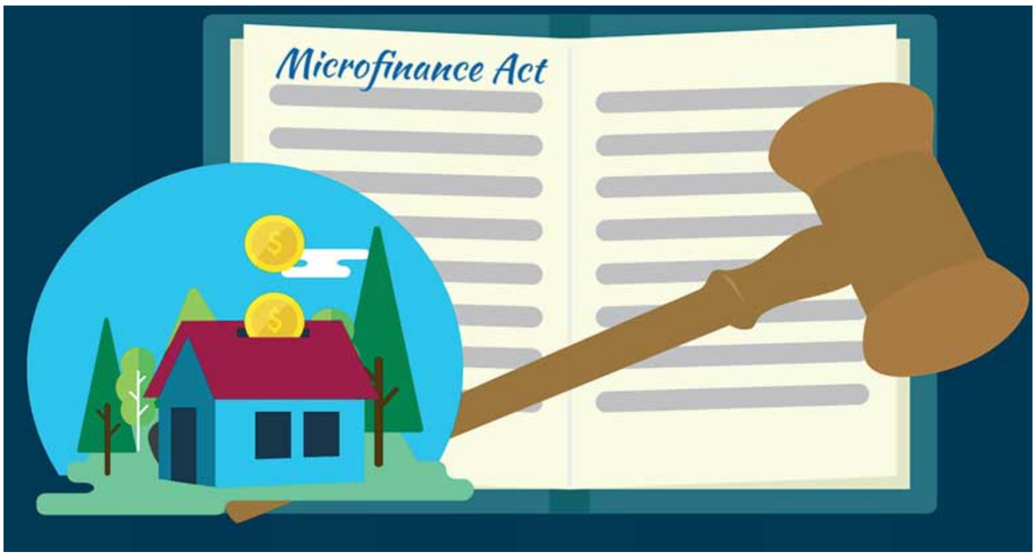
Regulating financial services for the poor in Sri Lanka: A closer look at the long-awaited Microfinance Act



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By Ganga Tilakaratna and Chinthani Sooriyamudali

The UN Day for Eradication of Poverty is observed today, 17 October, under the theme 'Moving from Humiliation and Exclusion to (http://static.ft.lk/ftadmin/wp-content/uploads/2016/10/16225458/Untitled-3121.jpg)Participation: Ending Poverty in all its Forms'. Microfinance has been widely recognised as an important tool for addressing poverty. Hence, this article to mark this day reviews the Microfinance Act of Sri Lanka that came into effect in July 2016 and discusses its benefits and concerns.

Microfinance is an important tool in addressing poverty and vulnerability. Sri Lanka has a long history of microfinance dating back to the early 20th century. At present, Sri Lanka's microfinance sector comprises a range of different institutions including co-operative societies, Non-Governmental Organizations (NGOs), microfinance companies, development banks, and special state programs like the Divineguma community-based banks. Despite a large number of microfinance providers, many of them lack proper regulation and supervision. Considering that the poor and vulnerable are the target group of clients in the sector, it is inarguably important to ensure proper regulation and supervision of the industry. To this effect, the long awaited Microfinance Act (No. 06 of 2016) came into effect from July 2016, after several drafts over nearly a decade. The Microfinance Act is expected to be beneficial to the clients, providers and the microfinance industry as a whole.

Key features of the Act

The Act provides for: 'The licensing, regulation and supervision of companies carrying on microfinance business; the registration of non-governmental organisations accepting limited savings deposits as microfinance non-governmental organisations; for the setting up of standards for the regulation and supervision of microfinance non-governmental organisations and micro credit non-governmental organisations and to provide for matters connected therewith or incidental thereto licensed companies can mobilise savings'.

As such, the Act broadly applies to two types of entities engaged in microfinance activities. They are: (i) Companies registered under the Companies Act, No. 7 of 2007, except companies limited by guarantee, private companies, offshore companies and overseas companies (hereafter referred to as MF companies); (ii) NGOs registered under Voluntary Social Service Organisations Act, No.31 of 1980 (hereafter referred to as MF NGOs). The Act does not apply to the following entities even though they may engage in microfinance related activities:

1.Licensed commercial banks or licensed specialised banks established under the Banking Act, No.30 of 1988

2.Finance companies established under the Finance Business Act, No.42 of 2011

3.Co-operative societies registered under the Co-operative Societies Law, No.5 of 1972 or under Statute of a Provincial Council

4.Divineguma community-based banks and Divineguma community-based banking societies established under the Divineguma Act, No.1 of 2013

5.Entities formed in terms of the Agrarian Development Act, No.46 of 2000

According to the Act, the MF companies that opt to be licensed will fall under the direct authority of the Monetary Board of the Central Bank of Sri Lanka (CBSL). With the aim to ensure that the objectives of the Act are achieved the Department of Supervision of Microfinance Institutions has been established at the CBSL. The NGOs that wish to apply for a certificate of registration under the Act fall under the direct authority of the Registrar of Voluntary Social Service Organisations. In this case, the Registrar, under the directives issued by the Monetary Board, will carry out all the regulation, monitoring, and supervision. However, the Monetary Board will not directly regulate or supervise the MF NGOs.

