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Regulation of Microfinance Institutions in Asia: A Comparative Analysis

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This paper compares the regulatory framework of the microfinance institutions (MFIs) in Asia. We find formal MFIs are generally regulated under the banking legislation and supervised by central banks. In contrast, semiformal institutions like NGO-MFIs are regulated by either an apex organisation or other government body. Informal MFIs are not regulated but some are of sufficient size to become NGO-MFIs or even banks. The formal MFI regulation seems effective but the internal controls, governance and ownership structure are disappointing for NGO-MFIs, and of course for the informal MFIs. We propose a prudential regulatory environment for MFIs similar to the banking sector with the realisation that some existing banking rules may not be applicable to MFIs. The regulator should also remember the cost of over-regulation. This regulation is a joint and separate responsibility of the governments, central banks, donors and private sectors. Their regulators require sufficient competence and supervision and enforcement skills to achieve a suitable regulatory environment to protect depositors but still encourage MFI to improve their outreach and attain sustainability.

Key words: Microfinance Institutions and Prudential regulations.

1. Introduction

Microfinance entails the delivery of financial services (such as deposits, loans, payment services, money transfers and insurance) to poor and low income households and their micro-enterprises. Microfinance institutions (MFI)[1] now play a key role in the fight against poverty by helping poor households build their income and assets (Zaman 2004). According to the State of MicroCredit Summit Campaign Report (2005) as of 2004 some 3,200 microcredit institutions reportedly to reached more than 92 million clients of which approximately 73% are living in poverty when their first loan was made.

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Credit delivery has been the main driver for the creation of MFIs in developing countries (for instance in Bangladesh). Now in order to achieve self-sufficiency (reduce donor[2]dependency) it is important for MFIs to mobilise savings as well. Savings will also help MFIs increase their lending activities and so allow for more growth. This in turn may permit higher profit margins and generate competitive strength (Nazirwan 2004).

Most Asian MFIs already engage in some deposit-taking activity from their members or borrowers. As these institutions move to raise deposits from the general public, however, a regulatory framework to protect these depositors becomes essential. Beside depositors, MFI regulation protects the industry from improper practices and through good governance, should improve managerial processes. Hence, these stronger MFIs should expand their outreach to the poor households and increase their lending as well as attain financial sustainability.

A major feature of MFIs is that they have a large number of clients but their total asset base is very small compared to traditional financial institutions. Their lending is to the poor people who have little, if any, collateral and often little formal business experience. Besides these obvious risks, MFIs also hold poorly diversified loan portfolios as they target households within the same region that are often engaged in similar activities. So, they are susceptible to high risk of default, information asymmetry[3] problems in assessing their borrowers' risk profile and a high variance in expected returns (Gonzalez-Vega 1998).

Traditionally, MFIs have depended on donor funds and subsidies. The next step, to raise their funds on a commercial basis, represents a considerable challenge. It also poses the question as to whether MFIs should be regulated or allowed to continue as before with relatively little formal regulation. The potential costs and benefits associated in this regulation must also be addressed as well as tradeoffs between MFI sustainability and outreach. Regulation may also improve MFIs governance and ownership structure and reduce asymmetry information and moral hazard problems. Its impact on MFIs competition and innovation, financing costs and social welfare, however, remains to be seen.

This paper examines these matters in Bangladesh, China, India, Indonesia, Nepal, Philippines, Pakistan, Sri Lanka, Thailand and Vietnam. Besides any regulatory differences, these countries' macroeconomic perspectives and institutional development are also considered. Based on their experiences, it is hoped a regulatory environment might be identified which would best suit MFIs at specific levels of development.

The remainder of the paper is organised as follows. The next section covers the rationale behind regulating these small institutions. Section 3 summarises the differing view points on MFIs regulation. Section 4 draws a comparative analysis of MFI regulation in Asia. Section 5 considers the policy implications for regulating MFIs. Section 6 finally summarises the regulation and supervision policies and concludes the paper.

2. Rationale for regulation

The prudential regulation for any financial institution rests on the need to protect the depositors from the loss of their savings and to preserve the confidence and strengthen the financial system. This regulation has often proved ineffective in developing countries due to information and data collection problems, weak accounting standards, lack of professionalism and political interference. Fortunately, many countries are now strengthening their prudential standards and extending them to cover other institutions such as MFIs. The standard MFI legal framework should identify the role of the regulatory authority, the rules for MFI entry and exit and the boundaries and benchmarks for sustainable operations (Gallardo 2002). Hence, the rationale behind regulating MFIs should also be similar. This is to protect the interest of the small depositors[4], enhance liquidity management, develop operational and financial sustainability and to protect against moral hazards.

As the MFIs clients are from the poorest households in society, any loss of their savings due to MFI insolvency or fraud (like pyramid schemes[5]) would be disastrous. They also lack the financial expertise to judge MFI riskiness. Ideally, regulation should encourage MFIs to avoid excessive risk.

The prudential regulation should also help MFIs to build confidence among their clients through the appropriate capital management, earnings and strong internal control mechanisms. It is vital that MFIs now consider operational and financial sustainability as important an objective as client outreach. However, to achieve sustainability in the long run, MFIs eventually require funds from commercial sources (such as public deposits); unless proper regulation is in place, attracting such funding will be difficult. There is also a risk for MFIs that do not develop these alternatives. Most developing country MFIs are dependent on donor subsidies and grants. So should donor funding cease, these MFIs and their clients are likely to fail. Thus MFIs need encouragement, via an appropriate regulatory setting, to raise sufficient cash flow so as to reduce their donor dependency.

In essence, MFIs regulation is a matter of strengthening MFI reputation and preventing fraudulent activities through increasing transparency in financial accounting and transaction reporting and increasing operational and financial sustainability (Meagher 2002, Rhyne 2002).

3. Overview of micro finance in Asia

MFIs have proved that the poor are bankable and that small loans can make a huge difference in the poor households' lives. With their expansion and the growth, specifically South Asian MFIs stand out in terms of breadth and depth[6]. Stephens and Tazi (2005) show the total number of active borrowers in East Asia and South Asia is some 3.8 million and 11.8 million respectively. However, East Asia dominates in mobilising savings. Their gross portfolio is some USD 1,832 million compared to South Asia with USD 959 million. The following section discusses the size and importance of the MFIs in general as well as the vast variety of formal, semiformal and informal microfinance providers.

3.1 MFI size and their importance

The State of Microcredit Summit Campaign Report[7] (2005) notes that more poor clients, some 60 million, have been reached in Asia compared to Africa, Latin America, Caribbean and Middle East. Furthermore, among some 1,500 MFIs in 85 countries, Asian MFIs mobilise the highest volume of savings and extend the most credit to the poor households. (Weiss and Montgomery 2004, Lapeneu and Zeller 2001). The well known MFIs in Bangladesh and Indonesia alone, accounted for more than 50% of the total number of borrowers in a worldwide sample of 300 MFIs. Bangladesh, Indonesia, Thailand and Vietnam serve the largest number of members, greatest loan distribution and savings mobilisation in terms of GNP in the world (Weiss and Montgomery, 2004).

