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MicroNOTE

REGULATING PAKISTAN'S NON-BANK MICROFINANCE INSTITUTIONS

By MEHR SHAH

INTRODUCTION

> *"In the Pareto-economic sense, if, as a society, we attach significantly greater weight to improvements in the welfare of low income families than to similar improvements in the welfare of the better-off, then the importance we should attach to the smooth functioning of the microfinance system increases substantially."*
>
> *-Sanjay Sinha, Managing Director, M-CRIL*

Pakistan's microfinance industry comprises three peer groups of retail players: microfinance banks (MFBs), microfinance institutions (MFIs) and rural support programs (RSPs). As the name suggests, MFBs are licensed as banks under the Microfinance Institutions Ordinance, 2001. The other two categories are primarily non-profit organizations registered under one of four separate legislative frameworks: the Societies Registration Act, 1860, The Voluntary Social Welfare Agencies Ordinance, 1961, The Trust Act, 1882, and the Companies' Ordinance, 1984.[1] Thus, at least five types of legislative frameworks are of relevance to the microfinance industry of Pakistan (see EXHIBIT 1).

EXHIBIT 1: LEGISLATIVE FRAMEWORKS RELEVANT TO PAKISTAN'S MICROFINANCE INDUSTRY[2] (MARCH 2011)

Legislative Framework	MFPs Registered under Framework	Proportion of Active Borrowers (%)	Proportion of GLP (%)
Microfinance Institutions Ordinance, 2001	8	35.09	41.76
The Societies Registration Act, 1860	6	6.45	8.27
Voluntary Social Welfare Agencies Ordinance, 1961	2	0.67	0.72
Trust Act, 1882	1	2.21	1.77
Companies Ordinance, 1984	9	55.58	47.49
TOTAL	26	100	100

NOTE: The number of organizations under the MFI Ordinance includes the newly-minted National Rural Support Program (NRSP) Bank
Source: *Pakistan Microfinance Network. 2011. MicroWATCH: A Quarterly Update of Microfinance Outreach in Pakistan. Islamabad.*

[1] ASA-Pakistan is the only MFI registered as a for-profit entity under the Companies' Ordinance.
[2] Only includes Pakistan Microfinance Network (PMN) member MFPs which account for more than 90 percent of microfinance outreach in Pakistan.

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Concerns regarding a level playing field between retail-level players continue to persist in this varying legislative context.

BOX 1: CONTOURS OF THE DEBATE ON A LEVEL PLAYING FIELD

As expected, the most intensely debated area has been the allowance for deposit-mobilization and intermediation for non-bank microfinance providers (MFPs)[3]. Equally important, but less intensely debated are the implications of the choice of a licensing framework for the institution in question and the statutory organization that will supervise these non-bank MFPs. Registration under a specific law determines important aspects of a business entity including ownership structure, governance, reporting requirements, accountability, and supervisory authority, among other aspects. These in turn have long-ranging implications for the nature of business that an organization can undertake, its profit-sharing arrangements, its ability to attract investors, and its eligibility to access loan recovery infrastructure such as banking courts which are available to a limited set of financial institutions in the country. The choice of statutory supervisory authority has equally important implications in terms of policy direction and legitimacy in the larger financial industry.

These concerns have expanded in scope and urgency following the delinquency crisis faced by one of Pakistan's largest non-bank MFPs in 2008–09, and more recently in microfinance industries in other parts of the world including Morocco and India. The crises have resulted in intense debate and introspection among industry players at multiple levels, including retail players, policymakers, donors, and investors. As the future course of microfinance is debated, there is realization that a large-scale crisis has the potential to not only irrevocably damage individual institutions, but carries significant reputational and existential risks for a national microfinance industry as a whole. Questions that are being asked at national and global forums include: Is there a need to limit commercial lending to the sector? Is there a need for regulated, more tempered growth backed by industry infrastructure such as credit bureaus, and grievance redressal systems? Is there a need for a code of conduct for consumer protection among retail players? Is there a need for a client education and financial literacy program? In summary, is there a need for tighter regulation and closer supervision? If yes, what should the scope of the supervision and regulation be? And which statutory body or bodies need to play a role in implementing the proposed actions.

In the case of Pakistan some of these initiatives are already underway. For example, a code of conduct was voluntarily developed and ratified by retail players in 2009; a pilot credit bureau initiative is under discussion for nationwide rollout. Despite this progress, Pakistan's industry has displayed a degree of vulnerability to market, political, and institutional risks over the last three years. Thus, for Pakistan, our assessment suggests that it is the right time to raise the question:

> "is it prudent to allow a large segment of the industry (estimated at approximately 65 percent of total outreach) to expand without a uniform regulatory framework in place to facilitate, protect, and supervise its expansion?"

In light of the vulnerabilities that have emerged in local and global microfinance industries the concerns raised above warrant deeper scrutiny, especially when aimed at an industry providing financial services to increasing numbers of low-income clients. The microfinance industry is viewed as a central player in the Government of Pakistan's (GoP) stated priority of improving access to finance. It is therefore important to ensure that legislative and regulatory vulnerabilities are plugged in time to avoid, or at least mitigate reputational, political, and institutional risks that could potentially retard the industry's development.

This paper will discuss the actual and potential implications of a fragmented legislative and regulatory landscape for the microfinance industry of Pakistan. The direct and indirect benefits that have accrued to regulated MFPs will be considered, following a brief history of the drive to regulate microfinance. Based on this analysis,

[3] All-inclusive term encompassing institutions that fall under all three peer groups - MFBs, RSPs, and MFIs.

the need for a single regulatory framework for non-bank MFPs will be examined, keeping in view the experiences of Afghanistan, Bangladesh, India, Kenya, the Philippines, and Uganda. It is important to keep in mind however, that the primary purpose of this note is to engender debate on an area of importance for Pakistan's microfinance industry. The concluding remarks and recommendations should be taken as discussion points for further dialogue and more in-depth assessment to be undertaken by legal experts and sector specialists.

