

Systems That Support Microfinance:

Toward a democratic, inclusive financial sector

As discussed in chapter 1, microfinance in South Asia grew out of a concern for poverty and a desire to provide the poor with the means to accumulate productive assets. Yet, after nearly 30 years of a gradually growing but lately intensive effort, microfinance has reached a poverty coverage of only 17 percent of the poor families in the region (see table 2.2). While this outreach level is high in a couple of countries, the overall performance is undoubtedly low. It is apparent that to make microfinance more effective, and to increase its outreach in increasing incomes of poor families (or at least providing them with relief), microfinance must have an effective set of support structures and systems.

Because stable financial systems are the backbone of modern economies, the provision of financial services is invariably controlled by the central banks of each country, albeit to various degrees. Access to microfinance services is likely to be influenced by the vigor of central banks in controlling that system and by the facilitative provisions of the regulatory mechanism. The extent to which that system facilitates its use can be influenced by the activities of networking organizations and their ability to lobby for supportive regulation.

Similarly, the extent to which the flow of funds within the financial system reaches and

augments the flow of funds in microfinance is likely to be affected by links with the formal financial system aspect that would entail a support infrastructure such as rating systems, credit bureaus, and apex funding organizations. And to reinforce the activities of microfinance service providers, reduce the cost of operations, and increase outreach to areas lacking conventional physical infrastructure, technology can play a catalyzing if not a revolutionizing role. To understand this, the role of technology in the growth of microfinance in South Asia needs to be examined.

Today, in South Asia, the status of appropriate support structures is highly variable: Nepal and Pakistan have introduced microfinance-specific regulatory frameworks while other countries are at various stages of discussion. All countries have well-established apex organizations, although their coverage is far higher in Bangladesh, in particular, and India; Pakistan and India have particularly active microfinance networking organizations. Although rating activities are well established in the region, coverage is extensive mainly in India and, to some extent, in Bangladesh. In each country, some aspect of these support structures needs to be built and developed further (and occasionally created from scratch).

Figure 8.1 Relative Microfinance Regulation in South Asia



Source: Authors' creation.

Microfinance Regulation in South Asia

In the matter of regulation, the countries of South Asia lie along a continuum. As indicated by the regulations in place, the position of the six countries covered by this paper relative to each other is depicted in figure 8.1. The continuum ranges from virtual *laissez faire* in Afghanistan to a substantial degree of regulation (at least on the statute book) in Nepal.

Afghanistan

Even at this early stage in the development of the microfinance sector in Afghanistan, there is considerable diversity in the types of organizations that provide services. While much of the focus has been on NGOs, one commercial bank provides microfinance services (and two more plan to enter the sector), a single leasing company provides some microleasing services, a private company has provided microfinance services through support to agriculture input supply dealers, and a few credit unions have been established.

The current legal framework for financial services outside of licensed commercial banks is incomplete, and leasing, credit unions, and finance companies exist in a legal vacuum. The central bank, Da Afghanistan Bank (DAB), has so far concentrated most of its limited resources on establishing and regulating a commercial banking sector. There is a banking law under which 13 local and international banks have been licensed, but other financial sector laws will take time. In the meantime, some of the 14 MFIs that have active programs are mobilizing deposits from their members and recycling these funds in their loan portfolios. In July 2006, DAB approved deposit-taking MFI (DMFI) regulations under the “exceptions clause” in the Banking Act. These DMFI regulations were developed in consultation with the microfinance sector and apply only to MFIs that are mobilizing voluntary deposits, not to those with compulsory savings that act as collateral for loans.

The DMFI regulations mention a variety of institutions, including NGOs, finance companies, credit unions, and cooperatives. So far, though, the only existing institutions that mobilize voluntary deposits are the credit unions. But given the peculiar nature of credit unions, it is not clear how they can fit under the DMFI regulations and ultimately it might be better to establish other regulations specific to credit unions as has been done in many other countries. In the past, DAB considered preparing an NBF framework law, under which MFIs as well as other financial institutions could be registered; for now, however, it has opted to go with the DMFI regulations under the Banking Act. The Ministry of Finance is not in favor of such a framework regulation for a disparate range of financial institutions and instead would like to see specific laws for each type of financial activity (cooperatives, insurance, leasing, and so on).

The Banking Act requires that banks first be formed as Afghan companies before they can receive a banking license, so each type of organization that applies under the DMFI regulations will require some form of underlying legal entity. The NGOs that dominate the microfinance sector are already registered under the new NGO law adopted in 2005, but given the growing negative public perception of NGOs in Afghanistan, the government had a strong preference that NGO-MFIs be established as “companies.” Because new regulations governing the establishment of companies are still under consideration, the government made a special decision in early 2006 to allow NGO-MFIs to be set up as “nondistributive” companies under the existing 1955 Commercial Code (although this code makes no mention of “nondistributive” companies) and to register with the Afghanistan Investment Support Agency. This suits government interests, because it means that the MFIs will not legally be NGOs, something that the government would like to

avoid, and also addresses the MFIs' interests in being categorized as entities that can migrate over time to become DMFIs regulated by the central bank, or even commercial banks with a microfinance focus.

Bangladesh

In 2000, Bangladesh formed a committee to oversee the drafting of a regulation for microfinance. The committee was chaired by the governor of Bangladesh Bank and included leaders from some of the best-known MFIs. A draft regulation was submitted to the government in March 2005 and was eventually recommended to Parliament, although in a considerably altered form. In July 2006, the Parliament approved the Micro Credit Regulatory Authority Act under which a separate regulatory authority will be established to oversee the operations of NGO-MFIs. This act also provides legal cover, which was previously missing, for the microfinance activities currently being undertaken by NGO-MFIs, including mobilizing deposits from members.

