

Amendments to the Microfinance Institutions Ordinance, 2001

Implications for the Sector

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Prior to joining the PMN, Ms. Shah worked for an environmental consulting firm where she was involved in various projects for the corporate sector, as well as the development sector. Functioning as a core team member, she conducted social and environmental impact assessment of development projects (oil and gas exploration, highway construction); developed socioeconomic community baselines and environmental management plans for protected areas; and was intensively involved in data collection in the field, conducting public consultations, sample surveys, vulnerability assessments, and focus group discussions.

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ABOUT THE SERIES

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PREFACE

THE PAKISTAN MICROFINANCE NETWORK (PMN) conducted this analysis in response to a request from the IRIS Center, of the University of Maryland, USA. The purpose of the analysis is to:

- Document the procedure adopted by the Government of Pakistan (GoP) and the State Bank of Pakistan (SBP), the Central Bank of the Country, to develop and amend regulation for the microfinance industry.
- Identify amendments to the Microfinance Institutions Ordinance, 2001 (Ordinance No. LV of 2001) and the Prudential Regulations for Microfinance Banks.¹
- Analyze the implications of the amendments for the sector and reflect these in light of experiences in other countries.
- Identify areas for further improvement in the legal and regulatory environment to attract private risk capital to the microfinance industry.

1. The amended prudential regulations are cited in: (i) the Finance Bill 2006 (FB 2006), which has been approved by the Ministry of Finance (MoF); (ii) the Small and Medium Enterprises & Microfinance Department (SMED) Circular No. 07 (2006); (iii) and the Banking Policy & Regulations Department (BPRD) Circular No.01 (2007).

INTRODUCTION

The Government of Pakistan (GoP) promulgated the Microfinance Institutions Ordinance (MFI Ordinance) in October 2001, making Pakistan one of the first countries in the South Asia region to introduce a comprehensive regulatory framework for microfinance.²

The Ordinance was enacted when the microfinance industry in Pakistan was still in its infancy. At the time, the sector was characterized by limited outreach and was dominated by a small number of multi-dimensional non-governmental organizations (NGOs) that were simultaneously involved in non-microfinance development activities. Accordingly, the formal financial sector—including the primary financial sector regulatory body, the State Bank of Pakistan (SBP)—viewed microfinance as a poverty-alleviating tool rather than as a core financial sector concern. As a result, the early regulatory structure, characteristic of most regulators' preliminary forays into regulating microfinance, was premised on the perception of the sector and its role.

Since then, however, the sector has seen rapid growth. The most visible growth has been in terms of active microcredit clients: the number grew tenfold during 2001 – 2006. Another area for growth has been the institutional front: since 2000 the SBP has licensed six microfinance banks (MFBs). These private sector entities, exclusively established with a view to enhance and deepen the financial penetration of the banking sector, are

2. India is in the process of developing a regulation. The regulation in Bangladesh came into effect in 2006.

directly supervised by the SBP. By March 2007, SBP-regulated MFBs accounted for approximately 35 percent of total microcredit outreach.³

3. MicroWATCH: A Quarterly Update of Microfinance Outreach in Pakistan. ISSUE 3: Quarter 1, 2007. (PMN Apr 2007)

With this growth has arisen the need to modify and supplement the regulatory framework. The last seven years have seen the GoP respond to the evolving needs of a growing and increasingly diverse sector.

BACKGROUND

A number of factors prompted the GoP to establish a regulatory framework for microfinance banks. One factor was international experience. A number of countries—including Bangladesh, Uganda, Bolivia, and Perú—had demonstrated that microfinance could not only alleviate poverty but also deepen financial sector penetration.

Another factor was the launch in Pakistan of the Microfinance Sector Development Programme (MSDP), which was implemented by the GoP through the Ministry of Finance (MoF) (with assistance from the Asian Development Bank (ADB)). The MSDP sought to broaden the scope and increase the pace of microfinance sector development in Pakistan. Following the launch of the MSDP, the GoP established the country's first MFB, Khushhali Bank (KB). Established under a special Presidential Ordinance (Micro-Finance Bank Ordinance 2000 [Ordinance XXXII of 2000]), KB was set up as a private entity with the express purpose of paving the way for further involvement with the formal financial sector. This marked the first major step towards an expansion of the formal financial sector's frontiers to include a hitherto unserved market.

The emphasis, however, was not only on formal financial sector players. Still another factor was the establishment in 1999 by the GoP of an apex institution—the Pakistan Poverty Alleviation Fund (PPAF)—to ensure availability of funds on a continuous basis to NGOs.