A BRIEF HISTORY OF REGULATING MICROFINANCE IN PAKISTAN

In 2001 the GoP ratified the Microfinance Institutions Ordinance (MFI Ordinance). Widely recognized as a progressive and facilitative framework, its passage has, to date, resulted in the establishment of eight privately-owned and operated MFBs with a singular focus on the provision of microfinance services. The MFI Ordinance was supplemented with a set of prudential regulations (PRs). The PRs laid out a comprehensive set of criteria to establish MFBs and carry on operations. Several iterations of the PRs have been issued over the years to keep pace with industry evolution. The State Bank of Pakistan (SBP) issued the latest version in January 2011 (see EXHIBIT 2 for details).

EXHIBIT 2: PRUDENTIAL REGULATIONS GOVERNING THE MANAGEMENT OF MFBS

Criteria	Detail	Underlying Logic
Minimum paid-up capital	Rs. 600 million (December 31, 2011) to be increased to Rs. 1 billion by December 31, 2013	A significantly large ownership stake by way of commitment of owner and investor funds to incentivize adequate oversight and management. When there is 'skin in the game,' owners will try hard to protect themselves, and thereby, other investors in the business
Reserves and liquidity requirements	Capital adequacy ratio (15 percent of risk-weighted assets); cash reserve requirement (5 percent of deposits); statutory liquidity requirement (10 percent of demand and time liabilities); statutory reserve (20 percent of annual profits); depositor's protection fund (5 percent of annual profit); provisioning requirements (100 percent loss declared on arrears of 180 days); exposure against contingent liabilities (<= 5 times equity)	To ensure that financial institutions have an adequate amount of 'cushion' to absorb potential losses To ensure that organizations do not over-leverage themselves and maintain prudent lending practices i.e., balance risk and profitability To ensure that organizations maintain sufficient liquidity to cover short-term asset-liability mismatches
Restrictions on loan size and transactions and investment of funds	Restrictions on activities with speculative purposes (e.g., stocks), real estate investment, and rental/lease arrangements with directors, employees, and owners. Funds may only be invested in government securities and 'A' rated securities. Investment in other microfinance entities is limited to 15 percent of own equity free of losses	To rationalize risks assumed by organizations using depositor money, and to maximize deployment of available funds into the microfinance market by channeling credit to the low-end of the market and to microfinance institutions
Audit and rating requirements	Annual audit within three months of close of financial year. Report to be submitted to the SBP Requirement of an internal audit department with the head of department reporting directly to the board or sub-committee of the board Annual rating requirement by an SBP-approved rater or an internal rating agency	To ensure layers of external oversight are built in so that transparency and accountability of organizations using depositor and shareholder money can be ascertained
Criteria for board members and managers	Prescribes minimum qualification, experience, and integrity standards for board members and managers	To ensure institutional access to individuals with the requisite skills for long-term organizational sustainability and success

Source: *http://www.sbp.org.pk/publications/prudential/micro_prs.pdf*

Two overarching benefits materialized as a result of the regulatory space provided: first, a sizeable group of privately-owned and managed institutions with a view to financial sustainability and a 'going-concern' philosophy central to financial institutions, have come into existence since the passage of the MFI Ordinance. As a result, the industry has seen a significant infusion of capital with defined ownership, governance, and management structures in place to receive and deploy the investments. In addition, safeguards built into the PRs ensure that the MFB peer group has managed to maintain sufficiently lower leverage ratios compared to MFIs and RSPs[4], and more diversified sources of funding. In terms of total equity invested in the industry, the MFB peer group accounted for more than 65 percent as of December 2010. The banks also account for approximately 40 percent of total microcredit outreach (see EXHIBIT 3). Thus, these organizations have established a significant presence in the industry over the last decade, with at least three MFBs ranked within the top five credit outreach provider category. The progress made so far indicates that the MFB peer group will account for a significant proportion of the industry going forward. This will be especially so in terms of loan portfolio. In terms of outreach however, it will not be imprudent to expect the non-bank players to continue to hold considerable space as over time MFBs are likely to move into larger individual loans, while non-banks players continue to work with the solidarity group model offering smaller loan sizes and reaching larger numbers of borrowers.

EXHIBIT 3: COMPARATIVE PERFORMANCE BASED ON AUDITED FINANCIALS OF PEER GROUPS (DECEMBER 2010)

Indicator	MFB	MFI	RSP
Outreach	39.9%	24.9%*	35.0%
Financing structure			
Debt	22.4%	82.8%	82.0%
Equity	27.5%	17.2%	18.0%
Deposits	50.1%	0%	0%
Debt-to-equity ratio	2.8	3.8	4.5
PAR (> 30 days)	3.6%	4.6%	4.6%
Write-offs	2.8%	2.7%	0%

Source: *Unpublished data for Pakistan Microfinance Review 2010: Annual Assessment of the Microfinance Industry. Islamabad: PMN. 2011*
* Excluding numbers for Kashf Foundation, an MFI accounting for more than 15 percent of market share in 2008.

Second, the retail core of the industry has been supplemented with oversight infrastructure established within the SBP. A Microfinance Division (MFD) dedicated to overseeing, monitoring, and facilitating the development of the microfinance industry, was established in 2001. The Microfinance Consultative Group (MFCG) chaired by the central bank and populated with retail players, the national apex[5], the national network, and donors, was also established in 2001. Both the MFD and the MFCG have played a central role in defining the strategic direction aimed at enhancing outreach, performance, and overall market development. Initiatives directly undertaken by the MFD are summarized in BOX 2. The assignment of responsibility to the central bank has not only created clarity of vision in terms of policy incentives for the MFB peer group, but has also demarcated the space for active engagement from outside the industry. As a result, the central bank holds the primary responsibility of determining the overall policy thrust of the industry; this is evidenced in the delegation by the Ministry of Finance (MoF) of the lead role to the SBP in crafting the *Expanding Microfinance Outreach Strategy*[6] in 2007 and the *Strategic Framework for Sustainable Microfinance in Pakistan policy document* in 2011.[7]

[4] Although MFBs are allowed under the existing PRs to leverage their capital five times, the lower leverage ratios are characteristic of start-ups moving into and creating a new market niche. Also, while the non-bank players have maintained lower leverage ratios than the recommended level for banks, without maintaining a similar capital base required of the MFBs, it's not a valid benchmark for the non-bank peer groups.