The committee proposed a regulation that would cover the microfinance activities of NGOs and microfinance programs of government ministries, while allowing for the creation of microfinance banks. It proposed five tiers for banks, from the national level down to the district level, the former requiring paid-up capital equivalent to an NBFIs and the latter requiring very little paid-up capital. Both the NGOs and the microfinance banks would be regulated by a new regulatory commission, not by the central bank. The cabinet, however, decided to leave government ministry programs out of the regulation and did not favor the creation of microfinance banks, believing that this could open the door to unscrupulous operators and questioning the capability of any regulator to oversee a large number of small institutions. Thus, the act that was approved in 2006 only includes requirements for NGO-MFIs.

Given that many NGOs have large microfinance programs, that the laws under which they are established are not intended to cover financial service activities, and that the authorities presently have little capacity to oversee these NGOs, creating a new legal environment will provide a stronger legal base for NGO-MFI activities. This should facilitate their access to commercial funding and improve their transparency and accountability. At the same time, some elected representatives and government officials would like to reign in the NGOs, which would not be conducive to scaling up and improving the performance of the microfinance sector.

Some stakeholders in Bangladesh see the next step in the evolution of the sector as allowing MFIs to mobilize public deposits (voluntary deposits from nonmembers) rather than depending on other sources of funds to scale up. NGO-MFIs already mobilize large amounts of deposits from their members, but becoming a microfinance bank would enable MFIs to mobilize deposits from the general public, something that Grameen Bank has done successfully. While the cabinet has expressed concerns about opening the door for microfinance banks, experience from Nepal, Pakistan, and Cambodia shows that, in the restrictive conditions normally applied to such separate microfinance regulation, there is little incentive for entities without a commitment to microfinance to enter the field. Thus, the danger of the regulator being overwhelmed by entities that qualify for such regulation is minimal.

India

The past six to seven years have seen substantial advocacy for microfinance regulation in India. Starting with the formation of Sa-Dhan, an association of microfinance institutions in 1999, advocacy for microfinance regulation intensified over the years until the finance minister's 2005 budget speech formally committed the government to present a microfinance legal framework to Parliament.

The drafting of this framework is in its final stages and it will be presented to Parliament in the winter session of 2006-07.

The framework, earlier proposed as an amendment to the NABARD Act,¹⁴⁰ is now to be presented as a standalone piece of legislation. The proposed Act mandates the establishment of a Micro Finance Development Council (MFDC) “for promotion, development and orderly growth of the micro finance sector...” It also mandates the creation of a category of microfinance service provider – the microfinance organization (MFO) – recognized, regulated, supervised, and promoted by NABARD. The MFDC would advise NABARD on the formulation of policies and measures to ensure the orderly growth and development of the microfinance sector. MFOs would be NGOs (societies, trusts, and cooperatives) that are “formed for the purpose of providing micro finance services...” and have net owned funds (net worth) of at least Rs 500,000 (\$11,100). The supervision proposed consists mainly of “setting sector related benchmarks and performance standards pertaining to methods of operation, management and governance, including model codes of conduct of business for Micro Finance Organisations engaged in the provision of thrift services and micro finance services.” For now, both types of companies (for-profit NBFCs and not-for-profit Section 25 companies) have been omitted from the Act on the grounds that these are already under the ambit of regulation by the RBI. Coverage of these under the new Act, therefore, is deemed by the government to be unnecessary.

During the long process of discussing, and agreeing on, a regulatory framework for microfinance in India, the RBI's main concern was with the need to control the entry of unscrupulous operators into the formal financial system. The RBI was concerned that such operators would creep in through the backdoor as microfinance operators, and collect and then embezzle the deposits of the public, especially low-income families. Should

this happen, the regulator would get the blame. As it is, the central bank has its hands full regulating and supervising large numbers of financial institutions, including the following:

- 27 scheduled commercial banks in the public sector with some 45,000 branches
- 55 private Indian and foreign commercial banks with some 5,000 branches
- 196 RRBs with another 14,000 branches – as rural subsidiaries of the public sector commercial banks
- 1,800 (single-town) urban cooperative banks, more than two dozen state-level cooperative banks at the apex of more than 350 district cooperative banks and nearly 100,000 primary (village-level) cooperative societies
- As many as 7,000 registered NBFCs

According to the RBI, allowing for the creation of regulated microfinance entities would open the floodgates to large numbers of institutions, increasing the magnitude of its task and multiplying the risk to the financial system if the operations of existing MFIs are accorded the legitimacy implied by the central bank. Against this backdrop, the government's acceptance of a limited regulation of MFIs that offer thrift services to members rather than the public is a promotional measure that could have far-reaching implications for the financial inclusion of many more poor people. However, the exclusion of companies from this legislation means that a dual regulatory regime is likely to emerge whereby the best MFIs transform into NBFCs in order to have access to the equity and large volume of debt funds available to such institutions while the less successful MFIs are subject to a relatively lax regulatory regime that inspires limited confidence. Discussions on the proposed Act are ongoing at the time of writing (November 2006) and the final form of the legislation is yet to be fully determined.

At the same time, the Indian government's engagement with the issue of microfinance and

¹⁴⁰ This statute established the National Bank for Agriculture and Rural Development in 1982

the need to increase the outreach of banking services to low-income clients has led to the RBI investing more energy in new ideas. In January 2006, the RBI officially floated the idea of “business correspondents” for the banking sector in India to disburse and recover “small value credit,” collection of small deposits, microinsurance, and pension products as well as remittances and other payment instruments.¹⁴¹ The circular specifically lists NGOs-MFIs as the entities that may act as business correspondents and provides for the banks to pay a reasonable fee to them while prohibiting them from charging customers any fees for services rendered directly by correspondents. In some other countries, for example Brazil, this approach has considerably expanded outreach of financial services to poor and underserved households.

Nepal

Nepal was the first country in the region to introduce specific regulations for the microfinance sector: the Development Banks Act was passed by Parliament in 1996 and the first Financial Intermediary Societies Act (FISA) was passed in 1999. Unfortunately, Nepal's attempts at regulation have been characterized more by confusion than by clarity in its strategy to pursue a poverty agenda. Microfinance regulation evolved from official attempts to promote a poverty agenda through the Nepal Rastra Bank's (NRB's) sponsorship of the five RRDBs. The RRDBs were established beginning in 1992, initially under the Commercial Banks Act, and had majority NRB shareholding and significant contributions from the commercial banking sector, albeit virtually on the instructions of the central bank.

