SAARCFINANCE Seminar on

"Regulation and Supervision of Microfinance Institutions (MFIs) in SAARC Region"

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It gives me great pleasure to address this august gathering at the opening session of this SAARCFINANCE Seminar on ""Regulation and Supervision of Microfinance Institutions in SAARC Region". We all know, micro finance has been a powerful instrument of self employment, empowerment and poverty reduction. But, it has not only different operational models but also different regulatory and supervisory systems. Meanwhile, the rapid expansion of micro finance has raised concerns on its effectiveness and sustainability, among others. As this seminar is being held at an opportune time to discuss these issues, it should provide a great opportunity for us to make necessary policy changes to our regulatory and supervisory system that would facilitate the development of microfinance in a sustainable way.

Ladies and Gentlemen,

In most developing countries micro-finance has been recognized as a credible development tool in bringing the financial services to the poor and low-income people. The poor and low-income people need a variety of basic financial services along with credit. Lack of access to credit is due to the absence of collateral for the poor to offer, and micro-finance institutions attempt to overcome such barrier through innovative measures such as group lending and regular savings schemes. The institutions involved in micro-finance business help people fight against poverty on their own terms in a sustainable way. In addition to the financial services like savings, credits, transfers and micro insurance, they also help improve schooling, health and women’s empowerment.

The ability of the market to respond to increased demand for micro-finance services depends not only on the extension of financial services by the service providers, but also on having an enabling policy and regulatory environment. Self-regulation and voluntary enforcement may not work when the market grows considerably in terms of size, number of players and the volume of transactions. Therefore, an appropriate regulation and supervision of micro-finance is critically important in bringing the poor and vulnerable communities within the formal financial net. Regulation and supervision of micro-finance sector is expected to create an environment for fair competition and efficiency in this sector and for integrating these institutions into the formal financial system. For this, the supervisory authorities require to come up with defined procedures for entry, operations, and exit of micro-finance institutions.

The selection of an appropriate and competent supervisory authority for micro-finance institutions is a critical task. There is no doubt that micro-finance institutions under the domain of the central bank will definitely build up public confidence in the system. However, central bank's involvement should be judged in terms of capacity, supervisory costs and the core functions of the central bank. This situation urges for establishing a new and separate supervisory authority and some countries have already initiated for such mechanisms.

Many developing countries have now been considering whether and how to regulate micro-finance. As deposit accepted from the general public involves a potential risk of loss in the system, deposit-taking micro-finance must be regulated and supervised by a competent authority to ensure that deposits are prudently mobilized and cushioned by adequate capitalization. We also need to consider that an important general principle is to avoid using burdensome prudential regulatory and supervisory framework for micro-finance institutions. Regulators and supervisors have to weigh the potential costs of regulation and supervision including the potential unintended consequences of regulation, particularly in regard to innovation and competition.

In my opinion regulation and supervision of micro finance institutions should be guided by two fundamental principles. First, it should ensure operational and financial sustainability of the institution concerned. For this, financial services need to be reasonably priced so as to retain a large part of profits for future expansion and growth of the institution. Secondly, the regulator and supervisor of micro-finance sector should also focus on expanding outreach of micro-finance services throughout the country and enhancing access of poor and low-income families to financial services.

Ladies and Gentlemen,

Let me now touch upon some benefits that emanate when central banks exert some level of regulation and supervision on MFIs. As we all know, most of these institutions are not commercially oriented. They serve mostly clients that may not be served by formal financial institutions. Through Central Bank intervention and oversight, it is possible for these institutions to become more sustainable and commercially oriented, while maintaining their social goal of providing financial services to the low income segments of society. They would improve their governance, comply with minimum prudential requirements set out by the regulator to improve their operations, as well as have more capacity to extend financial services outreach to more under-served people in the country.

Most importantly, appropriate regulation and supervision would minimize the susceptibility of these institutions and their clients to adverse systemic and prudential risks. It ensures the protection of the interests of depositors and creditors, and the maintenance of confidence in the overall financial system by promoting its strength and integrity. A clear and transparent regulatory framework is necessary because MFIs' traditional fund sources usually cannot keep pace with their lending business, and thus need to have access to external finance to complement their own resources and those from donors in order to reach as many prospective borrowers as possible.