[5] The Pakistan Poverty Alleviation Fund (PPAF) is the apex funding body for the industry.microfinance outreach in Pakistan.

[6] http://www.sbp.org.pk/about/speech/governors/dr.shamshad/2007/MF-PM-17-Apr-07.pdf

[7] http://www.sbp.org.pk/MFD/Strategic-Framework-SM-24-Jan-2011.pdf

The effectiveness of Pakistan's regulatory framework for MFBs has been widely recognized; in 2010 Pakistan was ranked fifth among 54 countries by the Economic Intelligence Unit (EIU) in terms of the overall environment for doing microfinance business.[8] The EIU based its assessment on three broad categories: regulatory environment, institutional development, and investment climate. Pakistan tied with Cambodia at number one for its regulatory environment. Its ranking for the other two dimensions was significantly lower, at 20 for investment climate and 12 for institutional development.

BOX 2: INITIATIVES UNDERTAKEN BY THE SBP

The MFD within the SBP has simultaneously played the role of policymaker, regulator, facilitator, and market developer for Pakistan's microfinance industry.

Funding Initiatives

The SBP is the implementing partner for three donor-established funds.

- **Improving Access to Financial Services (IAFS) Fund**
  A USD 20 million endowment fund was established by the Asian Development Bank (ADB) in 2008. The earnings from this endowment fund—amounting to approximately USD 2 million per year—may be utilized by both bank and non-bank financial institutions for training and capacity building needs. In addition, sector-wide financial literacy initiatives may also be pursued. IAFS provides a 20-year window.

- **Institutional Strengthening Fund (ISF)**
  Under the ISF, GBP 10 million (USD 16.47 million) is available to themicrofinance industry for its capacity building needs. This fund is part of the Financial Inclusion Project (FIP) funded by the Department for International Development (DFID), UK.

- **Microfinance Credit Guarantee Fund (MCGF)**
  Under the MCGF, GBP 10 million (USD 16.47 million) is available to the microfinance industry as guarantees to access commercial debt. This fund is also part of the FIP.

Expanding Microfinance Outreach Strategy (2007)

The SBP spearheaded the development of a growth strategy for the microfinance industry. It was developed in consultation with practitioners and aimed to grow microcredit outreach to three million borrowers by 2010. Although the sector did not achieve its target, it did achieve growth rates exceeding 30 percent in 2007 and 2008 to reach 2.1 million borrowers in December 2010.

Strategic Framework for Sustainable Microfinance in Pakistan (January 2011)

This is a medium-term strategic framework document providing a road map for the development of sustainable microfinance to foster financial inclusion. The policy focus is on promoting market-based financial services that meet the diverse needs of poor and low-income segments.

The SBP has also been a partner in setting up a pilot Credit Information Bureau (CIB) launched in 2010 and is now engaged in facilitating linkages between technology platform developers, telecom companies, and microfinance providers in order to reduce delivery costs restricting sector scalability.

THE CAVEAT

With the SBP as regulator and supervisor for only one of the three peer groups making up the microfinance industry, organizations falling under the remaining four frameworks continue to fall outside the purview of the central bank. As of March 2011, MFBs accounted for 35 percent of credit outreach; the MFIs and RSPs together accounted for 65 percent.[9] Thus, in effect the SBP regulates only one-third of the microfinance industry under the current scenario.

So far, regulation of the microfinance industry in Pakistan has been geared to facilitate a tiered structure whereby the degree of supervision is positively correlated with the fiscal space allowed to an MFP in terms of access to differentiated sources of capital (public deposits, private investment) and expanded business lines and financial services (deposits, remittances, advances). Thus, MFBs which are allowed to offer the whole range of financial services—including deposits and remittances—have the tightest regulatory requirements relative to the non-deposit-taking MFPs. Regulators also make a case for the limited regulation of

[8] Economist Intelligence Unit Ltd. 2010. Global Microscope of the Microfinance Business Environment 2010.
[9] Pakistan Microfinance Network. 2011. *MicroWATCH: A Quarterly Update on Microfinance Outreach in Pakistan.* Islamabad

non-bank MFPs based on the allowance given to those organizations looking to expand their sources of capital and business lines, to 'graduate' into a more complex fiscal and regulatory space through an SBP-sanctioned transformation process.[10]

However, this state of affairs has significant implications because registration under the four non-profit statutes places the non-bank MFPs under authorities which often have dissimilar and disparate policy agendas. As shown in EXHIBIT 4, for organizations registered under the Voluntary Social Welfare Agencies Ordinance, 1961, the expectation is to deliver charity-oriented welfare services while being fully dependent on grant funding. Similarly, the Societies Registration Act, 1860 and the Trust Act, 1882 also focus on 'charitable purposes' with a not-for-profit orientation. The Trust Act has the added risk of allowing for organizational closure on the basis of its activities being regarded as 'immoral or opposed to public policy' by a court of law; both terms have not been clearly defined in the text of the law and are open to (mis)interpretation. Although the Companies Ordinance allows for (but does not mandate) 'sustainable' microfinance activity it simultaneously contains an overt reference to poverty alleviation in addition to limiting the range of financial services

EXHIBIT 4: LICENSING OPTIONS AVAILABLE TO NON-BANK MFPS

Licensing Framework	Scope	Regulatory Authority
The Voluntary Social Welfare Agencies Ordinance, 1961 ORDINANCE No. XLVI (the "Social Welfare Ordinance")	A voluntary social welfare agency means an organisation, association, or undertaking established for the purpose of rendering welfare services in a wide range of activities including the fields of education, health, family planning, child welfare, etc. Organizations registered under this regulation are financially dependant on public subscriptions, donations, or Government aid	Provincial Government
Societies Registration Act 1860 Act XXI (the "Societies Act")	This Act requires the registration of literary, scientific, and charitable societies. The object of the Act as stated in the preamble, is to make provisions for improving the legal condition of Societies established for the promotion of literature, science, or fine arts, or for the diffusion of useful knowledge, or for charitable purposes. Thus, under this Act microfinance is covered as a 'charitable activity'.	Provincial Government
Section 42 of The Companies Ordinance 1984 (the "Companies Ordinance")	According to Section 6 of the Ordinance, microfinance institutions can render assistance to microenterprises and provide microfinance services in a sustainable manner to poor persons, preferably poor women, with a view to alleviating poverty. In the case of for-profit and limited-by-guarantee companies, under the Ordinance such organizations can only offer one service i.e., microfinance, and cannot be an integrated entity offering multiple development services such as health and education, etc.	Securities and Exchange Commission of Pakistan (SECP) (Federal autonomous body)
The Trust Act 1882	Under this Act a Trust may be created for any lawful purpose, including microfinance. The purpose of a Trust is considered lawful unless it is prohibited by law, or is of such a nature that it would defeat the provisions of any law in the country, or the court regards it as immoral or opposed to public policy.	Provincial Government