The purpose of the RRDBs was to provide financing to the poor in Nepal, initially in the *terai* (plains) areas, but with the hope that they would later be able to expand into the middle hills if not the high mountain areas. The potential demonstrated by the first RRDB in

the eastern region was sufficient to generate interest in more development banks being established and led to the introduction of the Development Banks Act 1996. This act allowed for the creation of more such banks with private equity and established the Nirdhan Utthan Bank as the first private development bank in Nepal. There are now four such private retail development banks, all established by leading NGOs and all operating in the *terai*.

The promulgation of FISA in 1999 came as a logical extension of this development. FISA was intended to introduce the concept of the “limited banking license” as a way to legitimize the financial services activities of NGOs registered as societies or cooperatives. The limited banking license gives its holder the right to provide microcredit to “low-income families” and to collect the savings of such families described as “members.” There were 49 NGOs and 19 cooperative societies holding limited banking licenses under the provisions of this law in late 2005.

FISA has been a major source of confusion in the regulation of microfinance in Nepal. The act says nothing about the collection of savings from the general public and has led to confusion with the Cooperatives Act, which is more liberal regarding membership and does not include income or account size limitations. It specifically prohibits the collection of deposits from nonmembers, which FISA does not. This has placed cooperatives that are limited banking license holders in a legal limbo with regard to deposit-taking. The main attraction of the limited banking license for cooperatives has been the stamp of legitimacy conferred by central bank supervision. At the same time, this stamp of assurance does not seem to have benefited NGOs, which have not been successful at raising voluntary deposits from members, let alone from the general public.

The original version of the act included a clause that implied NRB underwriting of the loans awarded to societies that were licensed

¹⁴¹ RBI 2006.

by the act. This clause is thought to have been introduced by the government under pressure from some of the leading international NGOs working in Nepal, although it was dropped in 2003 after vociferous objections by the central bank.

Whatever the history of regulation in Nepal, the advent of the licensing of microfinance activities has not presented opportunities for fraudulent operators; the number of registered institutions is small and few have been shut down for financial impropriety.

In the meantime, to compound the confusion, the central bank has recently proposed yet another microfinance law that would result in the creation of a “super apex” organization to be run entirely by government officials and be responsible for a multitude of activities, including licensing, regulation, supervision, financing, development promotion, research, and overall poverty alleviation through microfinance. With conflicting functions and overlapping responsibilities, such an institution would place all MFIs and cooperatives at the mercy of the proposed “Microfinance and Cooperative Center” with few safeguards to mitigate the problems likely to arise.

Pakistan

In 2000, microfinance was elevated to be a core aspect of the government's poverty reduction program. Thus, the introduction of the Microfinance Institutions Ordinance 2001, under which microfinance banks are licensed, was driven by a poverty reduction agenda rather than being focused on building an inclusive financial sector to include poor people in the mainstream. The ordinance restricted microfinance banks to provide loans only to poor people, defined as those with incomes below the income tax floor, and restricted loan size to a maximum of PRs 100,000 (\$1,700), too low to enable clients to easily make a transition into the mainstream financial sector and well below the amounts

commercial banks are willing to lend. Recent modifications to the law made in 2006, however, provide for greater flexibility and empower the regulator to continue to make changes as required.¹⁴² The ordinance particularly aims at creating special microfinance banks at four levels—national, provincial, regional, and district—each with different capital requirements that are well below the requirement for commercial banks.

The ordinance is not concerned with NGO microfinance programs and relates only to MFIs that wish to mobilize deposits. The microfinance banks are licensed and regulated by the SBP under specially designed prudential regulations. The regulator has adopted an open approach to the sector, including the creation of a microfinance consultative group chaired by the SBP and composed of representatives from the sector.

By late 2005, there were six microfinance banks with more in the pipeline, although the largest of these banks, Khushhali Bank, was established in 2000 under a special ordinance for that purpose before the Microfinance Institutions Ordinance was adopted. First MicroFinanceBank was licensed immediately after the ordinance was passed in 2001 and, to date, it is the only case of an NGO program “transforming” into a microfinance bank. Two district banks in Karachi district were licensed in late 2004 and are in the early stages of establishing their operations. In August 2005, another national-level license was granted for a bank that began operations in late 2005. In early 2006, another national-level license was granted.

The primary reason the government encouraged microfinance banks was to more rapidly scale up microfinance outreach. So far, however, only Khushhali Bank has achieved significant outreach, and the NGO sector still has more loan clients than the microfinance banks. But considering that demand is largely unmet, and that it will take huge amounts of funding to satisfy that demand over the next

¹⁴² Ahmed 2006.

decade or more, microfinance banks that mobilize deposits and can more easily access commercial funding have the potential to take a large share of the market, if they have good business models.

Only one microfinance bank has begun to mobilize deposits to any extent, and even that bank has found it costly to open flexible savings accounts for poor people. It is not clear whether poor people want to retain liquid assets in any quantity; many seem to prefer investments in livestock, housing improvements, other fixed assets, and consumption spending. Regarding loans, the restrictions on loan size reduce the flexibility microfinance banks have to offer the same range of products as commercial banks and other financial institutions.

Other than Khushhali Bank, the microfinance banks have had more limited access to soft money than NGOs, and if they are profitable, their profits are taxed at 43 percent, the same as commercial banks. The fact that most of the investors are not looking for returns does constitute a significant subsidy. Only one of the microfinance banks established thus far expects to generate much in the way of returns to investors for the foreseeable future. In fact, financial performance until now would not attract investors seeking even a modest return on their investments. Neither of the banks that have been operational for the past few years had a positive adjusted return on equity in 2004. Projections made for the most profitable MFI in Pakistan, an NGO that has been considering transformation into a microfinance bank, show that internal rates of return would be around 5 percent annually, whereas even socially minded international investors usually target returns of 10 percent.