Finally, in 2001, the GoP reinforced its commitment to microfinance by identifying the sector as a key policy area in the Interim Poverty Reduction Strategy Paper (I-PRSP) issued by the MoF.

Following these initial steps, the MoF joined hands with the SBP and the Ministry of Law, Justice and Human Rights (MoL) to develop and enact an exclusive regulatory framework for microfinance—the Microfinance Institutions Ordinance, 2001.

Process

The MFI Ordinance of 2001 was developed through a rigorous process. The main players involved were the MoF, the MoL, and the SBP. Primary reference points while developing the regulation were:

1. Microfinance regulations adopted by other countries (primarily Uganda in Africa, and Bolivia and Perú in Latin America)

2. Banking Companies Ordinance, 1962

3. Micro-Finance Bank Ordinance 2000 (Ordinance XXXII of 2000)

In 2001, the first draft of the regulation was shared with the PMN. In response, the PMN presented the consensus view of its members in a Position Paper.⁴ The paper prompted the GoP to consider microfinance as a mechanism to deepen financial sector penetration rather than as a tool exclusively aimed at poverty alleviation. Moreover, the paper encouraged coverage not only of credit and savings facilities but also of payment services and remittances. Additionally, it recommended creating a level playing field for all microfinance providers (MFPs) and advocated organizational diversity in the sector.

4. Position Paper #1: Regulating Microfinance (PMN 2001).

Although the framework created under the original MFI Ordinance was geared towards creating greater professionalism and introducing performance benchmarks in the emerging microfinance market, at the same time it indicated reservations on the part of the SBP as well as the GoP towards the emergent industry. This was clearly evident in the caution adopted by the SBP in the original regulatory framework laid down for the sector.

The Role of the State Bank of Pakistan

Since the promulgation of the MFI Ordinance in 2001, SBP has carried the dual responsibility of supervision and promotion of microfinance in Pakistan. To effectively perform the task of a catalyst while simultaneously inculcating good practices within MFPs, the SBP has undertaken several steps to: i) build its own capacity with regard to microfinance; and ii) streamline processes and assign areas of responsibility between departments. The measures taken include:

1. Creating a separate division for microfinance:

The Micro Finance Division is part of the Small and Medium Enterprise Department (SMED) of the SBP and has been in operation since 2000.

2. Training staff: The SBP has provided extensive training to a select group of officers in order to equip them with the knowledge and skills required to perform their tasks⁵ effectively and efficiently.

3. Hiring consultant groups and technical assistance providers: On a number of occasions, the SBP has sought external assistance in various areas, such as the development of on-site and off-site surveillance manuals for MFBs, developing a separate supervisory system (on-site and off-

5. These tasks include supervising microfinance banks, setting standards and reporting requirements for microfinance banks, and other related duties.

site) in collaboration with International Consulting Consortium Inc., etc.

4. Participating actively in international microfinance forums: The SBP has been an active participant in international microfinance forums, thereby seeking guidance and remaining updated on developments in the sector elsewhere in the world.

5. Restructuring and rationalizing departments: The SBP, pursuant to its restructuring and the creation of a separate Development Finance Group (DFG), has assigned the regulation and supervision of MFBs to its Banking Policy & Regulation Department (BPRD). Earlier, with the exception of on-site inspection, the work related to regulation and off-site surveillance was done at the Micro Finance Division in the SMED. This Division is now primarily involved in the promotion of the sector.

Since the promulgation of the Ordinance, the SBP has also introduced a number of supporting regulations for the sector:

1. Prudential Regulations for Micro Finance Banks (2003)
2. Guidelines for Mobile Banking Operations (2003)
3. Guidelines for NGOs Transformation (2005)
4. Fit and Proper Criteria for CEO/members of Boards of MFBs (2005)
5. Prudential Regulations for Commercial Banks to Undertake Micro Finance Business (June 2006)
6. Guidelines for Commercial Banks to Undertake Micro Finance Business (June 2006)

While developing and amending regulations for the sector, the SBP has adopted a consultative approach. The consultative process is institutionalized and formalized through the Microfinance Consultative Group (MFCG or “the Group”). The MFCG was established by the SBP in 2001 and includes key stakeholders from the sector, including multi- and bi-lateral donors, the microfinance apex organization, government representatives, all of the MFBs, and the PMN.⁶ The Group is chaired by the SBP and meets regularly to take stock of the changing environment. On the basis of these meetings, it proposes policy changes required to enhance the viability and realize the potential of the microfinance sector in Pakistan.