Source: *http://www.amlaw.pk/pakistan-law-site/ngo-npo-pakistan-islamabad-karachi-lahore-list-international-pakistan-registration-ngos-npos/laws-related-to-ngos-npos-in-pakistan/*

[10] The State Bank of Pakistan issued transformation guidelines for NGOs/RSPs/Cooperatives in 2005. *http://www.sbp.org.pk/about/micro/NGO_Guidelines/NGO_Guidelines.pdf*

that can be offered by an MFP[11]. Moreover, the Ordinance does not allow for equity investment, resulting in an ambiguous ownership structure; neither does it allow companies to distribute earned profits to shareholders, as Section 42 of the Ordinance pertains to non-profits. The latter has significant implications for the range of investors likely to engage with the industry, with specific disincentives built in for the commercial investor.

As a result of this fragmentation, policy incentives put in place for the sector carry the risk of dilution as the applicability of SBP-led initiatives and directives remains uneven. Moreover, operational standards among organizations registered under the various statutes also differ given the varying incentive structures. Concerns of a level playing field between bank and non-bank MFPs therefore, continue to persist. For example, PRs put in place by the SBP do not extend to non-bank peer groups. Accounting and disclosure practices therefore, differ considerably across and within peer groups.

The other regulatory body for the financial industry, the Securities and Exchange Commission of Pakistan (SECP)[12], considers MFPs registered under Section 42 of the Company's Ordinance as largely charity or welfare-driven concerns with supervision regimes similar to those for non-profits working in a variety of non-financial sectors such as health, education, environment, etc. Hence, even though all RSPs and a number of MFIs are licensed with the SECP, a comprehensive financial supervision framework is lacking. Moreover, limited or no protection can be availed by MFPs against a variety of risks. One of the most significant implications is no access to the banking courts of the country. In the absence of a common framework for supervision, there is also a heightened risk in terms of bad performance and bad practices going unnoticed with negative implications for a vulnerable set of clients with limited financial knowledge.

To plug the gap and introduce a degree of uniformity key industry players have introduced performance monitoring and financial transparency practices in a variety of forms. For example:

- The Pakistan Poverty Alleviation Fund (PPAF), the national apex, recently developed Appraisal and Monitoring Guidelines. The guidelines provide for a performance monitoring regimen based on portfolio size. Category I partner organizations POs have the most stringent requirements in terms of financial benchmarks (PAR, OSS, FSS and provisioning requirements), legal status (Category I MFPs are required to register with the SECP under the Companies Ordinance), governance standards, and requirements for internal and external audit.

- The Pakistan Microfinance Network (PMN) mandates all its members (as a criteria for membership) to submit audited financial data to be used and displayed in an annual financial benchmarking report. The report has been in production since 2005.

Similarly, a number of donors have also developed funding programs that have shifted focus from providing funds from on-lending to set up debt funds and targeted technical assistance TA facilities aiming at improving sector efficiencies and developing untapped capacities.

Although these initiatives all represent attempts to align incentives for improved performance leading to faster growth, the retail players have been unable to demonstrate sustained improvements in terms of sustained growth, sustained profitability, and sustained efficiency improvements. Given this reality, the need for a

[11] The limitation on deposit-taking for MFIs and RSPs under the Companies' Ordinance is in accordance with the fact that there are no prudential regulations supplementing the Ordinance.

[12] Regulator of non-bank financial institutions (NBFIs) and capital markets

uniform regulatory framework continues to be an option worth careful consideration.

ASSESSING THE NEED FOR A REGULATORY FRAMEWORK FOR PAKISTAN'S NON-BANK MFPs

A number of countries have struggled with regulating their microfinance industries. Experts have often cautioned against 'over-regulating' where national microfinance industries are still young. As national industries have grown however, the debate has often shifted from the provision versus non-provision of a regulatory framework, to questions about the scope of the required framework. In the end then, a call must be made on when to begin the regulatory process, and by how many degrees to tighten the operational space at a given point in time. The aim should always be to balance prudence (investor and depositor safety) with room to grow. This is possible by providing a supportive policy environment and an appropriate institutional framework(s) in order to ensure a level playing field for retail players and to avoid systemic risk and secure the client.

BOX 3: WHY REGULATE PAKISTAN'S NON-BANK MFPS

Despite its small size—approximately two million active borrowers—the case for greater regulation of Pakistan's non-bank MFPs can be made on the basis of the following sectoral realities:

- Pakistan's microfinance industry has grown to a size where practitioners are likely to see some amount of regulation as beneficial rather than restrictive. A case in point is the self-regulation introduced by the industry (such as the credit bureau) to rationalize increased levels of competition in urban geographic pockets. The initiative commenced with the aim to reduce overlapping in credit activities, to mitigate the potential for over-indebtedness, and to engender healthy growth.

- Instances of willful organizational and location-specific default among microfinance clients in the Punjab —the most heavily serviced microfinance market in the country—have emphasized the need for a degree of institutional protection. Regulatory uniformity can facilitate the process of ensuring that MFPs have access to legal recourse for portfolio recovery under specific circumstances.

- As MFPs grow in size, access to diversified and cheaper sources of funding becomes a necessity. These include commercial monies and increased deposits. Access to both sources is likely to be heavily impacted by the regulatory umbrella that the recipient MFP is licensed under. MFPs that have set their sights on non-donor sources of funds for growth and expansion will need to make a realistic assessment of the impact of their regulatory placement on access to diversified sources of funding. As they grow and leverage their balance sheets beyond a prudent level, non-deposit taking MFPs will start hitting their capital adequacies. This will require equity injection from existing or new shareholders. Being regulated as non-bank MFPs will allow them to attract serious investors going forward.