Investors in Pakistan have largely been motivated by “corporate social responsibility” or similar reasons, resulting in little motivation to act in a commercial manner or hold the microfinance banks accountable to achieve better financial or outreach performance. The government encouraged the commercial banks

to invest PRs 1.7 billion (\$285 million) to capitalize Khushhali Bank, and some commercial bank executives have said that they invested out of a sense of national responsibility.

Sri Lanka

The main issue in the practice of microfinance in Sri Lanka is the crowding out of private sector initiatives and impediments on the path to sustainability. These impediments result from a series of government-promoted development programs that back up the panoply of institutions (for example, SBSs and CRBs), which are characterized by operations supported by market-distorting subsidies. The cooperatives, the largest suppliers of microcredit and savings services to low-income clients, are inadequately regulated and supervised and lack a legal framework in which to legitimize or supervise the activities of NGOs. Even the ban on the supply of deposit services by unregulated NGOs is not enforced. The commercial banks, meanwhile, are only minimally engaged in microfinance. As a result, there is a high degree of laissez faire in the provision of microfinance services in the country.

In 2006, the long-discussed Micro Finance Institutions Act was finalized and will likely up for approval soon. It provides a lot of flexibility to establish various sizes of MFIs, which can act as banks (for example, they will be able to mobilize deposits). Barriers to entry, such as minimum paid-up capital, have been set at low levels. The act allows for NGO-MFIs to mobilize deposits once they have received the regulator's permission. Furthermore, it states that the Central Bank will regulate cooperative societies that are engaged in microfinance. All of this puts a large burden on the regulator. So far, however, no regulation beyond the existing supervision by the societies' registrars is proposed for the SBSs. These groups constitute an important part of the government's antipoverty agenda and are virtually an untouchable element of the country's

development framework. Yet, because these societies dominate the microfinance landscape, regulation that excludes them is virtually meaningless. At the same time, the Central Bank has not shown a lot of enthusiasm for regulating a microfinance sector populated with a large number of institutions that are not transparent or well managed.

Conclusions on microfinance regulation in South Asia

It has become fashionable in South Asia for the microfinance sector and governments to draft, consider, and adopt special microfinance regulations. All six of the larger countries in the region have a microfinance regulation in place (Bangladesh, Nepal, and Pakistan), are

considering a draft law (India and Sri Lanka), or have developed special regulations under the banking law (Afghanistan).

Table 8.1 summarizes the status of regulation of the major institutional types engaged in providing microfinance services in South Asia. As the table shows, only Nepal has a comprehensive microfinance regulatory mechanism in place, however faulty it may be. Apart from Nepal, Bangladesh and Pakistan have specific microfinance frameworks in place, although only the latter allows for microfinance banks to set up. In India, the idea of allowing such banks has been specifically rejected by the respective governments, whereas Sri Lanka's cooperative banks are really independent initiatives without central bank oversight.

	NGOs in Microfinance	Cooperatives / Credit Unions ^a	Non-bank Microfinance Companies	MF/Rural Development Banks in MF
Afghanistan	REG	REG	REG	n.a.
Bangladesh	REG	Cooperative regulation	n.a.	Rejected by government
India	TBR	Cooperative regulation, TBR	REG	Rejected by government
Nepal	REG	REG	—	REG
Pakistan	UNR	Cooperative regulation	—	REG
Sri Lanka	TBR	Cooperative regulation	—	UNR

Source: Authors' compilation.

Note: REG = already regulated; TBR = to be regulated in the foreseeable future (or under discussion); UNR = unregulated; n.a. = not applicable; — = non-bank microfinance companies don't exist in these countries.

a. Refers to cooperatives that are active as modern microfinance entities rather than conventional agricultural cooperatives.

From a regulators' perspective, regulation should take the broadest possible approach and not be based on narrow interests, particular products, or narrowly defined special institutions. In fact, the main goal should be to increase access, not limit it, maintaining a balance between the autonomy financial institutions need to operate effectively and sufficient accountability to ensure that financial service institutions remain strong. The purpose is to increase access, not be prescriptive about

financial products, and to ensure clear, transparent reporting and accountability. The regulatory approach in Latin America since the mid-1990s, for example, focuses on access, allows for a wide range of financial service providers, sees financial service provision primarily as a business activity, and regulates by exception, allowing service providers a fair amount of leeway until there is a proven need to regulate exceptional circumstances.

By contrast with Latin America, South Asia's approach to regulation focuses on the special microfinance niche that has emerged over the past 30 years. It is designed for special, relatively narrowly defined MFIs, views microfinance as primarily being a socially oriented poverty reduction tool, and uses an extensive set of rules based on this particular view of microfinance. In a sense, this approach recognizes the success of the microfinance sector in South Asia over the past 30 years as a poverty alleviation tool and tries to embed that history in the law and regulations. In the region of the world with some 40 percent of the world's poor, this is perhaps appropriate.

Nevertheless, this approach is not particularly forward looking and does not consider the changes the sector will undergo with the introduction of new approaches, institutions, and technologies, for example, allowing banking correspondent relationships as in India or changing banking regulations to allow for mobile telephone banking. It focuses on a special niche market instead of looking at the big picture, and it enshrines the importance of MFIs instead of microfinance.¹⁴³ The only exception to this approach is Afghanistan, the most recent entrant to the microfinance industry and the only country that explicitly recognizes microfinance as a mainstream financial activity. Afghan MFIs are but one form of microfinance service provider in a sector in which other mainstream financial institutions, including banks, leasing companies, and credit unions, already provide microfinance services.