We have divided the sample countries into South Asia (Bangladesh, India, Nepal, Pakistan and Sri Lanka) and South-East Asia (China, Indonesia, Philippines, Thailand and Vietnam) to discussion the importance of MFIs in Asia. The breadth in South Asian MFIs is reflected in MFIs like the Grameen Bank, ASA and BRAC which cover 75% of the total borrowers served in the South Asia. Their depth of the outreach can also be measured in their percentage of women clients and average loan balance per borrower. Stephens et al (2005) note South Asian MFIs have 85% women borrowers compared to other regions. The portfolio loan figures are dominated by the East Asian MFIs. The Chinese MFIs has the largest loan portfolio with some US$ 145 billion followed by BAAC in Thailand and thrift banks in Philippines[8]. The South Asian MFIs excel in credit delivery compared to the South-East Asian MFIs where they focus on voluntary savings (Stephens et al 2005). However, South Asian MFIs do collect mandatory savings as part of membership or loan access. Their active borrowers are more than triple those in South East Asia, but the voluntary savers in South Asia are more then ten fold those of South Asia. For example the BRI in Indonesia manage more small deposit accounts within Indonesia alone than that of all South Asian MFIs combined. Furthermore, sustainability plays a key role to increase MFI outreach and for this they need sufficient revenue to cover their operational costs. The financial performance for South Asian MFIs is not impressive compared to those in South-East Asia. The self reliance of BAAC in Thailand has lead to achieve a deposit to liability ratio 86% and deposit to loan ratio 98% within a decade's operation. While ASA in Bangladesh is the most profitable[9] MFI in South Asia.

3.2 Formal, semiformal and informal institutions in the MFI industry

The first step in understanding microfinance regulation is to realise that MFIs are not just one entity but rather take several forms. As shown in table 1 these can be classified into three major types: formal, semi formal and informal institutions. Among the formal institutions the Grameen Bank in Bangladesh and Bank Rakyat Indonesia (BRI)-microfinance division in Indonesia have captured the highest number of borrowers (Stephens et al 2005). As of 2004, Grameen had a total of some 3,700,000 active borrowers followed by BRI with some 3,100,358. Furthermore semiformal institutions specifically NGOs like BRAC in Bangladesh cover 3,993,525 borrowers and ASA has the highest number of savers with some 2,986,622. Finally, the informal MFIs are the most numerous but individually are very small and service relatively few clients. The following subsections will discuss each of these institutional types in turn.

Table 1: Variety of microfinance providers in Asia

Country	Formal institutions[a]	Semiformal institutions[b]	Informal institutions[c]
Bangladesh	Commercial and specialised banks; Grameen Bank, cooperatives	NGO -MFIs	ROSCAs
China	Rural credit cooperatives (RCCs). Some state-owned banks	Domestic NGOs, local government initiatives	ROSCAs, moneylenders, relatives
Indonesia	Commercial bank like BRI's Unit Desa system, non bank financial institutions like rural funds and credit institutions (People's Credit Banks: BPRs or LDKPs), village credit institutions (Badan Kredit Desa, BKD) and savings and credit cooperatives	NGO-MFIs in four forms: cooperatives, Islamic lending cooperatives foundations, community banks(LPDs)	ROSCAs and variants, Self help groups and village banks, individual money lenders, traders and shopkeepers
India	Domestic commercial banks: public sector banks, private sector banks, local area banks, regional rural banks; societies, public trusts, non-profit companies, cooperatives	NGOs	Self help groups

Nepal	Commercial banks, development banks, finance companies, rural microfinance banks	Savings and credit cooperatives, societies and financial intermediary NGOs	Self help group, informal savings and credit organisations, money lenders , traders , friends and relatives
Pakistan	Commercial banks, Microfinance institutions, Khushhali Bank (KB)	NGO-MFIs, rural support programs (RSPs)	ROSCAs, loans from friends and relatives, money lenders and wholesalers and purchases on credit from shopkeepers/agricultural-input dealers/suppliers etc.
Philippines	Thrift and rural banks, cooperative banks, credit unions, and NGOs.	NGOs	Traders, input-suppliers, money-lenders, ROSCAs, and ASCAs
Sri Lanka	Cooperatives, commercial banks	NGOs	Money lenders and family members
Thailand	Specialised financial institution (Bank for Agriculture and Agricultural Cooperatives, BAAC), Commercial banks (including retail banks that target the SME sector), cooperatives	NGOs	Moneylenders, traders, input suppliers, friends, and relatives
Vietnam	Banks, including state-owned banks and shareholding banks; NBFIs; microfinance institutions; cooperatives, including credit cooperatives, people's credit funds and cooperative banks. The government uses the VBP[d] to provide subsidised loans to poor households. It is regulated as a commercial bank with some key exceptions.	NGOs, government programs	Moneylenders, ROSCAs, relatives, friends

Sources CGAP: Microfinance Gateway; http://www.microfinancegateway.org/resource_centers/reg_sup, Bank Indonesia and GTZ, Microfinance Directory

[a] Formal financial institutions are under prudential regulation. They have legislation/ regulated and licensed registration under which they operate.
[b] Semiformal institutions have no legislation or are unregulated but are registered under an Act.
[c] Informal institutions are unregistered and unregulated
[d] Vietnam Bank for the Poor

3.2.1 Formal institutions

Formal microfinance providers operate under prudential regulation (like commercial banks or microfinance banks) or special regulation (like Grameen Bank in Bangladesh). For example China's rural credit and cooperatives (RCC) provide micro-credit to 43 million rural farmers, while its urban credit cooperatives and city commercial banks serve the city-dwellers. In India the National Bank for Agriculture and Rural Development (NABARD) combines the state and the private commercial banks initiatives in providing microfinance. For instance, ICICI Bank under the NABARD programme offers a range of microfinance services to the poor. The Indian microfinance industry is also dominated by the mutually aided cooperative societies and the non-profit companies.

Nepal has a vast variety of formal institutions engaged in microfinance: commercial banks, development banks, finance companies and rural microfinance banks. Some 34 savings and credit cooperatives (SCCs) (semiformal institutions) have been licensed to conduct limited banking activity with non-members. We can say these semiformal institutions have been elevated to formal institutions as they are now regulated by the central bank. Nepalese formal microfinance is dominated by Small Farmer Development Bank (SFDB) with 189,000 member/borrowers followed by the Grameen Bikash Bank (GBB) with 130,000 clients. In contrast, formal microfinance in Pakistan is comprised of two commercial banks (Bank of Khyber and First Women Bank) and two specialised microfinance institutions (Khushali Bank and the First Microfinance Bank Limited). Philippine has aggressive sought to formalise a MFI regulatory framework. It's 'National Strategy on Microfinance' also encourages the formal financial system to embrace microfinance clients (Donaghue 2004). Thus, Philippines central bank statistics (2002) show one hundred and nineteen (119) banks engaged in microfinance of which only four (4) are specialised institutions.