The Malegam Committee Report to the Reserve Bank of India (RBI) following the largescale crisis in the state of Andhra Pradesh cited similar reasons when making its case for developing a separate framework to regulate the non-bank finance companies (NBFCs) offering microfinance services (see BOX 3 in the following section for details).

GLOBAL EXPERIENCE

The regulatory trajectory is unlikely to be a linear and clear-cut process, with some countries favoring more regulation while others opt for less depending on a variety of factors including the size of the industry, its level of development, and the preparedness of public authorities needed to play a regulatory and supervisory role. The rankings assigned by the EIU to 54 countries indicate the variety of oversight regimes that have been established (see EXHIBIT 5 for a sample of the rankings).

Thus, as expected, our assessment of a global sample of six countries has yielded a range of regulatory arrangements (see EXHIBIT 6). For example, in India most MFIs are registered as non-bank financial companies (NBFCs) while the rest are registered under regulations such as the Societies, Cooperatives, and Trusts Acts. These organizations share the microfinance space with village-based groups known as self-help groups (SHGs). According to the Malegam Committee Report, SHGs account for approximately 58 percent of the outstanding loan portfolio, microfinance NBFCs for 34 percent, and trusts and societies for eight percent.

EXHIBIT 5: COMPARATIVE RANKING OF BUSINESS ENVIRONMENT (2010)

Country	Composite Index	Regulatory Framework	Investment Climate	Institutional Development
Afghanistan	N/A	N/A	N/A	N/A
Bangladesh	33	32	27	23
India	8	14	14	7
Kenya	10	5	6	23
Pakistan	5	1	20	12
Philippines	2	1	18	4
Uganda	11	5	16	23

Source: *Economic Intelligence Unit Ltd. 2010. Global Microscope of the Microfinance Business Environment 2010*

Regulation for MFIs registered as NBFCs is now under serious debate following the large-scale crisis in Andhra Pradesh, India, in 2010. In the words of Sanjay Sinha, CEO of Microcredit Ratings International Ltd. (M-CRIL): *"The RBI [Reserve Bank of India] should take charge of microfinance NBFCs [Non-bank Financial Companies] as a separate category and create prudential and operational regulations that are conducive to the smooth growth and responsible functioning of the sector. A similar framework to facilitate the smooth functioning of NGO-MFIs would also be helpful and the Government of India is reported to be making a renewed effort to draft and introduce a new legal framework for them."* [13]

BOX 4: EXCERPTS FROM THE MALEGAM COMMITTEE REPORT

Reasons cited in the Malegam Committee Report for regulating microfinance NBFCs include:

- Microfinance borrowers represent a particularly vulnerable section of society and lack individual bargaining power;
- The NBFCs compete with the SHG-Bank Linkage Programme; practices adopted by the former impact the latter;
- Adequate regulation will encourage responsible growth by providing access to finance while protecting clients;
- The need for a special dispensation for MFIs will be facilitated if a separate category of microfinance NBFCs is created.

Microfinance NBFC's accounted for an estimated 34 percent of the outstanding microfinance loan portfolio in India when the Report was released.

Source: RBI. 2011. *Report of the Sub-committee of the Central Board of Directors of the Reserve Bank of India to Study Issues and Concerns in the MFI Sector.* http://www.rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=608.

Microfinance in the Philippines has been recognized explicitly as a banking activity under the overarching "General Banking Act" of 2000. The Act gives microfinance retail organizations autonomy to set credit terms and conditions and make adaptations to their lending approach vis-à-vis commercial banks and cooperatives. The recognition given to the industry via the Act was preceded by the "National Strategy for Microfinance" that was developed as early as 1997. The strategy played a significant role in emphasizing: **i)** a market-oriented approach ensuring the financial viability and sustainability of MFIs as a cornerstone of sector development, **ii)** a holistic approach to regulation and supervision that accounted for all three types of players active in the microfinance space i.e., banks, cooperatives, and microfinance NGOs; and **iii)** the need for providing capacity building support to MFIs through the "People's Development Trust Fund."

The "Microfinance Regulation Act" was introduced in Kenya in 2008. Most MFIs were registered under the NGO or cooperative framework when the act was passed. The Act was supplemented with the Savings and Credit Cooperative (SACCO) Society Act in 2008 in response to reports of fraud in non deposit-taking microfinance institutions (DTMs). The development of these acts was spearheaded by full-fledged

[13] M-CRIL welcomed RBI's approach to microfinance but felt RBI should facilitate its responsible functioning in an enabling environment. May 5, 2011. http://www.microfinancefocus.com/m-cril-welcomes-rbis-approach-microfinance

microfinance units in the Ministry of Finance (the Treasury) and the Central Bank of Kenya.[14]

DTMs in Uganda are regulated under the "Microfinance Deposit-taking Institution Act" of 2003. The Act was developed by the Central Bank of Uganda in consultation with the Ministry of Finance and retail players. Non-DTMs are registered under a variety of laws and function as NGOs or SACCOs. Once again, reports of misconduct surfaced in 2009 among the SACCOs, which resulted in pressure to regulate the sector. According to the EIU 2010 report, the Ministry of Finance is "expected to develop a SACCO regulation framework soon."[15]

Specific microfinance regulations are now also in place in Afghanistan and Bangladesh. Regulation in Afghanistan has been introduced for DTM institutions only, as the industry is still new. Bangladesh on the other hand, is a late starter with regard to industry oversight: regulation was introduced after market penetration peaked. Nevertheless, the ability or good fortune of Bangladeshi MFIs to elude large-scale crises has not precluded the need for regulation with the Microcredit Regulatory Authority (MRA) spearheading the passage of the national policy framework for NGO-MFIs in 2006.

