# ARE THE MACRO PRUDENTIAL POLICIES APPLICABLE TO MICROFINANCE INSTITUTIONS? – A CASE OF SRI LANKAN MICROFINANCE INSTITUTIONS

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**ABSTRACT**

*Before the existence of first Co-operative Rural Bank in Sri Lanka, villagers had the habit of borrowing money from either relatives, friends or boutique owners, etc. or went for Rotating Savings and Credit Associations (ROSCAs) or 'Cheetus/Seetus' which played a crucial role in providing finances to villagers for their emergencies and life activities in very good old days (Pokhrel, u.d.; Colombage, u.d.; Ratwatte, 2012 c). The first Sri Lankan Co-operative Rural Bank was reported at Menikhinna in the Kandy District in early 1900 (Ratwatte, 2012 b) as the first official microfinance initiative and thereafter large number of Micro Finance Institutions (MFIs) (Kelegama, and Tilakaratna, 2014; Ratwatte, 2012 a) were reported and currently providing their services to poor and underprivileged people (ADB, 2000; Venkatapathy, Pretheeba, 2012) in Sri Lanka. The Microfinance industry would mostly vulnerable to much economic turbulence as most of these MFIs are not properly supervised and therefore may trigger lots of issues at economic depressions and would hit the development of the country. The MFIs expose to vulnerabilities due to non-availability of proper supervision and regulation (Galapattige, 2009) and weak authorization but there are MFI regulatory and supervision mechanisms placed in some countries. Therefore such MFI regulatory and supervision mechanisms recommend to Sri Lanka too. Therefore this paper is trying to evaluate the microfinance sector in Sri Lanka and to see the requirement of an appropriate rule, regulation, and supervision for MFIs (Alawattage et al, u.d.) effectively. Further writer wishes to review whether the proposed regulatory method is appropriate for the Sri Lankan Microfinance industry under the new Microfinance Act No 06 of 2016 (Democratic Socialist Republic of Sri Lanka, 2016).*

*Though the Microfinance industry is accepted worldwide as a bundle of services to the poor (ADB, 2009) without any collateral or sometimes with less collateral or guaranteed by someone. It was reported that 16,400 MFIs (Ratwatte, 2012 a) or more are functioning in Sri Lanka and some of which are registered under different authorities (Kelegama and Tilakaratna, 2014; Wijesiri, et al., 2015; Ratwatte, 2014 b; Galapattige, 2009; GTZ ProMiS & The Lanka Microfinance Association, 2010; German Technical Cooperation , 2010) and their guidance. However, most of the MFIs are not under the preview of any authority. Nevertheless, the important factor is that irrespective of the registration by different authorities the MFIs handle the microfinance activities as a whole (GTZ ProMiS & The Lanka Microfinance Association, 2010; German Technical Cooperation, 2010; Galapattige, 2009). Therefore it is required to have a clear regulations somewhat similar or lesser scale to Licensed Commercial Banks (LCBs), Licensed Specialized Banks (LSBs), Licensed Financial Companies (LFCs) and Licensed Leasing Companies (LLCs) when adopting appropriate regulation and supervision mechanism on MFIs to protect public deposits and their savings (Alawattage, et al, u.d.).*

*Even though a regulatory mechanism for microfinance sector proposed in Microfinance Act 2016, authorities needs to check whether the existing institutions are willing and can joint with so-called regulation and whether it gives proper prospects in microfinance. The establishment of relevant law and authority for Microfinance is must because the inability to cater the low income rural and urban community is seen due to many inherited/ structural reasons filling the gap of credit to the poor is a responsibility of government. So it is believed that the strategy for MFI regulatory mechanism identifies what is to be supervised, what are to be potential and which will undergo lesser supervision, which is to be monitored and follow-up to upgrade or downgrade. Therefore based on the literature writer proposed to have 5 layer institutions for MFIs to avoid social distresses while giving proper recognition to MFIs to strengthen their activities in a country-specific standard way.*

Key words: Micro Finance Institutions, Sri Lanka, Rotating Savings and Credit Associations, Co-operative Rural Bank, Formal & informal Financial Institutes.