While it is still too early to judge the impact of this “rush to regulate,” the examples of the Pakistan and Nepal laws show that a specially designed microfinance banking regulation intended to rapidly scale up outreach and introduce a wide range of microfinance services will not necessarily succeed in achieving either one of those objectives. The growth in the number of microfinance service providers presents regulators with a dilemma. In one sense, they want to control the practice

of so-called banking activities, while at the same time, they are reluctant to get too involved. As witnessed by the lack of central bank regulation and any other form of effective regulation of cooperatives, central bank regulators have historically been loathe to take on the regulation of a very large number of organizations, especially organizations they do not understand well. Thus, Pakistan is reluctant to allow for too many microfinance banks and Bangladesh, India, Nepal, and Sri Lanka have created or are proposing to create special regulatory bodies, outside the central bank, just for microfinance. Yet, there is no example in the world of special regulatory bodies for microfinance having been particularly successful.

All of this raises the questions of why regulation is needed and at what stage of evolution of the sector might it best be introduced. On the one hand, there is little reason to impose prudential regulations on NGO microfinance service providers unless they are taking and intermediating deposits. On the other hand, most countries already have several laws, such as banking, NBFIs, and cooperative laws, which were specifically intended to provide financial services to the poor.¹⁴⁴ Between these two approaches, there needs to be consideration of what else is needed to scale up, deepen, and diversify outreach. New regulations for NGOs, primarily because of deposit mobilization from members, were adopted in 2006 in Afghanistan and Bangladesh, and laws are being considered in India and Sri Lanka. Yet, there is an increasing sense worldwide that MFIs mobilizing deposits from members need not be regulated like banks, since the risks are considerably different and may not represent a threat to the overall financial system because the institutions are typically very small. This has been taken into account by the regulator in Afghanistan.

From the point of view of the MFIs, the main reason for wanting regulation is to mobilize deposits from the public, both to provide

¹⁴³ To quote Vijay Mahajan, the head of BASIX in India, “microfinance is important, MFIs are trivial.”

savings services that poor clients value and to have a source of funds that is not dependent on donors, government, or commercial organizations. If this is the main reason, however, it might be easier and more useful to amend existing laws than to create new, specialized laws. Both governments and central banks, although keen to pursue the poverty agenda through financial services to low-income clients of MFIs, are fearful of the impact this could have on the security of depositors' funds and on the public's perception of the government's commitment to its financial security, particularly in relation to the poor. They are, therefore, generally unwilling to accede to any such measures. The one exception is Afghanistan, where lessons learned from other countries are being applied early in the evolution of microfinance, resulting in more generalized regulations that fit into the overall financial sector.

In theory, India's banking correspondent model diminishes the argument for regulation to facilitate deposit collection by MFIs, because it will make the service of small deposits, particularly passbook savings accounts, available to low-income clients, along with microcredit and other microfinance services. In practice, it will take some time to work out the mode of operations of the business correspondent model because the level of fees and a series of rules governing such operations will need to be determined. More important, the cost of business correspondents being borne by the banks substantially increases the latter's operating expenses. Indeed, there is no reason to expect that the expenses incurred by banks in financial service delivery to low-income clients will be any lower through the business correspondent model than it is through the SHG-bank link model. On the contrary, to the extent that group liability and transparency of operations is a significant risk-mitigating factor in the link model, its absence in the business correspondent model could become an important impediment to the latter's growth. The banks' outreach of

microfinance services through the business correspondent option is unlikely to increase any more significantly than it has through the link model. By November 2006, almost 11 months after the announcement of the business correspondent option, the measure remained dormant as banks were unable to obtain any serious response from potential correspondents (NGOs, MFIs, and others) to the low-value offers for such services. As with the bank-SHG link model, it is likely that banks will extend financial services via this model to the point at which the marginal real cost of operations equals the marginal return on appearing to be a socially responsible institution; it is unlikely to go further. While substantial numbers of low-income clients will be served, this does not negate the potential value of facilitating the collection of deposits by MFIs at the same time, leaving the regulation conundrum unresolved.

The general consideration that has determined the agenda of the frameworks adopted in Bangladesh and proposed in India is the fear of unscrupulous operators hijacking the measures proposed to siphon off the deposits of poor families. The experiences of Nepal over the past seven years and, more recently, Pakistan do not portend any significant number of fly-by-night companies that would undermine the credibility of genuine microfinance service providers.

Overall, microfinance regulation in South Asia has been primarily concerned with the poverty agenda. A country's approach to regulation will have considerable impacts on the future of microfinance, not the least of which are how access will be increased, who will be reached, what services will be provided, what kinds of institutions will provide those services, and how an inclusive financial sector will take shape. The rejection of microfinance development banks as important elements in the financial system by the governments of Bangladesh and India, at this stage, can be seen as a reflection of the focus on the

¹⁴⁴ India's Regional Rural Banks Act, 1976, is a specific law in this matter.

poverty issue. Nevertheless, in a long-term context, this approach presages an emerging concern for the “missing middle,” where microenterprise finance becomes as important as capital formation for low-income families. To this extent, the concept of tiered regulation may be counterproductive, resulting only in a niche market for financial services for low-income clients rather than an inclusive financial

landscape. In the long run, it may be far more effective to allow and enable freedom in pricing for banks as well as MFIs and encourage competitive market development for financial services. The combination of tiered regulation and greater freedom in pricing gives Indonesia and the Philippines far more inclusive financial sectors than any country in South Asia.

The Role of National Microfinance Associations

A recent paper estimates that national microfinance associations are active in more than 60 countries around the world and are playing an increasingly important part in the development of national microfinance sectors. The paper describes four main roles that associations played over time:

- **Advocates:** taking on a prominent role in dialogue with the financial sector, government bodies, and organizations outside the country
- **Standard-setters:** proactively promoting financial transparency and codes of conduct
- **Service providers:** offering fee-based services to members and nonmembers such as training, credit bureau information, and technical assistance
- **Funding channels:** directing funds to retail MFIs

Five countries in South Asia have national associations, while Sri Lanka is in the early stages of a second attempt to form a viable national association. The first such association in South Asia was the Credit and Development Forum (CDF) in Bangladesh, established in 1992. The Pakistan Microfinance Network (PMN) was formed in 1997, the Centre for Micro Finance (CMF) started in Nepal in 1998, Sa-Dhan began in India in 1998, and the nascent Afghanistan Microfinance Association (AMA) began in 2005. In addition, one regional network, International Network for Alternative Financial Institutions (INAFI), works out of Bangladesh and includes some of the national associations in its membership,

but it has not been a particularly visible or influential network.