EXHIBIT 6: REGULATORY FRAMEWORK IN SELECTED COUNTRIES

Country	Relevant Regulation	Comment
Afghanistan	Depository Microfinance Institutions (DMFI) Act (2006) MFIs also exist under general registration for NGOs	Licensing under DMFI Act is required in the express instance of wanting to access and intermediate more than 10 percent of deposits from members So far, registration under the law has not occurred
Bangladesh	Grameen Bank Ordinance (1983) Microfinance Regulatory Act (2006)	As of June 2011, 580 microfinance institutions have been licensed under the new Act[16]
India[17]	MFIs register under various regulations: Societies Registration Act (1860), Indian Trusts Act (1882), not-for-profit companies register under Section 25 of the Companies Act (1956), NBFCs under the Banking Regulation Act as applicable to cooperatives	No specific regulation for MFIs Following crisis, a law for microfinance NBFCs is now under consideration and being pushed by the Reserve Bank of India (RBI)
Kenya[18]	Microfinance Act (2006) Microfinance (categorization of deposit-taking microfinance institutions) Regulation (2008) Microfinance (deposit-taking microfinance institution) Regulation (2008) SACCO Society Act (2008)	Five DTMs are registered under the Microfinance Regulation.[19] Growing interest in registering under the Act has improved the business environment. The Ministry of Finance is in discussion on developing and introducing the regulation of non deposit-taking MFIs. Another player—the SACCOs—have been regulated since 2008
Philippines[20]	General Banking Act (2000)	Recognition granted to microfinance as a legitimate banking activity
Uganda[21]	Microfinance Deposit-taking Institution Act (2003) Preceded by Policy Statement on Microfinance Regulation in Uganda (1999)	Non-DTMs exist under general registration for NGOs, companies, and cooperatives. The tiered framework allows for graduation from one tier to the next

[14] Omino, George. 2005. *Regulation and Supervision of Microfinance Institutions in Kenya.* IRIS Centre, University of Maryland, USA.Pakistan.

[15] Economic Intelligent Unit Ltd. 2010. Global Microscope of the Microfinance Business Environment 2010. pp. 60.

[16] http://www.mra.gov.bd/images/Licensed_NGO_MFIs/english-list%20of%20licensed%20mfis%20as%20of%2028%20june%202011.pdf

[17] Sa-Dhan Microfinance Resources Centre. 2006. *Existing Legal and Regulatory Framework for the Microfinance Institutions in India: Challenges and Implications.* New Delhi: Sa-Dhan.

[18] Kenya Gazette Supplement No. 98 (Acts No. 14). December 2008.
http://www.cgap.org/gm/document-1.9.44950/SACCO%20Societies%20Act,%202008.pdf

[19] http://www.centralbank.go.ke/financialsystem/microfinance/deposittaking.aspx

[20] Microfinance Council of the Philippines, Inc. and the SEEP Network. 2008. Microfinance Industry Assessment: A Report on the Philippines. Manila: Microfinance Council of the Philippines, Inc.

[21] Microfinance Regulation – Who Benefits? Uganda's Experience in Regulating Deposit-taking Institutions. Presentation by Governor, Bank of Uganda at the International Conference on Microfinance Regulation in Dhaka, Bangladesh. March 2010.
http://www.mra.gov.bd/conference/images/speakers/justine%20bagyenmda-%20uganda.pdf

Experiences in all six countries examined for this paper indicate that as industries grow and start to account for larger numbers of poor households, the tendency to regulate also rises. It is also worth noting that the process has generally been an iterative one i.e., policy statements and regulations have been expanded and supplemented with prudentials and supporting institutional arrangements over a period of time. Even though the regulatory space provided is not standardized with a one-size-fits-all approach, belief in the need for regulation is evident in the widening regulatory net for microfinance industries in all of the six countries examined. Also, as the regulatory landscape has deepened central banks, retail players and sector stakeholders have maintained continuous dialogue to inform and steer the process. In fact, central banks have played a leadership role in the regulatory development process in five of the six countries examined.

REGULATORY SCOPE

Generally speaking, the scope of a regulatory and supervisory framework expands as soon as deposit-taking and institution size become part of the overall equation. This principal has held through consistently in the countries in our sample (see EXHIBIT 7 for details). Deposit-taking is normally associated with commercial banks, and the right to accept savings from the public usually comes with a high level of regulatory scrutiny and capital requirements. The importance of having higher capital has become clearer given 2008's global financial meltdown. In most countries, unregulated microfinance institutions are restricted in their ability to mobilize deposits from the public. Afghanistan, Kenya, and Uganda have enacted regulatory frameworks specifically for DTMs while the rest are allowed to operate under a range of frameworks which do not necessitate central bank oversight. In India, although a degree of oversight via private debt and equity investors does exist, this investor-backed due diligence has not provided the RBI sufficient comfort in terms of regulatory oversight to allow retail players to intermediate public deposits. Generally therefore, savings products are available only to members of microfinance providers, and those too come with restrictions on the amounts deposited at a time, and an inability to intermediate the amounts collected i.e., the primary purpose of such deposits is to ensure repayment.

One of the primary purposes of introducing adequately high paid-up capital requirements is to ensure that owners of the entity have an ample stake in the institution to prudently manage operations. An additional purpose is to ensure that future expansion can be funded out of own-resources rather than relying on depositors' funds. Higher capital amounts are introduced in order to curb opportunistic behavior of owners of institutions, to avoid undue risks. Thus, sufficient capital makes the incentives of owners compatible with those of depositors. Having stated the reasons underlying paid up capital requirements, it is also important to note that where these requirements exist, they are lower than those for commercial banks because the microfinance portfolio is not concentrated in a few large loans i.e., credit risk is lower.

Coupled with transaction and investment restrictions on depositor monies, paid-up capital requirements also ensure that ownership retains interest in monitoring organizational performance. For example, neither losses in an MFI nor the regular payment of salaries are usually covered by depositors' funds.

Layers of protection are also built in through requirements of maintaining asset quality, mandating the selection of qualified board members and management teams, participating in depositor funds, and instituting internal and external annual audits.

In all the instances examined, the scope of regulatory oversight therefore has

increased alongside with the fiscal space provided. The primary aim of the additional regulatory cover, as stated above, is to ensure that layers of internal and external oversight are built in to organizational systems so that transparency and accountability can be maintained in organizations using other people's money (depositors and shareholders).