In addition, the SBP established a Task Force on Mobile Phone-based Banking in 2006. The Task Force was put in place to lead efforts to increase the use of this technology in the delivery of microfinance services. This Task Force is also chaired by the SBP and includes representatives of commercial banks, the Ministry of Information Technology (MoIT), and practitioners.

6. Members of the MFCG include: State Bank of Pakistan (Chair), Ministry of Finance, Ministry of Women Development, Pakistan Poverty Alleviation Fund, Pakistan Microfinance Network, Khushhali Bank, The First MicroFinanceBank Ltd., Network Microfinance Bank Ltd., Tameer Microfinance Bank Ltd., Rozgar Microfinance Bank Ltd., Pak-Oman Microfinance Bank Ltd.

Finally, it is worth mentioning that as the SBP's understanding and knowledge of the sector have deepened, it has recognized the need to develop an inclusive framework that also accommodates informal retail organizations, which dominated the sector during its first twenty years. In addition to merely recognizing the non-SBP-regulated players, the SBP has also taken concerted steps to include and accommodate these players in the regulatory framework. First, the SBP has increasingly recognized the need for a joint credit information sharing system that would include both MFBs and NGOs. Second, the SBP has provided NGOs with a legal means to 'transform' into formal financial sector entities.⁷

7. The first transformation under the new law occurred in 2002, when the Aga Khan Rural Support Programme (AKRSP) separated its 20-year-old credit program from its other development activities, setting up the private-sector-owned First MicroFinanceBank Ltd.

AMENDMENTS

Since 2001, a number of amendments to the Ordinance and the Prudential Regulations (PRs) for MFBs have been recommended by the MFCCG. These recommendations have been discussed extensively at the MFCCG forum. In addition to the amendments to the Ordinance, revisions were also made to the PRs to accommodate the evolving needs of a growing sector.

Implications for the Sector

A detailed explanation of each amendment and its expected implication for the sector is given in the exhibit below. The amendments have been in effect for approximately two years, but given that the impact is expected to be long-term in nature for most of the changes introduced, this analysis looks at the expected implications instead of tracking any immediate impact. Overall, the amendments made to the Ordinance and the PRs indicate a proactive and healthy approach to addressing the evolving needs of the sector:

1. Through the current amendments, the supervisory role of the SBP has been strengthened. This clearly indicates increased confidence in the Central Bank's understanding of microfinance business. It also indicates greater confidence in the new breed of financial organizations authorized by the regulation (the MFBs) not only among policy makers but also by the principal regulator—the SBP. Since supervising microfinance operations is more costly than (and distinct from) the monitoring of commercial banks, supervision is one of the key challenges of the regulatory framework. Thus, locating the supervisory role within the SBP through a special structure is considered a salient point of the supervisory framework. In the long run, this will lead to greater enforcement of PRs in the sector and to the mainstreaming of microfinance by ensuring better performance of MFBs.

2. Perhaps even clearer evidence of this increased confidence is provided by the GoP's and the SBP's unanimously-stated aim to integrate microfinance into the larger financial landscape of Pakistan. One of the key aspects of a good microfinance regulation is to promote sustainable and profitable microfinance providers in order to enhance and maintain

increased outreach in the long run. The amendment authorizing MFBs to invest surplus funds in ‘marketable’ securities (in addition to GoP securities) clearly highlights that policy makers now realize the importance of the existence of wider avenues for investment of surplus funds for the sustainability of MFBs and the sector as a whole.

3. The amendments also indicate recognition by policy makers and regulators of the need for a diverse microfinance sector by clearly differentiating between other microfinance institutions (i.e., NGOs) and MFBs. As stated above, this recognition has been substantiated by steps to build an inclusive regulatory framework to accommodate all players and provide a level playing field to SBP-regulated and non-SBP-regulated institutions. It is worth noting, however, that despite recognizing the role of NGOs in the provision of credit, this recognition is not accompanied by a move on the part of the SBP to regulate NGOs or allow them to take deposits.