South Asia's approach to regulation lays emphasis on the special microfinance niche that has emerged over the past 35 years. It is designed for special, relatively narrowly defined MFIs, views microfinance as primarily being a socially oriented poverty reduction tool, and uses an extensive set of rules based on this particular view of microfinance. In a way, this approach recognizes the success of the microfinance sector in South Asia as a poverty alleviation tool and tries to embed that history in the law and regulations. In this region of the world with some 40 percent of the world's poor, this is perhaps appropriate. Nevertheless, this approach is not particularly forward looking and does not take into account the changes the sector will undergo with the introduction of new approaches, institutions, and technologies.

Supervision is very challenging in countries of our region due to the multitude of small institutions and limited supervisory capacity. Effectively regulating small institutions without stifling them may entail creating national federations or promoting collaboration between different institutional types. Regulation without supervision would cause costs without benefits.

Ladies and Gentlemen,

Let me take this opportunity to share with you the state of micro finance in Nepal. Microfinance services in Nepal are being provided by 26 microfinance development banks, 33 financial NGOs, and about 12 thousand financial cooperatives in 64 districts of Nepal. Though microfinance services have reached about 1.8 million households, there are issues of multiple banking, mis-targeting, limited outreach to remote areas, and overall low impact on sustained poverty reduction. The NRB has been playing a promotional, regulatory as well as facilitator's role for the promotion and support for the development of micro-financial services in the country. With an objective of bringing micro-finance services under the single umbrella through creating necessary structural and legal provisions, National Micro-Finance Policy was announce in 2008. The policy was promulgated in order to do away with the problems related to organizational and legal issues with a view to smoothly providing microfinance services in the rural areas, increasing the access of the destitute class to such services, creating a healthy and competitive atmosphere among MFIs, and encouraging the private sector to get involved in the task of providing such services on a sustainable basis.

Nepal faces a number of challenges with respect to the microfinance sector, resource mobilization being a principal one of them. The NRB has directed banks to support MFIs by extending credit under the deprived sector lending schemes. As per the deprived sector lending policy, commercial banks currently need to lend at present 4 percent of their total loan portfolio to the deprived sector and development banks and finance companies are also required to allocate 3.5 percent and 3 percent of their credit respectively to the deprived sector, which in turn provides resources for the microfinance institutions for on-lending to the poor. The size of lending that banks and financial institutions are required to make to the sector is being increased by 0.5 percentage point annually for the next two years.

Although there is donor support to some MFIs in Nepal, this may not continue for a long time. Hence, it is crucial that the MFIs have to resort to their own resources on a sustainable basis. And this can be done through the mobilization of local savings. However, the question that arises is whether or not they should be permitted to mobilize saving outside the membership or the groups, in the form of deposits. When microfinance institutions have to mobilize deposits outside the group, they may have to be guided by the central bank's general regulations which could be quite harsh for the microfinance industry as a whole. And on top of that, the low capital base of the MFIs and deposit collection facility may not be supportive. Hence, whether the MFIs should be equipped with proper deposit mobilizing facilities or not is an unsettled issue, although the NRB has already provided this facility to some of the MFIs functioning in the areas where there is no presence of commercial banks and other financial institutions.

Another issue is related to the lending rates of micro finance institutions. There is a general complaint that lending rates are exorbitant, that the margin between the cost of fund and lending rate is extremely high and that some of the poor borrowers have problems in borrowing at such a high rate. This aspect must be addressed if we want to see the MFIs distinct from local moneylenders. Hence, it is imperative for MFIs to revise the interest rate structure. They need to be more transparent and follow better corporate governance. They have to be ready to maintain prudential norms regarding credit to deposit ratio, liquidity ratio, and capital adequacy, if they want to collect deposits from non-members as well.

Ladies and Gentlemen,

Let me conclude by mentioning that during the course of this seminar, you will definitely be able to address many of the specific issues arising in the microfinance sector and conceptualize the most relevant and effective framework for regulating and supervising microfinance activities in your own countries. I look forward to a most active participation and exchange of ideas from the participants. When the seminar ends tomorrow, I am sure that you all will come out better informed and with a deeper understanding of the issues relating to regulation and supervision of MFIs. I wish you all a pleasant stay in Kathmandu along with making the seminar very fruitful and successful.

Thank you very much.