EXHIBIT 7: SCOPE OF PRUDENTIAL REGULATION IN SAMPLE COUNTRIES

Country	Relevant Regulation	Comment	Relevant Regulation	Comment
Afghanistan	AFN 25 million (ten percent of commercial bank requirement)	8 percent (exclude: cash, claims on DAB, 80 percent deposits with other banks, intangible assets; provision for individual requirements)	Comprehensive quarterly and annual reporting to the Central Bank Provision for real-time data requests of varied nature at any time	DMFIs allowed to intermediate deposits taken from members Non-depository MFIs can only accept and intermediate up to 20 percent of loan portfolio deposits accessed from members
Bangladesh	No prudential regulations developed and imposed so far		Mandatory reporting to MRA	Grameen Bank is permitted to accept deposits from the general public and to sell bonds and debentures guaranteed by the Government Under the MRA, MFIs are allowed to intermediate deposits from members (up to 80 percent of loan portfolio)
India	INR 20 million	10 percent (to be progressively increased to 15 percent)	Comprehensive quarterly/annual reporting; rating mandatory	No allowance for NBFCs to intermediate deposits Additionally the Malegam Committee Report recommended the imposition of ceilings in terms of loan size, tenor, and interest rate spreads
Kenya[22]	National-level – Sh 60 million (USD 877,000) District-level: Sh 20 million (USD 292,000)	To be decided by regulator on an institution-to-institution basis, depending on institutional risk profile and performance	Quarterly and annual reporting requirements for deposit-taking MFIs. Mandated to have audited financial statements appear in a national newspaper and be put up in a prominent location at the place of business	Restriction on direct or indirect shareholding of 25 percent on any one individual or associates, and a minimum number of five individuals on the board of directors of each organization
Philippines	No prudentials regulations (only required for deposit-taking institutions i.e., banks and cooperatives)		Submission of annual audited data and a general information sheet to the Securities and Exchange Commission (SEC)	Allowance to access deposits from members while total amount less than 100 percent of loan portfolio In case of excess (>100 percent) in amount of deposits accessed, the MFI must register as a bank or cooperative (both recognized as deposit-taking institutions)
Uganda	USD 250,000	15 percent (compared to eight percent for commercial banks)	Banks, credit institutions, and DTMs report to the Bank of Uganda (BoU) using a uniform format developed for financial statements Reporting requirements for MFIs are non-existent	Allowance for DTMs to access deposits from the public MFIs accessing forced savings are not required to be licensed; no intermediation of amount collected

[22] Micro Capital: The Candid Voice for Microfinance Investment. 2007. *Central Bank Gets a Grip on Microfinance in Kenya as New Regulations are Introduced*. http://microcapitalmonitor.com/cblog/index.php?/archives/761-Central-Bank-Gets-a-Grip-on-Microfinance-in-Kenya-as-New-Regulations-are-Introduced.html;
The A-Z of Licensing a Deposit-taking Microfinance Institution
http://www.centralbank.go.ke/downloads/bsd/appforms/MFI/A-Z%20of%20Licensing%20a%20DTM.pdf
http://www.centralbank.go.ke/downloads/bsd/MFI/Microfinance%20_Deposit-Taking%20Microfinance%20Institutions_%20Regulations%202008.pdf

REGULATOR AND SUPERVISOR

In the countries researched for this paper, central banks have played a leading role in most instances where a regulatory framework for microfinance exists. In Pakistan the central bank directly supervises the MFB peer group. In India, Kenya, Uganda and Afghanistan the central bank has played a direct role in developing the regulation with a role in supervision for DTMs. Even in Bangladesh where an independent regulator, the Microfinance Regulatory Authority (MRA) exists, the central bank is involved as the chair (see EXHIBIT 8).

EXHIBIT 8: REGULATORY RESPONSIBILITY IN SELECTED COUNTRIES

Country	Regulator	Comment
Afghanistan	Da Afghanistan Bank (Central Bank) for all DMFIs	The relevant registering body requires annual accounts for non-depository MFIs
Bangladesh	Microcredit Regulatory Authority (MRA)	Independent body with Central Bank representation on board
India	The RBI acts as regulator of NBFCs (80 percent of outreach is accounted for by NBFCs) Other registration bodies play a minimal role for non-NBFC MFIs	NABARD has been recommended in the proposed NGO-MFI Act as the regulator of MFIs (considered to be a conflict of interest based on its role as industry apex)
Kenya	Deposit-taking MFIs are regulated by the Central Bank SACCOs are regulated by the newly established SACCO Societies Regulatory Authority Non-DTMs are not regulated by any entity	Recognized under the Banking Act, but not regulated by the Central Bank as it is not a deposit-taking entity
Philippines	The SEC registers MFIs	There is no regulatory or supervisory oversight from the government body
Uganda	The BoU regulates banks, credit institutions, and DTMs MFIs are unregulated	The question of regulating MFIs is under debate

Multiple arguments are offered in defense of single and multiple financial sector regulators. Proponents of multiple regulators cite the benefits of having a sector-specific regulator with a greater depth of understanding of sectoral peculiarities. In contrast, arguments put forth in favor of a single regulator cite the need for a holistic approach to the financial industry with a need to view the microfinance sector as players at one end of the financial spectrum rather than as separate entities. Needless to say, both approaches have their merits. The decision to go either way will be determined largely by the national reality in terms of industry knowledge and regulator capacity, and the opportunity cost of setting up a separate regulatory body given the size of the industry to be regulated.