Sri Lankan microfinance, too, has a wide network of formal financial institution including the cooperatives, rural banks and the thrift and credit cooperative societies along with commercial and development banks. Despite many Sri Lankan MFIs being highly subsidised and protected against private sector entry, the Hatton National Bank, the Seylon Bank and the Sampath Bank are all involved in microfinance. Finally, Thailand focuses on microfinance sector via a specialised financial institution, the Bank for Agriculture and Agricultural Cooperatives (BAAC[10]). So, in each country, microfinance has tended to develop differently with a few types of formal MFI providers dominating a nevertheless diverse sector.

3.2.2 Semi formal institutions

Semi-formal MFIs typically have no specific legislation but can register under an existing Act. Non-government organisations (NGOs) are the most common semi formal institution. In Indonesia for example, the range of semiformal institutions is vast with Badan Kredit Desa (BKDs, or village credit organisations), and LKDP, finance and insurance companies, cooperatives and credit unions, and NGOs. In contrast, in India NGO-MFIs are the main types of semi formal financial intermediary. These institutions help groups of informal organisations to transform into federations. In addition, some larger rotating savings and credit associations (ROSCAs) in India, also an informal organisation, have been transformed into semi formal institutions under the Indian Chit Fund Act 1982.

Moreover the NGOs may use commercial bank funds for on-lending. In Pakistan this includes semi-formal institutions include organisations operating under the National Rural Support Program with some 293,000 clients. Their structure falls somewhere between a government body and an NGO. At the same time Pakistan NGOs, like Kashf Foundation and Orangi Pilot Project, serve significant number of microfinance clients.

3.2.3 Informal institutions

The informal microfinance institutions, as the name suggests, are both unregulated and unregistered. They are both the most numerous type of MFI and the oldest form in each country and include both rotating savings and credit associations (ROSCAs) and self help groups (SHG). They are also very important in serving their target market. Indeed, the informal sector in Bangladesh[11], India, Philippines and Sri Lanka cover approximately 65%-75% of the credit supply to poor households. In Pakistan informal sector is even more important with 83% of this credit. Similarly, 20% of Chinese and Thais access the informal market for credit. In Central and Western China the informal market (specifically the farmers and micro entrepreneurs) serves 78%-90% households and overall in China informal markets have circulated loans of some US$8.6 billion. The Nepalese informal sector is dominated by SHG groups and informal savings and credit cooperatives[12]while in Pakistan and Vietnam, they are mainly ROSCAs[13].

In essence, the diversity in the microfinance providers helps determine which institution should fall under which regulatory environment. The formal institutions require prudential regulation that can help strengthen themselves through expanding outreach and improving free lending[14]. Regulatory and supervisory support is needed to protect the interest of both depositors and lenders. Finally, informal institutions might well be left alone except for fraud and allowed to grow to a sufficient size to be transformed into semiformal institutions.

4. Comparative analysis of regulation and supervision

The diversity of MFIs shown in the previous section obviously suggests a similar variety in their regulation and supervision. Although MFI regulation does vary from country to country, the focal point remains the same. This is that the regulation should be sufficient to protect depositors interests but not so prescriptive as to hamper poverty alleviation.

Table 2 details some of the key aspect of regulation and supervision among the sample countries. Typically, the governments or central banks handle MFI regulation and supervision in Asia. Alternatively, their supervisory authority may be delegated to an apex organisation such as Palli Karma Shahayak Foundation (PKSF) in Bangladesh NABARD in India with the ultimate regulatory power remaining with the government. Nevertheless, it is essential that MFIs also disclose sufficient information to maintain a standard accountability and transparency. The following discussion addresses regulation and supervision practice in Asia under five sections: the general approaches to MFI regulation, choice of MFI regulators, ownership and governance and finally, reporting and risk management tools.

Table 2: Microfinance regulation and supervision in Asia

Country	Registration	Administrator for registration and other related issue	Regulator	Supervision method
Bangladesh	All NGOs/MFIs Companies Act 1994, Bank Companies Act 1991,Societies Registration Act 1860, Section 28 – Association Not for Profit - of CA, Securities and Exchange Commission, NGO Affairs Bureau, The foreign Donations (Voluntary Activities Regulations Ordinance, 1978 PKSF rules and regulations).	Registrar of cooperative societies.	NGO-MFIs: Central bank’s Microfinance Research and Reference Unit.	Off-site and onsite inspection
China	1995 Commercial Banking Law, 997 Regulations for the Management of Rural Credit Cooperatives, Regulations for the Management of County Level Rural Credit Cooperatives Union, Provisional Management Rules for Rural Credit Cooperatives at Provincial, Municipal Directly Under the Central Government and Autonomous	Operation permit granted from Banking Supervision and Management Bureaus then register with Industrial & Commercial Administration Authority for license and the legal form requires minimum of 500 members.	RCCs: China Banking Regulatory Commission, Department of Cooperative Finance supervises	Random on-site and off-site inspections from the CBRC. Each RCCs’ internal Board of Supervisors monitor

	Regional Level.			
Indonesia	Banking Law of 1992.	Bank Indonesia	Bank Indonesia(rural banks and village credit institutions, provincial government LDKP	Off-site and on-site inspection
India	Andrha Pradesh Mutually Aided Cooperative Societies Act 1995, Societies Registration Act 1860.	State and National Credit Cooperatives: Reserve Bank of India & Central Registrar respectively, NGOs and MACS –state government, fees determined by the state government.	Central bank (RBI)	Off site and on-site inspection
Nepal	Bank and Finance Ordinance 2004, Financial Intermediary Societies Act 1995, Cooperative Act 1992.	NGOs: Ministry of Home Affairs, and annual renewal registration fee of US$1.36, Cooperatives: Ministry of Agriculture.	MFIs: Central bank	Central bank conducts inspection , no on-site inspection mandated
Pakistan	Microfinance Institutions Ordinance 2001 NGOs: Societies Registration Act 1860, The Voluntary Social Welfare Agency, the Trust Act 1882 or unregistered Cooperatives are under Cooperatives Societies Act 1992	MFIs: public limited company, administered by central bank.	Central bank	On-site and off-site inspection
Philippines	Rural Banks Act 1992, Thrift Banks Act, Law on Trusts and Non-Profit Foundations, cooperatives code 1990	NGO-MFIs: Registration with Securities and Exchange Commission, central bank or Cooperative Development Authority, cooperatives: Cooperative Development Authority, legal form of NGOs: corporate, non profit or cooperative	Central Bank and Securities and Exchange Commission	On-site and offsite review. NGO-MFIs: PCFC Delegated supervision Other: MFI networks monitor observance to standards
Sri Lanka	Cooperative Societies Law and Rules, Companies Act, No. 17 of 1982 Voluntary Social Service Organisations Act of	NGOs: Social Service Department, Cooperatives: The Registrar and Commissioner of Cooperative	Cooperative Development Department and for NGOs the central bank.	Cooperatives: onsite and off-site inspection

	1980	Development, legal form of NGOs can be private or non profit organisation		
Thailand	Cooperatives: The Cooperative Societies Act B.E. 2511 (1968) Regulation on the establishment of Savings and Credit Cooperatives in communities B.E. 2521 BAAC: The Bank for Agriculture and Agricultural Cooperatives Act, B.E.2509, 1966	BAAC: Ministry of Finance	BAAC: Ministry of Finance and Cooperatives: Ministry of National Development, supervised by Registrar	Cooperatives: Inspection by registrar
Vietnam	Decree on Organisation and Formation of Microfinance Institutions in Vietnam (2004), Law on the State Bank of Vietnam (1998)Law on credit Institutions(1997)	The legal form of MFIs: NGOs or company, upon acceptance of application the license is issued in 90 days.	State Bank of Vietnam regulates and supervises	MFIs: off-site and on-site supervision done at branch or sub-branch level.