Area	Amendment	Implications
Definitions of MFI and MFB amended	<p>“Microfinance institution means an institution which extends micro credit and allied services to the poor through sources other than public saving and deposits” <i>[FB 2006, Section 18, Amendment 1, Clause (a)]</i></p> <p>“Microfinance bank means an institution licensed by State Bank under this Ordinance to establish and operate as microfinance bank” <i>[FB 2006, Section 18, Amendment 1, Clause (b)]</i></p> <p>“Furthermore, the term “microfinance bank” has been reserved for use by SBP-regulated banks specifically involved in the provision of microfinance services. Offenders are punishable by law.” <i>[FB 2006, Section 18, Amendment2, Clause (b)]</i></p>	<p>This amendment indirectly legitimizes the role of NGOs (microfinance providers not regulated by the SBP) as providers of microcredit services. However, it spells out equally clearly that NGOs are not licensed deposit-taking institutions (as stated in their respective charter / memorandum of articles approved by the registering authority).</p> <p>The amendment indicates that market segmentation, a likely outcome of the diversity of microfinance providers (MFPs), is acceptable to policy makers and the central bank. The underlying understanding is that there should be several types of MFPs that compete on a level playing field in the hope that competition will empower the unbanked with more choices, ultimately resulting in improved services and increased access.</p>
Definition of “poor person” altered	<p>In addition to having a “meager means of subsistence”, the SBP has been authorized to determine the income level below which an individual is eligible for microfinance services.</p> <p>“... Whose total income during a year</p>	<p>Under the original Ordinance, only individuals with an income level below the taxable limit (annual income of approximately Rs 100,000) qualified as “poor persons” and, thereby, as legitimate microfinance clients. By authorizing the SBP to determine this maximum income</p>

	<p>is less than such minimum limit as the State Bank may, from time to time, prescribe” <i>[FB 2006, Section 18, Amendment 1, Clause (b)]</i></p> <p>In the revised Prudential Regulations (PRs) for MFBs, the SBP has defined “poor person” as: “... persons ... whose total income during a year is less than Rs 150,000/-. The total income would be arrived at after deducting the business expenses of the borrower during that year.” <i>[PRs for MFBs, Clause 30]</i></p>	<p>level, the amendment will soften the rigid income limit established in the original Ordinance. It is expected that through the MFCCG forum, practitioners will continue to have greater say in the future on revising the income level from time to time to reflect market conditions and sector tendencies. This has been witnessed in the recent increase of the threshold by SBP on the recommendation of the MFCCG.</p> <p>Providers have often demanded a change in the definition of the term “poor person” in order to continue the provision of services to clients as their incomes increase over time. By responding to their demand, this amendment will enable MFPs not only to increase their client base, but also to bridge the gap between the microfinance and the small- and medium-enterprise (SME) sectors.</p> <p>On the regulatory side, a factor to consider is the cost involved in monitoring this aspect of the law. The supervision costs of microfinance already can be many times greater than those of the rest of the commercial sector. Adding this particular proviso could further increase supervisory costs, which may need to be subsumed in the overall operational costs of MFBs.</p> <p>The SBP, however, states that since it does not charge its regulatees for supervision, therefore an increase in supervision costs is unlikely to have an adverse impact on MFPs. The MFBs, however, contend that additional supervisory requirements will add to their compliance costs, as they will have to build provisions into their sanctioning and internal monitoring processes to verify compliance with this requirement. So far, however, the cost implications of this amendment appear likely to be small.</p> <p>While this limitation in the Ordinance does not apply to NGOs, it may nevertheless have an indirect impact by discouraging them from seeking to transform into MFBs (which would</p>
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		subject them to a loan size cap). Given that the current average loan size in the sector is approximately Rs 15,000, however, the impact on the likelihood of NGO transformation is also expected to be marginal.
Investment options for MFBs increased (GoP Securities PLUS)	<p>Additional investment options have been made available to MFBs: “to invest in shares of any body corporate, the objective of which is to provide microfinance services and technical, vocational, educational, business development and allied services to the poor and micro enterprises”.</p> <p><i>[PRs for MFBs, Clause 16]</i></p> <p>“To invest its surplus funds in Government and such other marketable securities as the State Bank may, from time to time, notify”.</p> <p><i>[FB 2006, Section 18, Amendment 3, Clause (a) and (b)]</i></p>	<p>This amendment allows MFBs to invest in other debt instruments (such as term finance certificates (TFCs) and mutual funds that invest in debt) and limited equity instruments (including investments in bodies corporate with developmental objectives, e.g., microfinance, vocational, educational, business development, and allied services). Generally, the trend in other countries is to allow regulated MF providers to invest their surplus funds in approved securities and government bonds and bills, as is the case in Bolivia, Ghana, and Mexico. The current amendment allowing investment in limited equity (as specified above) and debt instruments is in keeping with the above trends.</p> <p>In the short run, given that such bodies corporate currently do not exist in Pakistan, the implications of this amendment are expected to be limited.</p> <p>In the long run, however, the ‘GoP Securities PLUS’ amendment has direct implications for the sustainability and financial efficiency of MFBs. Increasing investment options likely will help MFBs to improve their financial strength, which should make the sector more attractive for private risk capital.</p> <p>It is important to note that the SBP has not allowed MFBs to invest in shares floated on stock markets, which is largely in keeping with global good practice.</p>
Regional MFB tier created	“The SBP has approved the establishment of ‘Regional’ microfinance banks, in addition to the three existing tiers (national, provincial, and district). The paid-up capital requirement for setting up a regional MFB is “one hundred and	By creating the provision for a tier between the district and provincial level, this amendment has given MFBs looking to expand their geographical coverage the option of doing so in a phased manner with limited financial implications (i.e.,