## Introduction

The provision of no of financial services to the poor ( ADB, 2000; Kelegama and Tilakaratna, 2014) is called as microfinance, and the delivery of microfinance happens in three ways; Formal institutions; Semi-formal institutions and Informal sources (Kelegama, and Tilakaratna. 2014; Kumari, 2014; Steel, & Andah, 2003; Berensmann et al., 2002; GTZ-ProMiS & Ministry of Finance & Planning, 2008; Ratwatte, C., 2012 c and Aheeyar, 2007 cited Attanayake,1997) in Sri Lanka together with government-sponsored microfinance schemes (Balasooriya, 2009). However around 16,500 MFIs was reportedly operating in Sri Lanka (Ratwatte, 2012 a; Kelegama, and Tilakaratna, 2014; CGAP, 2006); GTZ Promis, 2008) but the sector, in general, suffers weak governance, poor repayments, high transaction costs, recurring losses and deficiencies in regulation and supervision (Wiedmaier-Pfiste, and Wohlner 2004) causing embedded risks in such institutions.

The existing execution of MFIs comes under several Ministries, Departments, and Government Acts and therefore uses different regulatory requirements for the same objective of microfinance. The weak and fragmented framework exists under various authorities, and most of the MFIs are not appropriately regulated and not in a single independent, competent, regulation mechanism (Ratwatte, 2014 b). Therefore the absence of consistent single regulatory and supervisory body might result in many awful ways (German Technical Cooperation, 2010; GTZ ProMiS & The Lanka Microfinance Association, 2010; Ratwatte, 2014 b; Kelegama, and Tilakaratna, 2014) especially to the financial system stability and public confidence too. However to avoid such a situation a Microfinance Regulation and Supervision Authority (MRSA) was proposed for licensing, regulating, and supervising all the NGO–MFIs and any type of co-operatives engaged in microfinance (Ratwatte, 2014 b, Kelegama, and Tilakaratna, 2014) which is vital to the stakeholders and the country but not enacted.

The positive arguments for proper regulation of microfinance institutions were highlighted for; the protection of financial system and stakeholders, to address the consequences of the microfinance sector, for consumer protection, effective delivery of credit in the sector, cover for any financial risks and fraud and financial crimes prevention (Pouchous, 2012). Therefore Sri Lanka now enacted the Microfinance Act, No. 6 OF 2016 to provide the licensing, regulation and supervision of companies carrying on microfinance business. Establishing acceptable standards for microfinance institutions is a positive movement to microfinance sector and important the clientele of the MFIs.

However, It was known to the writer that more than 14,671 institutions exist and belongs to known institutions, i.e. 1,608- Co-operative Rural Bank, 8,440- Thrift and Credit Co-operative Societies (SANASA), 1,038- Samurdhi Banking Societies, 471- Agrarian Services Banks, 836- Gemidiriya People's companies, 278-Non-Governmental Organizations, 2,000-Sarvodaya Shramadana Societies, and there are other service providers to MFIs such as National Development Trust Fund, Sarvodaya Economic Enterprise Development Services (Guarantee) Ltd (SEEDS), Co-operative Rural Bank Unions, Samurdhi Authority of Sri Lanka and Regional Development Department of the Central Bank of Sri Lanka etc. who provide microfinance solutions to poor in Sri Lanka as of 2017.

**Study objectives and questions**

Therefore an appropriate regulation to supervise microfinance institutions are required according to country-specific fitting criteria, i.e. their size, type, nature or business and authorization agency. Further four areas were highlighted in prudential regulation and supervision, i.e. Systemic risk, cost of prudential regulation and supervision, bearing the risk of loss, and capacity of adequate supervision ( CGAP, 2012) to be evaluated carefully to suit Sri Lankan context for the benefit of stakeholders and the country. So the study is looking the possibility of fulfilling the expectation of stakeholders under the Microfinance Act and reviewing cover-up of existing laws enough to the microfinance institutions in Sri Lanka to achieve the objective of stability while benefiting poor clientele. Therefore the study questions are; whether required regulation to MFIs and if so what might be the regulation and or supervision which construct based on the proven literature.

**Literature review**

**What Microfinance is? and who provides Microfinance?**

Literature reveals that MFIs are the most effective instrument to improve deprived people and small-scale businesses. There is no universally agreed definition for Microfinance (Premaratne, 2007) however different definitions are given by many academics, institutions, and agencies. Most of the studies have identified microfinance as a provision of a broad range of financial services such as deposits, loans, savings, payment services, money transfers services, and insurance services etc. (ADB,2000; CGAP, 2002; Kamaluddin et al., 2014) to the poor. The poor is an individual who has a lower income which is not sufficient for basic requirements or required calorie intake and an individual who is unable to assess the risks no way to avoid such risks (Wijewardena, 2009). Also the poor are mostly uneducated low-income households and, microenterprise owners. Also, microfinance is the provision of credit and other financial services to the low-income group and micro-entrepreneurs enabling them to build a sustainable enterprise (Venkatapathy & Pretheeba, 2012). Further the United Nations has defined microfinance as an effective means of contributing to poverty reduction on a sustainable basis for Least Developed Countries (Napoleon, 2010) and microfinance has proven to be an effective tool for poverty reduction by helping the poor to increase their income, smooth consumption, building assets, and reducing their vulnerabilities in times of contingencies and economic shocks (Napoleon, 2010) especially according to the experience gained from Grameen Bank, Bangladesh.