All of these associations have taken on the role of advocates for the industry with various degrees of skill and success. This role has become even more important as most countries in the region are in the process of creating new regulations for microfinance, although national associations have not always been organized to influence this process as much as might have been useful. Sa-Dhan and the PMN have been more successful in advocating for the industry because of their reputation and credibility with the government, donors, and the main MFIs. Sa-Dhan, in particular, has achieved some success in helping to move the Indian Government from a position of ignoring microfinance as an activity to the verge of a national regulatory framework for microfinance. Bangladesh's CDF, while being well known, has suffered from repeated management changes and has not been able to establish the level of influence enjoyed by the other two among decision makers in government, banks, and donor agencies or even with their own members. The larger MFIs in Bangladesh have tended to take independent positions on microfinance and undertaken their own advocacy.

The PMN's most important role so far has been as a standard-setter through, among other activities, its Performance Indicators Report on member MFIs. Sa-Dhan has had a standards subgroup from the start, has

published performance and transparency standards for its members, and has educated members on this topic. Other associations are moving into doing this as well, mostly in terms of promoting financial transparency.

The only association that has attempted to act as a funding channel is CDF, which has worked with a commercial bank to channel funds to small NGO-MFIs. CDF is best known for its annual microfinance statistics report that, in 2004, included more than 700 MFIs.

All have conducted research and published position papers, as well as provided services to MFIs and other institutions, primarily training. While Nepal's CMF has attempted to perform the advocacy and other roles, it has remained largely confined as a service provider, perhaps partly because it has more the character of a consultancy company than a member-based association. While all the associations have played a service provision role, this role has changed over time as more and more private sector service providers emerge. The larger, more active associations have all received donor funds, although they have also used service provision to generate income in addition to generating small amounts of income from membership fees, but no association has been able to become financially independent of donor funding.

Each member-based association has its own rules for membership and has increased membership over time. Membership is commonly based around a core group of NGO-MFIs, although some associations also include individual members, organizations that provide services to MFIs, and even banks, government officials, and regulators. The PMN includes commercial banks, microfinance banks, and leasing companies in its membership besides NGOs, because its goal is to represent all the main retail MFIs, not just NGOs. Sa-Dhan has a similar membership profile.

While the associations in South Asia have emerged out of the NGO-MFI sector, it is clear that they will have to evolve in several ways if they are to keep up with the changes that are

taking place, increase their value to the industry, and strengthen their ability to influence positive change.

- First, they will need to broaden their vision to focus on the wider picture of creating inclusive financial sectors to address the gap in access that still exists in most countries.
- Second, as different kinds of organizations enter the market, they will need to reach out to and include new players, especially regulated, commercial financial institutions of various kinds, if they are to continue to influence policy and practice at a national level. If they do not do this, a dual association structure might emerge, such as exists in Bolivia, with one association for regulated MFIs and another for NGOs, a situation that could weaken the influence a unified association can have.
- Third, there is a growing sense of the need for associations to play a greater role in promoting transparency, especially financial transparency, and setting standards for conduct in the industry to help improve MFI performance and sustainability as well as increase the microfinance service providers' credibility with the public, regulators, policy makers, donors, and investors. Since 2004, Sa-Dhan has been drawn into such a role as objections have arisen in the governments of some of the southern states of India about the interest rates and collection practices adopted by a few of the leading MFIs. The national microfinance associations will need to play a more proactive and preemptive role in such matters if such problems are to be prevented. Until now, the tendency has been for some associations to focus on easier roles of documentation, research, and capacity building to the relative neglect of the essential role of advocacy and adherence to codes of conduct affecting behavior and performance.

Links in South Asian Microfinance

Apex funding institutions

Microfinance apex institutions have played a significant role in the development of the sector in South Asia, primarily by providing loan funds as well as operational grants, mostly to NGO-MFIs, although they have also provided capacity building support to MFIs and played a role in setting standards for the industry, in some cases acting as a quasi-regulator for the sector.

Several countries in South Asia have a history of such apex institutions playing a role in the development of the microfinance sector. What is now known as the National Development Trust Fund (NDTF) was established in Sri Lanka in 1990. The PKSf was set up in Bangladesh in 1991, the RSRF in 1993, the RMDC in 2000 in Nepal, the PPAF in 1999, and MISFA in 2003. In India, a series of apex funds was established by the national government directly (Rashtriya Mahila Kosh, the national women's fund), by state governments (state-level women's development corporations and minorities development corporations), and by national development banks (the SIDBI Fund for Micro Credit and the Micro-finance Development Fund of NABARD). Each one was first established sometime in the mid-1990s and evolved over time into a full-fledged fund. Preceding all of these funds was the FWWB fund established by SEWA Bank in 1993.

With the exception of some of the Indian apexes, all of these funds were established by the government and most have received significant donor support. NDTF, PKSf, and MISFA have focused exclusively on microfinance, whereas PPAF has funded other kinds of development activities as well. SIDBI and NABARD as national development banks have played a much wider role in the financial sector, but SIDBI's SFMC, in particular, functions as a separate unit with an exclusive microfinance role. With the exception of

NDTF, which has remained relatively small and has not been a particularly influential force in Sri Lanka, and the politically vulnerable RMK as well as state-level institutions in India, apexes have played a relatively dominant role in the development of their respective national microfinance sectors. In India, NABARD has presided over the rise of the large SHG-bank link movement, while SFMC has played a key role in the promotion of the microfinance sector, building on an agenda first established by FWWB. PKSf played a key role in the growth of the very large NGO microfinance sector in Bangladesh, although by 2003 its proportionate contribution to NGO revolving loan funds had declined to about 20 percent. PPAF came into existence at the same time the government elevated microfinance to national importance in Pakistan and became the primary source of funding for NGO-MFIs. MISFA has, thus far, been hugely influential in the start-up of the microfinance sector in Afghanistan.