	<p>fifty million rupees or such amount as the State Bank may from time to time prescribe for a microfinance bank in a region.” <i>[FB 2006, Section 18, Amendment 4, Clause (aa)]</i></p> <p>“For the purpose of the Ordinance, a Region is defined as “comprising up to five adjacent districts within the same province or any other area wherein this ordinance is applied with necessary adaptations as the case may be” <i>[FB 2006, Section 18, Amendment 5, Clause (a)]</i></p>	<p>any institution that wishes to work outside of one district can do so with an additional increase in paid-up capital amounting to Rs 50 million only (total Rs 150 million), as opposed to a total requirement of Rs 250 million for a provincial license (net increase: Rs 150 million)).</p> <p>This amendment will also enable MFBs to benefit from an organic growth model where institutions can capitalize on their local knowledge and spread out within a geographic region to achieve economies of scale.</p> <p>In some countries, regulation tends to create “tiers” based upon level of formalization. For example, in the Kenyan law there are three tiers of institutions: formally-constituted institutions that accept deposits (first-tier); credit-only MFIs (second-tier); and informal MFIs (third-tier). Another example is the Philippines, where rural banks have a lower minimum capital than microfinance banks.</p> <p>Theoretically, the minimum capital requirement should be based upon the economies of scale that result from financial intermediation; it should reflect the minimum infrastructure required to ensure profitable operations. The Pakistan law certainly has one of the highest minimum capital requirements. However, the new regional option may ease this slightly by matching equity requirements to the minimum operational size that can be profitable.</p> <p>So far, no regional MFB has been established. We also understand that the SBP has not received a request for licensing a regional MFB.</p>
<p>Maximum tenure of external auditors extended</p>	<p>MFBs are now allowed to appoint an auditor for a maximum term of 5 years, instead of 3 years, as was the case originally. <i>[FB 2006, Section 18, Amendment 5, Clause (a)]</i></p>	<p>This amendment is in line with the requirement for NBFCs (enforced by the Securities and Exchange Commission of Pakistan (SECP)), as well as the requirement for commercial banks (put in place by the SBP).</p>

		Experience has shown that building an external auditor’s knowledge and understanding of microfinance operations takes time. A 5-year proviso, therefore, will decrease the management and supervision time of an MFB in conducting external audits.
Increased flexibility in timeline for publication of annual audited accounts	<p>The State Bank has been authorized to extend the time period for the submission of audited financial statements by one month for MFBs. Originally, audited accounts were to be submitted to the SBP within 3 months of close of a financial year.</p> <p>It is important to note, however, that the SBP is authorized to grant the extension only under exceptional circumstances. <i>[FB 2006, Section 18, Amendment 5, Clause (a)]</i></p> <p>“..for MFBs licensed under the MFIs Ordinance 2001, the State Bank may, in exceptional circumstances, for reasons to be recorded, extend such period up to a period of another one month.” <i>[PRs for MFBs, Clause 23]</i></p>	<p>This amendment facilitates extension requests for submission of audited financial accounts. This amendment could lead to system-wide delays in finalizing financial statements if extension requests are routinely considered.</p> <p>It is important to note, however, that the extension can only be availed of with permission from the SBP.</p> <p>This amendment is not expected to impact either MFBs or the SBP significantly.</p>
SBP authorized to manage Liquidity and Cash Reserve	<p>The SBP now has the authority to monitor the liquidity position of an MFB through such returns and systems as may be prescribed by the SBP from time to time.</p> <p>MFBs can only maintain these reserves or liquidity in a current account with the SBP or an agent bank. <i>[FB 2006, Section 18, Amendment 10, Clause (a) and (b)]</i></p>	<p>The SBP was already authorized to require MFBs to maintain a cash reserve requirement (CRR). However, through this amendment, the SBP has been delegated authority to monitor the reserve requirement through returns and systems as the SBP may prescribe. This amendment has strengthened the supervisory role of the SBP.</p> <p>The SBP will no longer maintain a profit and loss (P&L) sharing account. Therefore, cash maintained in the current account, which was remunerated by the SBP through its own resources, will now be discontinued. However, MFBs are still authorized to maintain this cash reserve account with the SBP’s agent banks in a P&L account and have it marked as a CRR account. Therefore, this amendment does not deprive MFBs of any profit on the cash maintained in their CRR accounts.</p>