RECOMMENDATIONS

In light of recent experiences in Pakistan, coupled with lessons and patterns observed in the six regionally diverse countries researched for this publication, a deepening of the regulatory space for microfinance is recommended. However, to ease Pakistan's non-bank MFPs into a more defined regulatory space a tiered approach is recommended, as described in some detail below:

- All non-bank MFPs in Pakistan (MFIs and RSPs) should be registered under a single legislative framework, specifically crafted for non-bank MFPs.[23] In addition

[23] Legal experts may advise on the adequacy of the for-profit allowance within the Companies Ordinance with regard to fulfilling this requirement, especially if supplemented with a set of PRs for NDTs and DTMs.

to providing a level playing field to retail players, a single framework for non-bank MFPs will also align policy incentives more closely with those articulated by the SBP for a market-based, sustainable approach to microfinance;

- All non-bank MFPs should register with a single statutory body. Since the SECP is already registering RSPs and MFIs under the Companies' Ordinance, it is well-placed to continue the registration of these organizations, but under a separate framework specific to non-bank MFPs;

- The legislative framework for non-bank MFPs should be supplemented with a set of prudential regulations that specify rules for industry entry and exit, provide for an ownership structure, and lay down reporting, management and governance requirements. The PRs however, should be tiered based on deposit-taking (DT) and non-deposit-taking (NDT) status. Difference in the regulatory requirements for DT and NDT MFPs should be determined by a further detailed analysis of countries already regulating or looking to regulate and supervise similar MFPs. Examples include Bangladesh, India, Nepal and Kenya. Uniform PRs will aid in performance assessment due to improved comparability of non-bank MFPs;

- MFPs should be allowed to access deposits from members only. These deposits may be intermediated, but should at no time exceed advances to clients. The limit on deposit mobilization (members only) and deposit amounts (less than advances) will provide an additional source of capital to MFPs while ensuring that clients' overall negotiating power vis a vis the lending institution is protected. Limited access to public deposits will go hand-in-hand with less stringent PRs for non-bank MFPs relative to the MFB peer group;

- To access deposits, non-bank MFPs will need to acquire deposit taking (DT) status from the SBP. This status may be granted based on a series of requirements to be met by the applying MFP. To ascertain the details, further detailed analysis of countries already regulating or looking to regulate and supervise DT MFP is recommended, together with consultation with the SBP;

- For MFPs looking to access deposits from members, higher prerequisites in terms of paid-up capital and internal controls, should be set relative to non-deposit-taking MFPs. These requirements however, should be less stringent than the ones put in place for MFBs due to the limited exposure to public money. These requirements may be determined based on the experience of countries with allowances for deposit-taking by MFPs. Examples include Afghanistan, Bangladesh, Kenya, the Philippines, and Uganda;

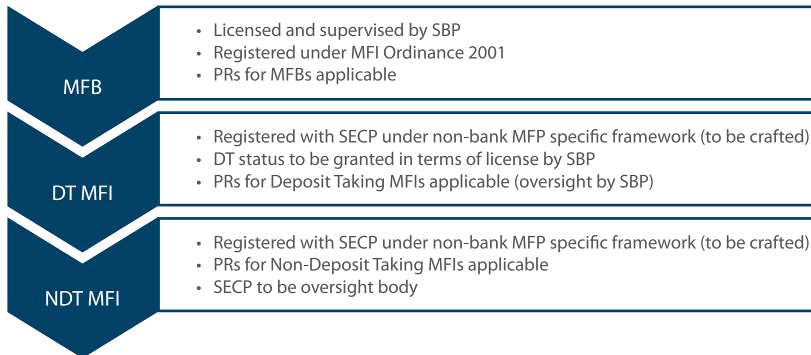
- The SBP is recommended as the supervisor for DT MFPs for two reasons. First, these organizations are not expected to be many in number in the short to medium term (no more than five over the next three to five years), so major increases in manpower will not be needed for the additional workload on the supervisory body. Second, the SBP has already developed a degree of sector-specific expertise given its ten-year interaction with MFBs, and through its implementation of sector-wide initiatives like the Institutional Strengthening Fund (ISF) established under the DFID-funded Financial Inclusion Programme (FIP). Building supervisory capacity in yet another state entity (such as SECP) will require time and incremental resources. The opportunity cost of the resources, given the overall size of the microfinance industry relative to the financial industry, will be significant. The national apex, Pakistan Poverty Alleviation Fund (PPAF) in such a role on the other hand, will need statutory status backed with legal authority (which it does not currently have)[24];

[24] PPAF is registered under Section 42 of the Companies Ordinance, 1984 and is regulated by the SECP.

- MFPs registered under the proposed regulation should be granted access to the banking courts already functioning in the country. This will serve to temper the political risk bound to increase in severity as the industry grows its numbers and becomes more visible.

The recommendations listed above are summarized in EXHIBIT 9.

EXHIBIT 9: TIERED APPROACH RECOMMENDED



CONCLUSION

The need to deepen the regulatory landscape to include non-bank MFPs should not be taken as a sign of industry weakness. Rather it is an affirmation of the fact that a vibrant segment of the financial industry has taken root, and must now be facilitated with adequate regulatory support into the next stage of its evolution and growth. After all, the fragmented regulatory landscape in Pakistan has had a number of negative bearings on some industry facets, namely: ambiguity on the ownership structure of non-bank MFPs, inadequate governance and performance standards due to absence of MFP-specific PRs, limited outreach due to institutions that have been unable to scale their operations, unhealthy competition driven by the impression (real and imagined) among retailers of a non-level playing field, and limited access to investor funds due to investor unease with most of the regulatory frameworks under which non-bank MFPs have been conducting their business so far. In conclusion therefore, deeper and more uniform sector regulation is one of the key actions required to enable authorities to define procedures for the establishment, operations, entrance, and exit of MFPs, and ultimately create an environment for fair competition and efficiency in the sector with which investors will be at ease.

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Sugandh Saxena
Program Manager, South Asia Microfinance Network (SAMN)

Qazi Shoaib Ahmad
Senior Joint Director, Agricultural Credit and Microfinance Department, State Bank of Pakistan (SBP)

Yasir Ashfaq
General Manager, Credit Enterprise Development Unit, Pakistan Poverty Alleviation Fund (PPAF)

Syed Mohsin Ahmed
CEO, Pakistan Microfinance Network (PMN)

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Authored by MEHR SHAH (mehr.shah@fulbrightmail.org)
Edited by ALI SHAHRUKH PRACHA
Layout by HEADBUMPED STUDIO

Copyrights © 2011 Pakistan Microfinance Network, 132, Street # 40, F-10/4, Islamabad, Pakistan
Tel: +92 51 229 2231, +92 51 229 2270, Fax: +92 51 229 2230, Email: info@pmn.org.pk
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