There is little doubt that the key role played by the leading apex funding institutions was especially necessary and useful in the early stages of the development of microfinance in South Asia. Their track record of performance in their promotional roles has been mixed and questions about their continuing relevance have been raised as the industry evolves.

Most apex institutions have defined their primary role in terms of reducing poverty rather than developing an integrated, inclusive financial systems to serve poor people. This has been cast in the context of the poverty agenda of national governments and has provided the justification for the large amounts of government and donor funding provided to them. The often unstated premise has been that there is a market failure in terms of financial services for the poor, requiring the use of initial subsidies to stimulate the provision of microfinance services. Because apexes were created by governments and

donors, even if some are legally and operationally autonomous, they tend to reflect the agendas of their founders more than the interests of the MFIs, poor clients, or the sector as a whole. For example, there was initially more focus on the sustainability of the apex than the MFIs, as well as the imposition of high transaction costs. The use of extensive reporting requirements based on apex, donor, or government “needs” sometimes is a substitute for a clear focus on MFI performance, especially financial performance. Examples of questionable apex policies and practices include the following:

- Use of subsidies beyond the needs of the start-up phase. This can delay sustainability and make it difficult to create a level playing field that might encourage other types of service providers and the use of market-based funding mechanisms (most countries).
- Interest rate caps (Bangladesh and Sri Lanka, with indirect pressure exerted in other countries)
- Low loan size caps (Pakistan, Sri Lanka, and Bangladesh)

While these apexes play a significant role in supporting the initial growth of microfinance outreach, in most cases have large amounts of funding, and have even become sustainable entities themselves, there is a danger of continuing for too long in the mold in which they were created. If the original purpose was to overcome a market failure and jump-start the growth of microfinance, should apexes have a sunset clause?

Except partly in the Indian case, there is little evidence thus far that, having played their original valuable role, apex funding institutions have done much to help MFIs graduate to become market players no longer requiring subsidized funds. In fact, subsidies are often used to tie MFIs to the apex for the long term rather than to help them move on. There is also a question of whether the role of apexes needs to change as microfinance sectors mature. For example, this could include financing a wide

variety of service providers and offering a much wider range of services than the limited credit products that have been the bread and butter of apex programs. This becomes relevant as increasing numbers of MFIs become profitable and are able to go to the market for their funding, and as technology changes the way services can be provided to poor people.

Nevertheless, two leading Indian apexes may demonstrate a way forward. As discussed in chapter 4, SFMC's role as the primary funder to India's NGO-MFIs has been largely overtaken by ICICI Bank and other private commercial banks, while SFMC has gradually shifted its focus to promoting the start-up of smaller MFIs in some of the poorer parts of India. Simultaneously, SFMC has increasingly encouraged the downscaling of NBFC and cooperative bank portfolios, thus promoting greater inclusion in the financial sector and at the same time pursuing the poverty agenda more effectively. Similarly, having initially encouraged the commercial banks to become engaged with SHG lending, and having provided refinance as well as capacity building support to them, NABARD now finds that refinance is in much less demand. The program continues to grow under its own steam, however, because government-owned commercial banks are keen to pursue it to burnish their image with government and the public. In reality, though, this amounts to the banks having adopted the original poverty agenda rather than serving as an example of inclusion and mainstreaming of SHG lending.¹⁴⁵

In South Asia, apex funding institutions have played an important role in scaling up microfinance but have had a smaller impact on promoting sustainable MFIs. Except in some limited situations, they have mainly pursued a poverty agenda without contributing significantly to the wider vision of an inclusive financial sector that is now emerging.

¹⁴⁵ The interest rate politically acceptable under the SHG link program (12 to 14 percent) simply is not sufficient to enable the banks to lend to these groups on a scale that goes beyond a very small proportion (5 percent) of their portfolio.

MFI rating

Rating addresses the problem of information asymmetry between lenders and investors, on the one hand, and MFI performance and capabilities, on the other. Thus, MFI rating can be a key factor in establishing links between MFIs and the investment community. South Asia is one of the worldwide pioneers in the field of MFI ratings: Micro-Credit Ratings International Limited, based in India, is one of the first group of three microfinance raters established internationally and accredited by the Inter-American Development Bank (IDB)-CGAP Rating Fund.¹⁴⁶ M-CRIL emerged out of the microfinance assessment and appraisal expertise developed by EDA Rural Systems Private Limited, a poverty and livelihoods consultancy. From the start, M-CRIL positioned itself as an international agency and conducted its first commercial rating in Bangladesh. By November 2006, it had conducted 387 ratings in 14 countries, of which about 300 were in India and another 44 in other South Asian countries. The dominance of India in this rating profile is attributable to SFMC, the most active of the apex funders, which adopted ratings as an essential part of its appraisal mechanism for lending to MFIs. With increasing investor interest in MFIs, however, there is also now a growing independent MFI market for ratings.

Based on M-CRIL's success, and encouraged by SFMC, Credit Rating and Information Services India Limited (CRISIL), a corporate rating agency based in Mumbai,¹⁴⁷ launched an MFI rating service in 2001. CRISIL has undertaken some 50 ratings so far, mostly in India. In addition, JCR-VIS, a corporate rating agency based in Pakistan, recently launched a microfinance rating service that subsequently formed a joint venture with Microfinanza, an Italian-based specialized microfinance rating agency that had not previously been active in South Asia. JCR-VIS has undertaken a few

ratings in Pakistan so far, largely through a recent SBP requirement that microfinance banks be rated annually if they take deposits or have been in existence for three years; it also rated a microfinance bank in Afghanistan.

Given the availability of widely accepted professional expertise in the field of microfinance rating, South Asia is well positioned to facilitate links between MFIs and investors. Indeed, the past couple of years have seen a widening investor profile in South Asian microfinance, particularly in India, with the advent of individual investors, international funds, and venture capital initiatives. These developments have begun to attract other corporate rating agencies, as well as specialized rating agencies based in other regions, to consider entering the South Asian market.