<p>SBP oversight with regard to governance and management of MFBs introduced</p>	<p>The following new section has been inserted in the Ordinance:</p> <p>“22A. Power of the State Bank to remove Directors or other managerial persons from offices.” <i>[FB 2006, Section 18, Amendment 11]</i></p> <p>Additionally, criteria have been developed for the CEO and Board Members of an MFB:</p> <p>“Fit and Proper Criteria for Board Members and President/Chief Executive” <i>[PRs for MFBs, Clause 26, Annexures B and C]</i></p>	<p>This amendment is also reflected in laws elsewhere, e.g. the Ghana NBF Rules 2000 state that the Bank of Ghana can remove any member of the Board of Directors or constitute an interim Board in the case of non-compliance. Likewise, in the case of the Rural Banks Act of the Philippines, there is a proviso that allows the Central Bank to remove directors and officers in cases of non-compliance or other matters.</p> <p>For the nascent microfinance sector, perhaps this level of due diligence and oversight is a good standard. A primary factor given by the SBP for strong regulatory oversight is the deposit-taking role of MFBs, which have been set up with a low capital base relative to commercial banks. Given that they are legally empowered to accept deposits from the general public, there is a need to regulate the MFBs at par with other deposit-taking institutions.</p> <p>Although the issue of procedures for removal was not discussed formally with the SBP, it is understood that SBP would invoke this clause following a procedure similar to that undertaken for commercial banks.</p> <p>There is a clear understanding, however, that strict regulation should be balanced with positive incentives, since punitive measures may not always work and could become hurdles in the long run, especially if objective criteria for removal are not applied. The MFB should also have the opportunity to present its case to a council or body within the SBP if it disagrees with the decision to remove a director or officer.</p>
<p>Secrecy and fidelity of records and information required</p>	<p>The following new section has been inserted in the Ordinance:</p> <p>“26A. Declaration of fidelity and secrecy” <i>[FB 2006, Section 18, Amendment 12]</i></p> <p>The original Ordinance did not include any clause related to maintaining confidentiality of records</p>	<p>The relevant clause, which requires the Board of Directors, auditors, and employees of an MFB to uphold and maintain secrecy and fidelity of records and information while discharging their duties, will improve the disclosure practices of MFBs. This is an important amendment and a sound practice.</p>

	<p>and information.</p> <p>The PRs also require:</p> <p>“Every member, director, auditor, and staff member of the microfinance bank shall, before entering his office and performance of duties, make a declaration of fidelity and secrecy...”</p> <p><i>[PRs for MFBS, Clause 32, Annex F]</i></p>	
<p>Writing off non-performing loans and provisioning</p>	<p>All Non-Performing Loans will be written off one month after the loan is classified as “Loss;” this shall not, however, extinguish the MFBS’ right to recovery of such written-off loans.</p> <p><i>[PRs for MFBS, Clause 12, 14]</i></p> <p>A. General Provisioning – 1.5% B. 30 – 89 days – 25%* C. 90 – 179 days – 50%* D. \geq180 days – 100%*</p> <p>* Indicates percentage of net delinquent principal after subtracting for cash collateral.</p>	<p>As a result of this amendment, MFBS are required to maintain a higher amount of capital for every rupee lent out, relative to a commercial bank (for unsecured lending). According to most MFBS, given the nature of microfinance, this will present a stumbling block in growth for MFBS, especially when there is a market event (elections, strikes, floods, etc.) and a larger portion of the portfolio becomes affected.</p> <p>Some MFBS further state that if MFBS are forced to recognize a decline in portfolio quality within 30 days, this could result in increasingly adversarial interactions between lenders and borrowers.</p>
<p>Truth-in-lending and promotion of consumer protection philosophy</p>	<p>Disclosure of Lending/Deposit Rates by MFBS</p> <p><i>[PRs for MFBS, Clause 31]</i></p> <p>Maximum Exposure of a Borrower from MFBS/MFIs/Other Financial Institutions/NGOs</p> <p><i>[PRs for MFBS, Clause 11]</i></p>	<p>The requirement to disclose terms and conditions to clients, in addition to service charges and penalties, is an important amendment to the PRs and is consistent with good banking and microfinance practices across the world.</p> <p>In the long run, the amendment on maximum exposure of borrowers—which aims to reduce/avoid over-indebtedness of clients—is likely to serve as a potential basis for a microfinance-specific credit bureau. Given the recent increase in outreach and the expected rise in competition among practitioners, this amendment is likely to have a positive impact on the industry in the long run.</p>
<p>Know Your Customer (KYC) requirement</p>	<p>Prevention of criminal use of MFB channels for the purposes of money laundering and other unlawful trade</p> <p><i>[PRs for MFBS, Clause 17]</i></p>	<p>This amendment could have substantially increased MFBS’ transaction costs, especially those operating in remote areas where establishing client identity is difficult due to the unavailability of National</p>