Source: CGAP Microfinance Gateway.
http://www.microfinancegateway.org/resource_centers/reg_sup

4.1 Approaches to MFI regulation

An optimal MFI regulatory environment should be designed to facilitate the objectives of these institutions (ADB 1990). This design may vary from country to country but the regulatory plan should be kept simple enough for the clients and authorities to work in harmony. The need for regulation also much depends on the nature of claims and the intermediary (Dewatripont and Tirole 1994). And so the approach may vary from government regulation at one end to purely private involvement on the other. They are classified here under three approaches: self-regulation (through governance/non prudential regulation), banking law regulation and special law regulation.

4.1.1 Self-regulation

The self-regulation concentrates this responsibility in the hands of the MFIs themselves without recourse to the government. So regulation and supervision is in the form of operational standards designed and enforced by an industry umbrella body or apex organisation. Supervision can be also conducted by a rating agency (Staschen 1999). This lack of government intervention can lead to reliability problems such as lack of depositor protection and even safe-guarding of the financial system. The domestic apex organisation, Palli Karma Shahayak

Foundation (PKSF) in Bangladesh is self-regulated in a sense they are really autonomous despite being government sponsored body. In contrast, the other apex organisations, such as NABARD in India, show considerable government intervention. Non-governmental organisations (NGOs) styled semi-formal MFIs are self-regulated in Philippines. In case of informal institutions, like rotating savings and credit associations (ROSCAs) or other savings clubs, have a built-in system of self regulation of sorts as their loans are self liquidating and time binding (Wright 2000).

4.1.2 Banking law regulation

Banking law regulation is the other extreme where MFIs are simply another form of financial institution and so regulated accordingly. Most countries like Bangladesh, Nepal, Philippine, Thailand have an existing banking or financial institution act and this is simply be extended to cover MFIs too. This approach has had the advantage that a regulatory body already exists to enforce the related law. There is also some logic as many commercial banks already provide (or are considering) microfinance. Indeed, commercial bank microfinance has the advantage that these institutions are already regulated and are more likely to have sound governance structure, cost effectiveness and profitability. They also more likely to meet other conditions like financial disclosure, capital adequacy and the ability to raise their own funds. Under this approach, MFIs supervision can take place on-site or off-site by the government authority, an external body or private supervisory institution (Staschen 1999). It would similarly monitor MFIs activities and their proper and effective utilisation of funds. Under this structure the government might also more easily assist MFIs with liquidity at times of cash-flow problems (Staschen 1999). While some question whether the banking law is a good fit for MFI activities, Greuning, Gallardo and Randhawa (1999) show existing financial regulation can be modified to suit MFIs through tiered banking and graduated regulation.

Therefore, banks regulators can promote risk management under a statutory framework that allow MFIs systematically to develop and transform into more full service organisation (Greuning et al 1999). There are already many such examples in Asia; Bank Rakyat Indonesia in Indonesia and the Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand. Bangladesh, China, Philippine and Vietnam have are all nominated by their central banks as their interim MFIs regulator under the banking law. In Nepal microfinance development banks are now regulated under the ‘Bank and Financial Ordinance 2004’ and so they are subject to normal prudential regulation and supervision.

4.1.3 Special law regulation

The final possibility is to regulate MFIs under their own special legislation. This approach potentially offers lower barriers to entry and may best suit the MFI needs. It is also valid where there are several financially self-sufficient (or near to) MFIs (McGuire and Conroy 1999). The actual regulation and supervision can still be conducted by the central bank. The disadvantage of the special law approach is that the regulator may effectively be captured by the industry. So, its attention becomes focused on model building and MFI development rather than prudential regulation (Hanning and Mugwanya 2000). Moreover, this reduces the incentive to merge with other NGOs to transform into a bank.

Special regulation may also lead to increased costs of supervision and political interference. In Pakistan, for example, its ‘Microfinance Institutions Ordinance’ allows microfinance banks to operate under their own specific MFI guideline and be regulated and supervised by the State Bank of Pakistan (central bank). In Bangladesh the Grameen Bank is under special regulatory environment the ‘Grameen Bank Ordinance 1983’.The external, domestic and macroeconomic stability, good governance and policies would determine the continuity of this specialized of regulatory treatment approach.

In summary, each regulatory approach has its pros and cons, but placing MFIs under the banking legislation seems more effective than special MFIs legislation. Experience in developing countries suggests self regulation fails due to enforcement problems. Also engaging an apex organisation for supervision, as a delegated authority by the central bank may give rise to disagreements and conflicts of interest. The right choice will depend on any country specific MFI issues, deficiencies in supervisory capabilities and knowledge, the time and ability of the MFIs to grasp the proposed regulatory environment.

4.2 Choice of MFI regulators

Our sample contains a mixture of MFI regulators. The central banks and government are the major regulator and supervisor along with apex bodies or the second tier organisation. Thus, MFI regulators can be divided into two groups: first, those directly under central bank regulation and supervision second, those under other government bodies or apex bodies. In our study we also find NGOs that were once semi-formal institutions have since developed into formal institutions under direct central bank regulation and supervision. Some informal institutions, like the chit funds in India and in Thailand, have also graduated to semiformal status as they are now formally registered under an Act. The following discussion helps us to explicitly define the regulators of the NGO-MFIs, cooperatives and banks across the sample countries.

4.2.1 Directly under central bank regulation and supervision

Central banks may help in developing a suitable financial infrastructure for MFIs. As well as MFI capacity building and rationalising directed credit programs (Llanto 2000). For example the central bank in Philippine (BSP) encourages MFI development by opening opportunities for private sector investment, and allowing market forces to operate. As shown earlier in table 2, central banks appear the most common MFI regulator. In addition, other government line agencies may administer the registration and related issues such as permission to operate, fees registration etc. It also shows the range of Acts and laws that have evolved to recognise the significance of MFIs. The following discussion is divided into semiformal and formal institution to show the similarities and diversities in regulation and supervision.

4.2.1.a Semi formal institution (Non government organisation)

The semiformal institutions, although only registered, nonetheless have gained importance in size and outreach. This has interested central banks in regulating and supervising the larger NGO-MFIs. In Bangladesh a steering committee of the central bank's 'Microfinance Research and Reference Unit' (MRRU) has been appointed as an interim regulator of NGO-MFIs. The licensing and registration of NGO-MFIs have now been quite precise. Similarly, rural credit cooperatives (RCC) in China operate under the regulation and supervision of Peoples' Bank of China (PBC), the China Banking Regulatory Commission (CBRC) and the Department of Cooperative Finance. Nepal has considerable number of NGO-MFIs and Savings and Credit Cooperative Societies under its 'Financial Intermediary Act'. Under this Act the institutions regulated and supervised by the central bank are licensed to mobilise deposits from the general public and commercial banks. Sri Lankan NGOs are regulated by the central bank but registered by the Department of Social Services (a government body). In Vietnam, NGOs and other social organisations providing financial services independently are under central bank licensing and supervision.