As proved by many studies microfinance requires a supportive policy, and therefore regulatory environment is necessary to the effective delivery of microfinance services that expand outreach and at the same time improves access to the poor (Napoleon, 2010). Furthermore, microfinance is an emerging phenomenon that opens access to capital for individuals who had previously been shut out from formal financial services (World Bank, 2006). Microfinance engagement with the poor, microfinance represents a new way for financial capital to stimulate economic growth in developing countries potentially. However, microfinance is misunderstood, and it remains unclear whether it delivers required things (Susanna, 2010). The microfinance institutions were trying to capture the excluded people from formal systems in South Asian countries, and microfinance is a series of possibilities to extend markets, poverty, and social change but the puzzles behind this have not yet been fully discussed (World Bank, 2006). Microfinance has identified as the provision of a broad range of financial services to poor and low-income people (ADB, 2000; CGAP, 2002). Therefore a suitable delivery method to the poor and low-income people have to be followed to improve access to finance where it lacks all the time around the world. Literature shows that three types of delivery methods exist and few methods were successfully applied in some countries. Financial Self-Sustainability Paradigm (FSSP), Poverty Alleviation Paradigm (PAP) and Feminist Empowerment Paradigm (FEP) are those (Premaratne, 2007 and Rehman, et al., 2015). Therefore 70%-80% of MFI borrowers in South Asia are women (Kelegama & Tilakaratna, 2014; Atapattu, 2009). Also, different types of models have been using to deliver financial services (ADB, 2000; Atapattu, 2009; World Bank, 2006 and Guntz, 2011).

**Who has the potential to be in Microfinance? and why?**

The low-income earners who are rejected or are not provided with any access to financial services by the formal sector (Anderibom & Samuila, 2015 and CGAP, 2012) are the potential customers in semi-formal and informal sectors in Microfinance (World Bank, 2006). The rejection/ restriction happens due to; lending prohibitions to former defaulters, no collateral, collateral is not up to the acceptable standard, no guarantors, guarantors are not at acceptable level, psychological barriers to getting services from formal institutions, and their complicated procedure for credit, lack of social proximity and lack of knowledge, exclusion due to political or social reasons, repayment of a loan by a fixed amount during the tenure of loan, mismatch between credit offered and actual loan required and sanctions in case of non-repayment (Zander, u.d.) and are practically seen in the Sri Lankan and mostly in Asian context. Also Tanzania and Kenya experienced barriers to access formal institutions like; no collateral, no guarantor, no place nearby to get a loan, not knowing where to get access, negative myths or cultural barriers, not enough money earned to repay the loan, higher charges by formal institutions, misunderstanding or suspicious of formal institutions, no proper identification available to submit an application and some people not required a credit from formal institution (Lemma, 2010).

Most of the time, nearly 70% of loans are provided without any collateral by informal sector but sometimes 30% of loans require some collaterals like land, buildings/property, jewelry, household items, personal guarantee, etc.. in order to cover-up the loan to avoid potential risk (GTZ-ProMiS & Ministry of Finance & Planning-Sri Lanka, 2008). Poor and low-income people are mostly preferred to use informal sector credit due to so-called barriers (Zander, u.d.; Lemma, 2010) in the formal sector. Therefore the popularity of the informal sector is mostly due to the ease of access/ ability to borrow quickly without collateral requirements (GTZ-ProMiS & Ministry of Finance & Planning -Sri Lanka, 2008). Most people highlighted some key features in the informal sector; easy to access, quick borrowing, no collateral being required, flexible terms and conditions, simple procedure and no complicated application process, no restriction to use, lack of access to formal institutions, ability to borrow any amount, no enforced savings and also believe that the interest rate is lower and more affordable than in the formal sector as the reasons for poor to use more informal sector credit worldwide (GTZ-ProMiS & Ministry of Finance & Planning, 2008).