	<p>Identity Cards (NIC), the chosen method of identification. However, this has already been accounted for through the insertion of the clause: “In far-flung and remote areas ... the MFB may extend micro-credit by establishing identity through other appropriate means.”</p> <p>Thus, this amendment is not expected to significantly increase loan disbursement transaction costs.</p>
<p>Tax Holiday</p>	<p>Through the Finance Bill 2007-2008, the government has given MFBs a five year tax holiday (starting June 2007). This amendment is expected to have a number of positive impacts on the sector:</p> <p>Firstly, in the short run, this time-bound tax break will positively impact the sustainability of MFBs by substantially reducing costs during the start-up phase of an MFB.</p> <p>Secondly, in the long run, the exemption is likely to attract private capital to the sector, resulting in additional sources of capital.</p> <p>Thirdly, this exemption will ensure that ‘mission drift’ does not occur, since high tax rates could force MFBs to focus on larger loan products, thereby moving away from the lower end of the market.</p> <p>And fourthly, it will remove a significant disincentive for NGOs looking to transform into MFBs.</p> <p>The tax break has been provided for five years based upon the reasoning that (i) it takes an MFB about three years to break even; and (ii) practitioners strongly feel that five years will be required to enable an MFB to generate sufficient retained earnings to build up its overall equity for sustainable operations.</p>

ADDITIONAL RECOMMENDED AMENDMENTS⁸

8. These amendments have been recommended by the MFBs. The recommended amendments are currently being discussed with the regulator.

Although the recent amendments constitute a step in the right direction, additional amendments to the Ordinance and Prudential Regulations are suggested below:

1. **Clearinghouse Membership:** While not excluding MFBs from participating indirectly, current regulations prohibit MFBs from direct membership in the clearinghouse. Instead, MFBs are required to form an agency alliance with a commercial bank to access clearance facilities. To facilitate payments and settlements and enhance their deposit-taking capability through reduced cost, MFBs have been advocating for direct membership in the clearinghouse.

One of the requirements for becoming a direct member of the clearinghouse, however, is that a bank be equipped with a real-time gross settlement (RTGS) system. RTGS requires a sophisticated back-end management information system (MIS), which some of the MFBs presently lack. Direct membership is also costly, as there is a significant membership fee. Additionally, to become a direct member of the clearinghouse, a bank must be notified as a “scheduled bank;” currently, none of the MFBs meets this criterion.⁹

9. See below for a discussion of scheduled bank status.

Given the above technology and cost requirements, it is recommended that only MFBs that have sophisticated MIS and that can afford the membership fee be allowed the option of becoming direct clearinghouse members.

2. **Scheduled Bank Status:** In the past, when bank ratings were not available from independent rating companies, SBP used to provide a confirmation of the health of a bank by declaring it to be “scheduled.” This was a confirmation that the bank was regulated by SBP and that the regulator was satisfied with the financial health of the organization. Over the years, pension funds, mutual funds, and institutional investors adopted the requirement that a bank have “scheduled status” as a means of managing their risk.

As bank ratings have become more common, a comprehensive rating process is now available whereby an independent investor can judge the health of a bank and make an educated decision with respect to risk and return. However, institutional investors still require banks to be “scheduled” prior to investing. Since the SBP still allows only commercial banks to be licensed under the SBP Act (a necessary prerequisite for achieving scheduled bank status), MFBs cannot achieve the status of scheduled banks. As a result, MFBs are excluded from the large institutional deposit market. With scheduled bank status, MFBs would be able to attract different kinds of investors and improve their balance sheets. Such a provision would also help MFBs in marketing their brand to attract deposits, and it would also meet a prerequisite for becoming a member of the clearinghouse.