4.2.1.b Formal institutions

The formal institutions providing microfinance such as commercial banks and finance companies are already under central bank regulation. Grameen Bank's formal bank status, for example helped it to mobilise member savings and raise capital. In India non bank finance companies are regulated and supervised by the Reserve Bank of India (central bank of India) and subject to normal the prudential and capital adequacy requirements. In Indonesia all commercial bank microfinance is regulated and supervised by the Bank Indonesia except for some small institutions (like BKD) which are under BRI supervision. In Pakistan MFIs have grown rapidly either through the transformation or the creation of microfinance to access the favorable regulatory environment under the State Bank of Pakistan.

In the Philippine the central bank[15] (BSP) regulates 100% locally owned rural and thrift banks. It also offers a rediscounting service to refinance their microfinance loans. In Vietnam, two major government controlled banks are under central bank supervision; the AgriBank[16] and Vietnam Bank for Social Policies (VBSP). The decree[17] to regulate the MFIs in Vietnam allows the VBSP to be independent of the former in case of supervision. Besides banks, the induction of market economy led to the collapse of some 7,200 cooperatives but with the effective central bank regulation and supervision over 1000 Cooperative People's Credit Funds, a new kind of Vietnamese cooperatives, have surfaced.

4.2.2 Under other government or apex bodies regulation and supervision

Within this environment the MFIs are mainly cooperatives and non governmental organisation (NGOs). An exceptional case is Indonesia where the rural banks are under government regulation and supervision other than the central bank. The following section discusses the semiformal and formal institutions regulated by their other government or apex organisations.

4.2.2 a Semiformal institutions(Non government organisations (NGOs)

Small to medium NGO-MFIs either operate under the regulation of the government or the apex organisation or are under severe negligence by the authorities. Our sample show in Bangladesh, the Palli Karma Shahayak Foundation (PKSF), an apex organisation regulates and supervises partner NGO-MFIs only. In contrast, Chinese MFIs are registered as NGOs but bear no formal legal status to operate. Similarly, majority of the NGO-MFIs in other sample countries are unregulated but registered. For example, the NGOs in Indonesia are unregulated but are registered and /or licensed by other state authorities or regional governments (Bank Indonesia and GTZ 2000). This may assure some sort of off site monitoring by the government but not direct regulation or supervision. The NGO-MFIs in Nepal are usually registered under Ministry of Home Affairs. In Pakistan one wholesale microfinance institution the Pakistan Poverty Alleviation Fund (PPAF) regulates and supervises some of the small MFIs. In Philippine some NGOs are self-regulated, owned by the private trustees and monitored by the apex organisations and NGO-MFI association. Other NGO-MFIs are regulated by the Securities and Exchange Commission (SEC) and the central bank.

4.2.2 b Formal institutions (Banks and cooperatives)

Within this regulatory environment the formal institutions like the commercial banks and cooperatives are under an other government body. This is an exception for the commercial banks and is seen in the rural bank form of LDKP[18], regulated by the Ministry of Finance and supervised by provincial governments and regional development banks (BPD). Some Indonesian deposit taking MFIs are regulated and supervised by BRI[19]. Indonesia differs from other countries as it does not have large independent NGO-MFIs, the main microfinance providers are state owned or private commercial banks.

The other sample countries are structured similarly. In Bangladesh, for example the cooperatives are under the regulation of government registrar of cooperatives. The registrar has little preventive or protective regulation and conducts minimal or no supervision (Ahmed 2004). In India mutual aid cooperative societies or MACS receive financial services from the government but are free from any government intervention. In Nepal cooperatives are supervised by the Ministry of Agriculture, Department of Cooperatives. In Thailand they are regulated by the Ministry of National Council and supervised by the registrar except for the Bank for Agriculture and Agricultural Cooperatives (BAAC). The latter is regulated and supervised by the government and Ministry of Finance. In Sri Lanka the cooperatives hold a large share in MFI industry whose regulation is with the Cooperative Development Department.

4.3 Ownership and Governance

Ownership and governance is a key issue in regulating MFIs. Under international standards, the owners, board members, managers must be certified as ‘fit and proper’ and must be accountable for their positions (Robinson 2005). This issue should apply to commercial banks, for-profit, non-profit, and mutual cooperatives equally, but MFIs present their own challenges in terms of compliance both in respect to ownership and governance. It is believed good regulation will install a defined ownership and governance structure. The following discussions are on ownership and governance of MFIs across the sample countries.

4.3.1 Ownership

Where MFIs lack formal ownership structures, this may lead to poor accountability and profit orientation. A clear ownership structure is important as these owners should have an obvious interest in how their MFIs operate. Proper ownership structure adds value to the organisation with more access to financial resources, some protection from government interference and management experience from like-minded financial institutions (Wright 2000). In Bangladesh, 88% of Grameen Bank ownership is spread over 1.5 million borrowers and the remaining 12% is with the government. In contrast, most NGO-MFIs have no defined ownership structure. In India the task force formed to regulate MFIs focuses on the self-regulation of the NGO-MFIs (central bank regulation for deposit taking MFIs) but lacks any precise definition of ownership and governance. In Nepal MFI ownership is typically concentrated with the government, central bank, state commercial banks and a minority held by private commercial banks. Moreover, the regulatory framework should necessitate private investors with equity participation so to enable them to exercise power in major corporate decision (Jansson, Rosales, Westley 2004). This is not to say that private investors are the best MFI owners but on an average they do monitor the management of their investments more carefully than donors and social investors (Jansson et al 2004).

4.3.2. Governance

The ownership composition in turn should result in a governance structure to overcome shortcomings like weak internal controls and poor risk management. Perhaps, introducing depositors and borrowers as MFI shareholders may help address the ownership issue as mentioned in the previous section. However, increased size will eventually require professional MFI governance such as Grameen Bank in Bangladesh and BRI in Indonesia. According to Otero (1998) the two elements of good governance, ‘duty to loyalty’ and ‘duty to care’, are essential for the best interest of the institutions and to make good decisions. This in turn requires the regulators to focus on board composition and sound policies and management. The Grameen Bank governance is by board of directors: (three government appointees and nine member shareholders). In contrast, Khushahali bank in Pakistan is governed by an autonomous, private-sector board comprising of professional bankers and social developers. The governance issue is also varied among the apex/wholesale organisations such as India's NABARD is governed by the board of directors appointed by the central government. The semiformal institutions like NGO-MFIs often have weak boards and dominant executives that lead to ineffective governance[22].