Credit bureaus

Like rating agencies, the purpose of a credit bureau is to overcome information asymmetries. While in the rating case, the asymmetry is related to the lender understanding and being assured of the performance of the borrower, in the case of the credit bureau, the service provides the lender with information about the extent and historical record of the borrower's indebtedness. Rating occurs at the investor to MFI level, whereas credit bureaus address the asymmetry at the MFI to retail client level. Over the past couple of years, the possibility of establishing credit bureaus has become a common discussion in microfinance. Credit bureaus with a microfinance focus have been, or are being, established in a number of Latin American countries (El Salvador, Bolivia) and in Africa (Uganda).

In South Asia, serious consideration of establishing such a bureau for microfinance has

¹⁴⁶ The other two raters are MicroRate and Planet Rating. Chronologically, M-CRIL was the second microfinance rating agency to be launched (trial ratings began in early 1998 and it conducted its first commercial rating in September of that year).

¹⁴⁷ Now a subsidiary of Standard & Poor's the international rating agency.

taken place only in Pakistan (by the national network, PMN). While this initiative is at an early planning stage, the problem of establishing unique identifiers for microfinance clients could take a while longer to solve. In Bangladesh, PKSf is developing a database of the client profile of the MFIs it supports, but this initiative has a long way to go to become a useful borrower credit information system. Until biometric identification systems become available at a reasonable cost, the possibility of providing credit bureau services in the region

may need to wait. The relationship between cost and technical innovation for microfinance is a critical one, as discussed in the following subsection. Many MFIs have so far seen little reason to use and pay for credit information services, because their own approaches allow them to find new clients and manage risk reasonably well, although most do not have operations that are significantly influenced by competition with other MFIs.

The Role and Potential of Technology

Technology has considerable potential to reduce delivery costs and expand the scale of financial services for poor people. Using low-cost hardware and ubiquitous mobile phone networks, banks and MFIs may find it possible to deliver financial services less expensively than was earlier possible, even in rural areas. Such initiatives in the Philippines, South Africa and Brazil, in particular, appear to have successfully included more low-income people in the mainstream banking system, and these initiatives are increasingly attracting attention from commercially oriented microfinance providers in South Asia.

Still, banks and MFIs in the region are only beginning to consider the potential of technology. Most MFIs, which have specialized in serving poor people, are still putting in place basic information systems that track lending operations and can automate accounting and management reporting. These systems are the foundation for more advanced technology applications, such as bankcards for use at ATMs and point-of-sale (POS) devices, and mobile telephone banking. Although some organizations, such as ASA in Bangladesh, have grown large using manual instead of computerized information systems, most MFIs face constraints to growth because their information systems cannot track ever-larger numbers of transactions and branch accounts.

Some leading MFIs with relatively stable information systems have experimented with more advanced technologies during the past several years. These experiments, by MFIs such as SKS and BASIX in India, generally took advantage of more advanced information system technologies, such as handheld computers, to achieve greater staff productivity in the field. Loan officers used the devices to record client and loan information. However, most such attempts were discontinued or were not scaled up when it was found that manual operations achieved similar levels of efficiency over time. Advanced MIS implementations have been successful when the technology is used as part of a core process, or for multiple purposes, and justifies its costs. SafeSave's use of handheld devices in urban Dhaka is one such example.

Commercial banks typically have a strong case for using technology to deliver financial services to poor people and can usually allocate greater resources and expertise to technology implementation than MFIs. This is true of banks in South Asia that have increasingly become interested in serving low-income people, such as ICICI Bank in India and Hatton National Bank in Sri Lanka. These banks lack a rural distribution channel or find that their rural branches are not well-suited to handle poor customers and small transactions.

Typical branch hours of operation, processes, and costs preclude serving individual microfinance customers. The same is generally true of bank branches in urban areas.

Technology can enable alternative channels for banks to serve poor customers, particularly in rural areas. ICICI Bank in India is trying to develop low-cost ATMs to disburse and collect cash in rural areas. The bank is seeking to reduce costs and improve efficiency for its MFI partners by creating a single information system platform that all MFI partners can use and by automating cash transactions in the field. Instead of having loan officers collect and travel with cash, MFIs will be able to issue smart cards to customers and enable payments at rural retail outlets equipped with card readers. Banks in Bangladesh and Sri Lanka are exploring similar technology options to reduce the cost and risk of handling cash. In Pakistan, Tameer Bank, a newly established microfinance bank with an urban focus and a consumer finance approach, has introduced biometric identification technology and ATMs in its branches and is exploring the use of mobile telephone technology to expand and improve its services.

Everywhere, and in each case of technology application, the main issue is the extent of efficiency gain achieved from introducing the technology relative to the cost incurred. Although thus far the cost has outweighed the gain, as in all modern technology applications, the trend is positive. With further innovation, it will not be long until technology applications could have a revolutionary impact on microfinance and could build a more democratic, inclusive financial sector. This is especially true for mobile telephone technology because coverage levels are already ahead of western countries and growing rapidly, even in poorer populations, and could

introduce a whole range of new players into the microfinance sector. There are already plans or initiatives under way in Bangladesh, India, Pakistan, and Sri Lanka to use mobile telephone technology to increase access to financial services for poor people.¹⁴⁸

¹⁴⁸ One of the more interesting initiatives to employ technology to increase outreach and reduce costs might begin soon in the Maldives. The government is working with the two mobile telephone companies and the largest commercial bank to see whether they can establish a mobile telephone payment system. The Bank of Maldives already makes extensive use of ATMs, including mobile ATMs for remote islands, but mobile telephone banking, along with the introduction of POS units connected over the same telephone system, will considerably expand access in a country that has 200 inhabited islands with small populations, especially because mobile telephone coverage extends to almost every household. In this case, high mobile telephone coverage levels combined with sparse populations living at considerable distances from each other ensure that the application of new technology will make a significant difference in increasing access to the general population, including poor households.