Since bank ratings and additional performance assessment processes are now a common phenomenon in Pakistan’s banking

sector, it may be useful to assess the possibility of SBP's granting scheduled bank status to MFBs that meet certain minimum requirements. These could be based upon satisfactory audit, minimum rating, etc.

3. **Loan Loss Provisioning:** Comparing Pakistan's current loan loss provisioning requirements with other countries' shows some areas in which Pakistan's requirements can be loosened. For example, even though the general provisioning requirement has been reduced from 2 percent to 1.5 percent, in other comparable cases like Bolivia and Ghana, general provisioning is 1 percent.

As discussed earlier, higher provisioning requirements for delinquent MF loans mean that MFBs need to provide higher levels of capitalization relative to commercial banks as a result. According to some MFBs, approximately 60% of the microfinance customers are self-curing (i.e. they deposit installments on their own), 20% need up to two visits, and the remaining 20% remain delinquent due to temporary liquidity mismatches. This becomes an even larger stumbling block to the growth of MFBs when there is a market event (elections, strikes, floods, etc.) and a larger portion of the portfolio becomes affected. The requirement to recognize NPLs after only 30 days means that there is no safety margin for the MFB.

This could also have a spill-over effect on client relations: commercial banks have recognized that whenever a customer has "ability to pay" problems, it takes a certain timeframe to turn things around, thus the 90-day period before the decline in quality is recognized. If MFBs are forced to recognize a decline in quality within 30 days, their behavior towards the customer will lead to increasingly adversarial interaction.

It is suggested that this policy be reviewed and that MFBs be permitted to wait until 90 days before recognizing non-performing loans. Similarly, it is suggested that MFBs be permitted to wait until 360 days before writing off delinquent loans, instead of the current 210 days.

4. **Loan Size:** Capping the loan size, most practitioners agree, prevents mission drift. In addition, from the SBP's perspective, caps also ensure that investors do not use the Ordinance as a back channel for conducting commercial banking. At the same time, some MFBs strongly feel that capping loans creates the most significant impediment to financial sustainability. Their argument is based on the fact that there is a sizeable gap between what commercial banks will lend without collateral and the current limit for microfinance (Rs. 150,000 (approx. USD 2,500), as determined by the Ordinance. As a result, this restriction is likely to create a 'missing middle' in the market.

One of the core objectives of MFBs is to provide access to the un-banked in Pakistan. Today, however, outreach continues to be limited in the sector, while sustainable institutions are hard to come by. Enabling an MFP to continue serving its clients through an ever-increasing loan size leads to poverty alleviation and stronger financial institutions. In Bangladesh, for example, there are thousands of cases of Grameen Bank borrowers who receive loans of over Taka 1,000,000 (approx. USD 14,600). Artificially-generated loan caps would have prevented such clients from 'graduating' successfully into a larger loan amount.

The above contention is supported by international best practice, which tends to prefer higher loan caps. In some cases, even loan caps are kept flexible, e.g., in the 1993 Bolivian code, the only cap introduced is that a financial institution cannot grant credit to a borrower that exceeds 3 percent of its equity. In the proposed Afghanistan law, the maximum loan amount would be fixed at USD 10,000; while in the case of the Philippines, loans are capped at USD 3,000.

We suggest that the upper limit on microfinance loans be revised on a regular basis to ensure that the MF industry evolves with time. The revisions should be based on: (i) market research by practitioners, GoP, SBP, and independent survey organizations; and (ii) consultation with SME sector specialists and financial service providers, in order to effectively and realistically bridge the gap that currently exists between the micro and small and medium market segments.

5. **Borrowing against Receivables:** The Ordinance does not allow MFBs to use their receivables as collateral to raise debt. This reduces an MFB's capacity to leverage its balance sheet for growth. In other countries, banks, MFPs, and NBFIs are allowed to pledge their receivables. In Pakistan, the SBP should consider allowing similar flexibility in a structured manner that requires MFBs to provide a specific pool of assets as security, which is reviewed and renewed over the life of the borrowing.

6. **Tier II Capital as Part of Capital Adequacy:** The capital adequacy ratio for MFBs (15%) is higher than for commercial banks. As certain MFBs grow to a larger scale, they will begin to push up against their capital adequacy levels. To ensure growth, one option is to lower the capital adequacy ratio based on an institution's track record. Another option is to count certain kinds of Tier II capital in the capital adequacy ratio (currently, only Tier I capital counts towards capital adequacy requirements).

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