Another aspect of good governance is the monitoring of insider related transaction. The development bank in Nepal, the microfinance banks in Pakistan and BAAC in Thailand strictly prohibit insider trading or connected party lending. In contrast, the rural and thrift banks in Philippines first require written approval from the majority of bank directors. Chinese MFIs however seemingly have not even that limitation as the management, owners and other connected parties are granted loans as matter of course but on the same terms as normal clients. Moreover, cooperative ownership is often viewed as ineffective in promoting good governance as cooperatives seldom aim at maximising their profits (Wright 2000). Nevertheless, the good examples of member controlled MFIs are visible in India such as the SEWA (an urban cooperative bank) and the Women's Thrifts Cooperatives.

4.4 Reporting and risk management tools

Good regulatory and supervisory practice is supported by quality financial reporting and risk management. Some MFIs show high degree of reporting transparency. Risk management has been clearly defined in larger MFIs but still many others have no established information system, internal credit rating or scoring system. These reporting and risk management tools are covered under the following three sections: capital adequacy, flexibility in interest rates, disclosure and auditing and internal controls.

4.4.1 Minimum capital and capital adequacy ratio

A minimum capital requirement serves a number of functions. First, it requires the organisers to obtain a commitment fund before starting the business. Second, it serves as a cushion against MFI losses. Third, it provides a source of long term non-withdrawable finance. Finally, it also helps to build confidence among the depositors, investors and other lending institutions. Our study finds in Nepal MFIs often choose to register as savings and credit societies in order to avoid bank prudential regulations, such as minimum capital requirements and capital adequacy ratios. In contrast, rural banks operating as MFI in Indonesia require a minimum capital of only US$6,000 to US$0.59 million depending on their location. Moreover, the Khushhali Bank in Pakistan, a private -public microfinance bank, exists with a US$ 27.9 million. This is the highest MFI capital in our sample study. In contrast, the Grameen Bank in Bangladesh has only US$

2.5 million. In Philippines, rural banks require capital less than the thrift banks. In Sri Lanka and India small banks are encouraged to operate and maintain a minimum capital ranging around US$1.8 million. The credit only MFIs in Vietnam show a lower capital requirement compared to deposit taking MFIs.

Capital adequacy ratio (CAR) further protects depositors as MFIs grow in size and expand their risk profile (especially credit risk). The majority of MFIs in the sample must maintain CAR at minimum 8% of risk weighted assets. In Pakistan the special MFIs ordinance requires a CAR 15%; the highest within sample. One justification for a high CAR may be the credit risk in small lending may result in much higher non-performing loans. In Nepal, Philippine and Thailand this ratio ranges between 10%-12%.

4.4.2 Flexibility in interest rates

The flexibility in interest rate setting varies from country to country. Operational rules are flexible in some countries where bank styled MFIs are allowed by the central bank to set their interest rate such as in Indonesia and in Pakistan. Table 3 portrays the MFIs flexibility in setting the interest rates. Obviously, informal institutions are unregulated hence set their own interest rates. The formal MFIs in Bangladesh, China, Indonesia and Nepal show some level of flexibility in setting their interest rates[23]. The cooperatives in most sample countries have the greatest benefit as no interest rate ceilings exist except in Thailand where thrift banks and cooperatives are limited to 19%. The semiformal institutions in China, India, Indonesia, Nepal, Sri Lanka, Thailand and Vietnam, however, do have interest rate ceilings. China though is reducing the government's interest rate powers even on formal MFIs to allow an optimal financial resource allocation and macroeconomic management (CGAP 2003). Moreover, some NGO-MFIs (like in Pakistan) operate at a flat rate and other licensed NGOs (like in Nepal) have no interest rate restriction but these are monitored by the central bank. The central banks in Philippines and Vietnam play a greater role in regulating micro credit interest rates. Nonetheless, the apex organisation providing wholesale microfinance limits the interest rate to be charged by the member organisation to the poor households such as PKSF in Bangladesh, NABARD in India. The extreme case in our sample is the informal institutions that operate with no interest rate restriction. The Indonesian informal institutions charge the highest rate to their clients for the financial services.

Table 3 MFI Interest rates in Asia

Country	Formal Institutions (p.a.)	Semiformal institutions (p.a.)	Informal institutions (p.a.)
Bangladesh	In 2002 all interest rate restrictions have been removed (except for export lending rates) and linked the interest rate on national savings certificates to a market-determined treasury bill yield. Cooperatives interest rates must be published in cooperative's bylaws. General 12%-15%, Grameen Bank 20%	There is no cap or spread on interest rate offered for deposit and loan in case of NGO-MFIs. However, in practice on average NGO-MFIs offer mostly 5-7% interest on deposits to the members and charge	Informally charged by the money lenders. 120%-240%

		15% interest on loan in flat method.	
China	The government fixes the deposit and the lending rate although the RCC have some flexibility around that range. In 2005, the benchmark one-year bank deposit rate is set at 2.25% and the flexibility is that their deposit rate can be 0.9 times lower. The one-year lending interest rate is 5.58%. The maximum upper limit of RCCs' lending interest rate is 2.3 times this benchmark rate.	Interest rate ceilings exist 8%-18%	No restriction imposed.
India	Interest rates restrictions on commercial bank for retail loans below US$5,000 (all microfinance and beyond) remain and caps on deposit rates exist	Restriction on interest rate 20%-40%	SHG own interest rate determination. 24%-120% depending on state.
Indonesia	BRI sets prices, procedures and interest rates for village credit institutions (BKDs); cooperatives interest rate are set by the members typically around 18%; rural banks charge : 36%-48%	Interest rate restrictions exist. 28%-63%	Informally charged by the money lenders. 120%-720%
Nepal	Development banks and non bank financial institutions: of NRB can formulate interest rate policies, but delegates this to the banks financial institutions in question. Cooperatives no restrictions on interest rate.	Licensed NGOs: No restriction .Although the NRB reserves the right to require the FINGO to increase or decrease its rates. 18%-24%. Unlicensed NGOs: none	Informally charged by the money lenders. 60%-120%
Pakistan	Microfinance Bank and Khushali Bank: No restriction on interest rates and pricing of products and services 18%-20%	Kasf Foundation: lends at 20% service charge on flat rate basis.	Informally charged by the money lenders. 50%-120%
Philippine	Bangko Sentral ng Pilipinas *(BSP)* regulates micro credit interest rates and interest rate shall not be below market rates. For cooperatives: no interest rate ceilings. 24%-29%, rural banks around 34%	For NGO-MFIs standards are set by MFI networks. 60%-80%	120%+, Informally charged by the money lenders.
Sri Lanka	Interest rate ceilings exist.	Restriction on interest rate charged. 15%-22%	Informally charged by the money lenders
Thailand	BAAC: deposit rate set by Bank of Thailand (at April 2004 0.75% p.a. for normal savings and 1.0% p.a. for special savings). In 1999 BAAC board approved interest rate policy reform. From 2002 minimum lending interest 8%. BAAC has the flexibility to charge preferential interest rate to those borrowers with good track record.	Interest rate ceilings exist. 15%	Informally charged by the money lenders.
Vietnam	20%-34% Interest rates are decided by	Restriction on interest	Informally

	the central bank, with a range of flexibility surrounding the set rate. Cooperatives are granted higher rates than banks or NBFIs.	rate. 12%-21%	charged by the money lenders. 84%-120%

Sources: Microfinance Gateway; resource centre on comparative analysis of regulation and supervision of MFIs
Sinha (2003), www.adb.org, www.mixmarket.org,

4.4.3 Disclosure and auditing

Formal and the semiformal MFIs have their disclosure and reporting requirements enforced by their regulators and must provide them with annual or quarterly audited financial statements accordingly. The new regulator for MFIs in Bangladesh also requires the NGO-MFIs to submit receipts and payments accounts, income and expenditure statements, balance sheets, cash flow statements, changes in equity/fund, statement explanatory notes and portfolio reports. Cooperatives in Bangladesh, Philippines and Thailand submit quarterly reports and have their accounts audited by an external auditor appointed by the registrar. Moreover, the rural banks and thrift banks in Philippines have daily monitoring of their loan releases, collection and arrears. The central bank may also require external audit and for them to publish their financial accounts in local newspapers. This disclosure requirement also forces MFIs to report their loan loss provision, loan loss reserve and write offs.

