) Building a reserve fund through the allocation of 10 percent of the profits of MFIs as a provision for loan loss;
- (iii) Submission of all the data called for by NRB;
- (iv) Certifying the auditors authorized to carry on the audit of MFIs.

d) **India**

India also has followed a policy of non-regulation of MFIs formally. The requirements applicable to MFIs do not go beyond, as in other non regulating countries in the region, the administrative and simple accounting requirements of charities, trusts, etc. The country has been relying on self-regulation as an effective way of ensuring the proper functioning of MFIs.

Given the need for streamlining microfinance and promoting it as an effective tool for poverty alleviation, ADB (2000) has made the following proactive recommendations to be adopted by the Reserved Bank of India (RBI):

- (i) RBI should promote understanding that higher interest rates provide increased access to finance for the poor rather than exploiting them;
- (ii) RBI should initiate action to bring the needed legal framework for MFIs;
- (iii) RBI should establish prudential regulation and supervision structures for MFIs which are appropriate to their size;
- (iv) RBI should develop prudential norms and reporting standards for MFIs.

#### ***PART IV - SUMMARY AND CONCLUSIONS***

This paper argued that microfinance, covering an array of financial services extended to the poor is a potent tool for alleviating poverty. Yet, unlike medium and large scale finance, microfinance has not received its due place in national development policy framework. The ignorance of the role of microfinance has been partly due to the pessimism expressed by some of microfinance practitioners about its outreach capability and partly due to the negligible bargaining power of its clientele, viz., the poor, as against that of the middle class of the society.

The criticism of the pessimists appears to have been narrowly focused on microcredit rather than considering the wider scope of microfinance, credit, deposit, money transfer, insurance, market information and network services. With a successful social mobilization and empowerment program to precede the credit delivery, even the poorest of the poor stand to benefit from microfinance. However, to attain the maximum success and ensure sustainability, an attitudinal change in the target clientele should be effected. This change in the form of inculcating a high need for achievement would be instrumental in creating a successful entrepreneurial class among the microfinance users.

The best method of ensuring stability, solvency and viability of MFIs is to promote self regulation within such organizations, checked by market discipline. Such an MFI system, devoid of moral hazard and adverse selection issues would bring about net welfare gains for the society. Government regulation of MFIs should be effected only as a supplement to this approach.

In the South Asian region, except Nepal, all the other countries have chosen to leave MFIs for regulation by themselves. This approach has, in no way, impeded the growth and the spread of MFIs in the countries concerned. In fact, in some of these countries, MFIs have emerged as world models. The Grameen Bank and BRAC in Bangladesh are the cases in point.

In order to strengthen the MFI system in the region, the following proactive measures may be introduced.

- (a) Introduction of a separate accounting and auditing standards system for MFIs so that it would establish a uniform accounting system which is less stringent than the systems applicable to ordinary business firms;
- (b) MFIs should be managed by professionals to enable MFIs to maintain a high degree of professionalism in their operations;

- (c) MFIs should make a clearly specified policy statement that includes periodical voluntary disclosure of operations, activities, financial position for the benefit of the public;
- (d) MFIs should, on their own, consent to having a rating for their business activities, so that the members of the public would have required information on them.
- (e) MFIs should strive to build internal reserves out of operational surpluses to enable them to absorb loan losses, withstand adverse shocks and go through difficult periods.

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