The Act does not require all eligible microfinance providers to be licensed. It stipulates that a licence enables a microfinance provider to accept savings from their clients. Those providers who opt to not to be licensed can continue their business as usual and engage in microfinance activities but are not allowed to accept savings.

The licensed microfinance providers are subject to directions issued by the Monetary Board (for example, with regard to terms and conditions in the case of savings, loans, investment as well as reserve funds, non-performing loan ratio, fit and properness of the management, etc.). The exact guidelines are currently being designed by the CBSL.

Why is it important?

Establishment of a sound regulatory and supervisory framework for the microfinance sector has been a long-felt need to ensure the financial soundness of microfinance providers and to build confidence among depositors, borrowers, and funders. Such a regulatory framework would help achieve financial sustainability of the organisations and greater financial inclusion in the country. The majority of microfinance providers lacked prudential regulation, with a few exceptions like the Sanasa Development Bank and the Regional Development Bank. The absence of regulations has been a major barrier for many microfinance providers in attracting external funds.

Furthermore, many non-bank microfinance providers were not permitted to mobilise savings from their members/clients prior to the Act. The only exceptions were co-operatives such as Thrift and Credit Cooperative Societies (TCCSs) and the Samurdhi/Divineguma Development banks. A key provision of the Act is that the regulated microfinance providers are authorised to accept savings deposits. From the viewpoint of microfinance providers, this is advantageous in that savings deposits can constitute an additional source of financing; they can mobilise internal funds thereby reducing their dependence on external funds. This, in turn, would also help these institutions to enhance their lending capacity and become financially viable in the long-run. Additionally, savings act as partial collateral for their loans can be used to repay loans in case of defaults, thereby reducing the institution's credit risk.

From the perspective of the low-income groups (i.e., the target group of customers), this is favourable in that it can contribute to encouraging more savings among them. Microfinance providers are more accessible for the low-income groups (compared to more formal financial service providers). As such, this step was taken to enable microfinance providers to mobilise savings has the potential to play a crucial role in boosting savings among low-income groups. However, in order to fully realise this potential, it is important to raise awareness on the newly introduced regulation among the targeted population as well as the microfinance providers who will ultimately end up licensed under the Act.

Moreover, lack of regulation has hindered the ability of microfinance providers to compete with formal/regulated organisations that provide financial services to low-income groups. The Microfinance Act shall help such microfinance providers to compete on an equal footing, specifically in terms of attracting customers as well as investors. Furthermore, although not explicitly stipulated, the Act is expected to create the background necessary for microfinance providers to join the Credit Information Bureau (CRIB), which maintains consolidated information on borrowers and lending institutions in the country. So far, the CRIB Membership had only been extended to commercial banks, licensed specialised banks, leasing companies and finance companies that are under the supervision of the CBSL. Hence, the majority of microfinance providers are not integrated into the CRIB. However, allowing these institutions to integrate into the CRIB is of great importance, given the high and increasing level of multiple borrowing and rising debt levels in the microfinance sector. This would allow microfinance providers to screen their clients and minimise risks.

Issues and challenges

The Act does not apply to all the providers of microfinance. A number of microfinance providers including the Divineguma community banks and co-operatives such as the thrift and credit co-operative societies (TCCSs) will continue to be governed by their current Acts while only the MF companies and MF NGOs will be covered by this Act. Even for the MF companies and the MF NGOs, being licensed/registered is mandatory only if they wish to mobilise savings while the others can continue business as usual. Interviews with some stakeholders revealed that approximately 15-20 MF companies are expected to apply for a license, primarily the more established ones with a larger outreach. As such, a large number of microfinance providers would continue to operate outside of the regulation and supervision stipulated by the Microfinance Act.

Furthermore, as per the Act, the Monetary Board has the power to impose interest rate caps on the licensed/certified microfinance providers. While there are merits of imposing interest rate caps to prevent microfinance providers from charging exorbitant rates of interest on loans to the poor, interest rate caps may encourage the regulated microfinance providers to move away from lending to the poorer segments as this is often riskier and involves higher transaction costs. Instead, they may choose to lend to 'better-off' clients (a possible 'mission drift in the sector!).

Moreover, some stakeholder interviews revealed that there could be potential implementation challenges with regard to instilling the necessary financial, managerial and governance discipline required from the regulated microfinance providers. Certain adjustments will need to be made by the microfinance providers, incurring certain costs. Furthermore, capacity building of staff at the Department of Supervision of Microfinance Institutions of the CBSL, and raising awareness among the public about the Act and the licensed providers that are able to mobilise savings, are key to its successful implementation.

(Ganga Tilakaratna is a Research Fellow and Chinthani Sooriyamudali is a Research Assistant at the Institute of Policy Studies of Sri Lanka (IPS). To view the article online and comment, visit the IPS blog 'Talking Economics' – www.ips.lk/talkingeconomics).

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This is the final part of a revised and improved version of a paper published in the Association for Professional Bankers 2016 Annual Convention Publication titled 'Thriving in a Digital World'. Part I of this paper...