4.4.4 Internal controls

The aim of internal controls should be to monitor and manage risk, minimise fraud and irregularities, and control employee behavior, (Rachmadi 2004). Despite, internal control being weak in developing countries, MFIs like BRAC[24] in Bangladesh, BRI in Indonesia and BAAC in Thailand have all developed standard management information system (MIS) and procedures these operations and units. Specifically, the MIS in Thailand requires the borrower to be handled by credit chief and depositors be recorded separately by the tellers. This helps to assess and compare performance which results in transparent and coherent operational system. Bangladesh similarly requires the MFIs to maintain the system of internal control particularly in respect to loan management. An internal credit rating system also exists for microfinance providers like PKSF in Bangladesh, RCC[25] in China, MACS[26] in India and public credit registry in Vietnam. Thus MFIs should ensure internal control system via proper implementation of business strategy and policies.

5. Policy implications

The legal status of MFI is vital to attract investors. The regulatory status conveys a signal of MFI's medium and long term prospects. The extent of prudential regulation should depend on the level of risk these institutions pose on the financial system. Given the MFIs' growth, particularly in savings mobilisation, they will eventually need some form of regulatory framework. Selecting the correct approach is important as over regulation will then hamper MFI services and so hurt the poor. Table 4 highlights the difference between the formal (banks), semiformal (NGOs) and informal institutions (ROSCAs) and so their growing impact on the poor households. Policymakers must realise that these semi formal and informal MFIs offer a diverse range of products and services to their target groups. Moreover, these semiformal institutions are achieving operational self-sufficiency, deriving positive returns and minimising their risk. So, ideally regulation policy should not hamper their current activity but rather further enhance their operations.

Table 4 Comparison of Banks, NGOs and ROSCAs

	Formal institutions (Banks)	Semi formal institutions (NGOs)
Regulatory environment	Mainly under central bank regulation except small institutions like BKDs under the BRI regulation and supervision.	NGO–MFIs: under government or second tier institutions. exceptions under central bank regulation and supervision
Return	Profit margin: for BRI: 22.33% and Ruhuna Development Bank in Sri Lanka 18%, Grameen Bank in Bangladesh 1.20% ROA: 5.52% for BRI and -.87% for Nirdhan Uthan Bank in Nepal	Profit margin: ASA in Bangladesh 63% and in Pakistan Kashf Foundation shows 47%. ROA: ASA in Bangladesh 15% followed by Kashf Foundation in Pakistan 9%
Flexibility	Deposits can be made at any time	Varies monthly or weekly deposits
Transaction cost	Occasional small fees	Varies
Accessibility	Difficult to access as banks are often not close to the clients, some literacy and numeracy required	Relatively easy compared to the formal, branches close to the clients house, door to door service is also provided
Products	First Microfinance Bank Limited in Pakistan and BRI in Indonesia : Provide insurance and fund transfer services, training and consulting	Kashf Foundation In Pakistan, ASA and BRAC in Bangladesh : Training and insurance
Additions services	Development banks: second tier lending to MFIs, education, business development services	NGOs in Nepal provide education, health, business development services
Targeting	Household survey forms used by Nirdhan Uthan Bank Limited in Nepal targeting poorest 20% of the population	Vietnam: Household survey, ASA in Bangladesh use socio economic survey form and target clients between age 18-55
Operational self sufficiency	BRI-microfinance division in Indonesia: 129% , Ruhuna Development Bank in Sri Lanka providing 81%-90% microfinance	ASA in Bangladesh: 269.23%, Kashf Foundation in Pakistan: 187%

	has reached 122%	

Source: www.mixmarket.org
Data collected for all countries financial year as of 2003 except Sri Lanka financial year as of 2002

Thus, deposit taking MFIs should be subject to prudential regulation (tight regulation) whereas credit- only MFIs are subject to non-prudential regulation (light regulation). Too little and too much regulation are both harmful for MFIs as they lack the capacity to manoeuvre within the regulatory system. It is essential to judge the pros and cons of various regulatory proposals before introducing them. One threat of regulation can be the high compliance cost compared to the perceived benefit. In this regard, regulation should focus on internal controls, minimum capital requirement standards so that MFIs can generate profits within their range of operations. Policy makers should seek to develop more clear and flexible policies and reduce the interference of the politicised interest groups.

The following discussion seeks to provide some practical suggestions for the policymakers and other government authorities about MFI regulation. The crucial factors considered are: implications for the government, implications for the central bank, implications for the private sector and finally, implications for donors

5.1 Implications for governments

Once a MFI is regulated, there may be a variety of regulators (central banks, commercial banks, apex organisations or the private sector) but the government remains the ultimate regulator (Dewatripont and Tirole 1994). This role will vary depending on the country's macroeconomic, financial system, performance of the microfinance industry. Table 1 and specifically table 4 shows the three main institutions such as banks, NGOs and ROSCAs. In practice, the former two are either under government and/or central bank regulation while the later is member regulated.

The direct government intervention may not be justified if too much intervention leaves the institution politicised. One of danger of government regulation is a potential stifling of innovation and flexibility of formal deposit taking formal institutions (which may have transformed from a NGO-MFI to a formal institution) (Vogel 1998). It is evident that government ownership of banks for example may have unfavourable outcomes and even be associated with corruption (Barth, Caprio, and Levine 2004).

Due to the nature of semiformal institutions, the government might better strengthen their regulation and supervision environment rather than directly intervening as a regulator. Eventually, direct intervention can only be justified if it improves the poor's access to credit (Yaron, Benjamin and Piprek 1997). Moreover, governments can help provide the essential environment for maintaining a reporting standard and developing institutional mechanisms; like credit bureaus and rating agencies to improve the availability of information of borrowers. A large number of government microfinance programs running in Bangladesh, Nepal and Vietnam, but their performance is not comparable to the leading MFIs. The credible government development policies can help the MFIs effectively to integrate with the formal financial market. Nonetheless, the informal institutions should also be under some non prudential disclosure requirements to protect clients from fraud or more a consumer protection role.

5.4 Implications for central banks

Central bank as a regulator should play a more active role. First, a separate team of professionals is required for the microfinance work. Second, sufficient training and assistance should be provided to upgrade and integrate the MFIs in the financial markets. Third, the central bank governor may be responsible for granting license to MFIs when completely satisfied that conditions are met or MFIs are capable to meet the prudential regulations. Fourth, central banks may also delegate their authority to a commercial bank or apex organisation. In this case the central bank should be equally responsible for any non-compliance. Hence, regulation should generate a rapid and balanced growth, enhance transparency of the industry.

5.5 Implications for private sector

The private sector has often avoided microfinance for several reasons: the high risk associated with lending, high transaction costs, involved with small loans difficult and expensive accessibility (World Bank 2001). Fortunately, this scenario is changing over the years; Bangladesh, Nepal and Pakistan now all have private sector involvement in successful semiformal institutions. This participation has helped change the ownership structure, reduced funding costs, brought active governance, and enhanced outreach and effectiveness in lending operations. Besides, specialised operations, they can offer adherence to prudential norms set by regulators.

5.6 Implications for donors

The donors are the investors and their involvement in regulating MFIs is essential. The donors should assist closely with the government body/central bank to develop a framework for licensing, regulating and supervising MFIs and enforcing contracts. A carefully designed system linked between donors, shareholders, members and the board of directors and trustees will enhance effective governance of the MFIs. The donors' should focus on building institutional capacity (includes training facilities, diversified menu of products and services at a competitive price), elaborating the lending policies, underpinning the MFIs to follow sound accounting practices and sufficient financial disclosure.

6. Conclusion

This paper examined the regulatory policy and supervision of the MFIs in Asia. The cross comparison has helped identify those features that appear most effective. Direct regulation and supervision under the banking law have lead to some positive outcome in Bangladesh, China, Nepal, Pakistan, Philippines, and Vietnam. However it is too early to decide for sure in regards to Bangladesh and Pakistan. The indirect central bank regulation and supervision in Indonesia, where Bank Rakyat Indonesia is authorised by Bank Indonesia to supervise branch network, also proved an effective policy approach. Other regulatory and supervisory authorities include other government bodies or the apex organisations, where Thailand's BAAC has been most successful. However, Pakistan has also formulated special MFI law whereby the central bank also plays a vital role. Finally, the NGO-MFIs show a mixed picture where self regulation by the NGO-MFIs association or apex bodies (like in Philippines) or regulation and supervision is run solely by the apex organisation (like in Bangladesh, India and Pakistan). While these latter two approaches have their merits, experience suggests self regulation is not as effective and special regulation similarly impedes the growth of the microfinance industry.

MFIs ownership and governance also needs addressing as many NGO-MFIs lack a formal structure. However, in the narrow definition of governance, we can find good governance in large MFIs in Bangladesh and India. The ownership structure, governance and lending to connected parties such as directors; family members should be addressed while formulating regulation to optimise MFI productivity.

It is also evident that MFIs typically maintain prudential capital and liquidity reserves. MFIs also usually have some flexibility in the interest rate charged to their clients. Better disclosure and reporting requirements are still needed as are internal MIS and credit rating systems. The problem is that many MFIs do not consider these aspects of their operations quite seriously as their outreach related performance indicators.

It is not simply a matter of creating the legal basis for the proper regulatory environment and then waiting for the regulation to work as expected. It instead requires a constant dialogue among the regulators, the MFIs and the MFIs' borrowing and funding clients. Some may argue that the compliance costs will be just too expensive and work against the public (read MFI borrowers) interest. Instead, the reverse may well be true. A poorly developed regulatory system resulting in a suboptimal MFI industry has an even higher opportunity cost that of the potential financing opportunities denied that nation's poor. This opportunity cost is something that a proper and well functioning regulatory system should well control.

Endnotes

1. Some well-known MFIs include, the Grameen Bank (Bangladesh), BRAC (Bangladesh), ASA (Bangladesh), BancoSol (Bolivia), Bank Rakyat Indonesia (Indonesia).
2. Some well-known donors include United Nations Capital Development Fund (UNCDF), World Bank, Asian Development Bank, Deutsche Bank Microcredit Development Fund.

3. These information asymmetry problems are due to heterogeneity among their clients, firms and households, little documentation of credit histories, and minimal financial statements and project feasibility studies (Gonzalez-Vega 1998). This information asymmetry also leads to difficulties in enforcing loan contracts.
4. Non prudential regulation can address other operational issues like lenders charging high usurious interest rate, improper way of collecting debt
5. Pyramid schemes refer to the practice of paying interest on earlier deposits with the funds raised form new deposits. They are also known as Ponzi Schemes.
6. Breadth is usually in terms of number of clients (borrowers and savers) and depth measured in terms of average loan balance per borrower and percentage of women clients.
7. The State of Microcredit Summit Campaign Report (2005) shows that by the end of 2004, 3,164 micro credit institutions reached 92.27 million clients in which 66.6 million clients were among the poorest and this figure affected some 333 million family members. The institutional action plan demonstrates 330 institutions among which 210 are dominated by Asia.

8. Even so South-Asian MFIs like the NGO-MFIs in Bangladesh have disbursed some US$3.257 billion quite similar to thrift banks in Philippines.

9. This demonstrates ASA's objective to be productive and cost efficient.

10. BAAC has undertaken gradual reform process from short-term agricultural loans to non-farm micro and small enterprise lending both in its own right and through its agricultural associated cooperatives (Donaghue 2004).

11. An interesting study by Rutherford (2005) show in Bangladesh the informal sector is the dominant player in providing savings and lending facility to the very poor, upper poor and near poor.

12. These informal groups stand with 120,000 borrowers (240,000 members) with a repayment rate of 95%.

13. ROSCAs can be formed spontaneously or organized by the NGOs.

14. This can be indirectly through funding semiformal institutions or lending directly to the poor households

15. The Philippine central bank has allowed informal money lenders to register as 'private investors' in order to reduce interest rates and increase outreach.

16. Formerly known as Vietnam Bank for Agriculture and Rural Development, VBARD

17. The decree introduced in 2004.

18. LDKPs have been encouraged to convert into BPRs.

19. Some NGOs have transformed into rural banks (People's Credit Banks, BPRs) which are regulated by the central bank but supervised by the BRI.

20. BAAC, is a specialised bank, under the Cooperative Act with decentralised operations. Lately, a bill has been passed for the transformation of BAAC into a rural development bank.

21. This focus of regulatory framework should require that the private investors are not involved in excessive risk taking behaviour (Vogel 1998)

22. However, BRAC in Bangladesh are exceptional which proved good governance dominated by the non executives (BRAC homepage).

23. Specifically, in Bangladesh the fear of interest rate restrictions prevent the furtherance of legal and regulatory reform.

24. The internal control of BRAC is dealt by Internal Audit, Monitoring and Financial monitoring section.

25. Each household is rated and provided a report on their line of credit. MIS China International Center for Economic and Technical Exchanges (CICETE)

26. MACS in 14 branches have established Financial Accounting and Management Information System (FAMIS). Micro-Credit Ratings and Guarantees India Ltd (M-CRIL) the only one in Asia.

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