**What are the key challenges Faced by MFIs?**

The microfinance sector is open to many risks as the financial services and credit to poor/ low-income with minimum or no collateral/ guarantees and also regulation, and supervision of the microfinance is in a fragmented and complicated mode under different authorities in Sri Lanka (Galapattige, 2009). The main challenges and potential issues for Sri Lankan Microfinance industry can be categorized as; lack of appropriate regulation and oversight for MFIs, weak portfolio quality, models of MFIs, inefficiencies of fragile institutions, savings mobilization only by few MFIs, transparency, IT knowledge, public sector microfinance involvement, human resource capabilities, inadequate credit ‘Plus Services’, management weakness, methodology adoption, inappropriate donor subsidies (Atapattu, 2009; EY, 2014 and Campion, u.d), entry of regulated institutions into microfinance business and lack of funding to MFIs. Therefore suppose that the enacted Microfinance Act no 6 of 2016 for the regulation of microfinance institutions will provide some coverage to the above challenges. However, the output, the outreach and the growth in unorganized semi-formal and non-formal microfinance institutions severely affects due to the operational level issues in microfinance sector and the human resource issues in the microfinance sector (Modoran & Grashof, 2009).

**What is the risk involved in Microfinance Sector**

MFIs are exposed to a variety of risks and therefore need to make necessary arrangements and appropriate adjustments on regulation and supervision for identified risks. Major risk categories of MFI s are (i) credit risk, (ii) liquidity risk, (iii) interest rate risk, (iv) operation risk, (v) new industry risk, and (vi) subsidy dependence risk. Therefore a proper regulatory mechanism is required to evaluate and to deal with such risks (Premaratne, 2007). In addition to that the poor/ low-income clients frequently face a broad range of risks such as structural factors like seasonality, inflation, or issues with weather, unexpected emergencies like sickness or family member's sudden death due to poor health condition, loss of employment, fires, and theft, and comparably high costs associated with life cycle events like marriage, funerals, and educating children. Therefore the risks related to these clients’ vulnerability might be a great shock to them as they are in the depths of poverty (CGAP, 2000) with minimum income, food, health, education, and shelter and may have adverse butterfly effect to the financial system.

**The structure of the Microfinance Industry is in Sri Lanka**

Very old type of practices were differently used in most of the countries as a source of the savings and credit such as; Susus-Ghana, Chit funds-India, Dhukuti-Nepal, Tandas -Mexico, Arisan-Indonesia, Cheetu or Seetu-Sri Lanka, Tontines-West Africa, and Pasanaku-Bolivia, and various savings clubs and burial societies found all over the World in very good old days (Pokhrel, u.d.) and Sri Lanka as well. Therefore, Sri Lankan villagers had the habit of borrowing money from relatives, friends or boutique owners and also used rotating savings and credit associations (ROSCA-Cheetus/Seetus), which played a crucial role in providing finances for villagers emergencies and activities (Colombage, u.d; Ratwatte, 2012 c and Wikipedia). Therefore the ‘Cheetus / Seetus’ was enacted under the Cheetus Ordinance No. 61 in 1935 (Ratwatte, 2012 c.) due to the importance and vitality of the society in Sri Lanka. Three prominent types of microfinance institutions can be seen in Sri Lanka as sources of funds to poor and low-income households.

i. Formal institutions - i.e., LCBs, LSBs, LFCs and LLCs (Kelegama, and Tilakaratna. 2014; Steel, & Andah, 2003 and Aheeyar, 2007 cited Attanayake, 1997) together with government-sponsored microfinance schemes (Balasooriya, 2012 & 2009).
ii. Semi-formal institutions - i.e. rural banks and cooperatives; nongovernment organizations, cooperatives, NGO–MFIs, CBOs, and state Programs like Samurdhi/Divineguma; (Kelegama and Tilakaratna. 2014; Steel, & Andah, 2003 and Aheeyar, 2007 cited Attanayake,1997 and Ratwatte, 2012 c) and semi-formal financial institutions are largely microfinance providers (Kelegama, and Tilakaratna. 2014).
iii. Informal sources - i.e., money lenders, shopkeepers and rotating savings and credit associations (ROSCA), etc. (Kelegama and Tilakaratna. 2014; Steel, & Andah, 2003 and Aheeyar, 2007 cited Attanayake (1997)). It is believed that the informal financial sector plays an important role in Sri Lanka. Even though money lenders and Cheetus/Seetus or ROSCAs are considered as main actors in informal financial sector (Berensmann et al., 2002), but it was revealed that relatives/ friends/ neighbors, money lenders and cheetus/seetus or ROSCAs are not much significant in Sri Lankan society (GTZ-ProMiS & Ministry of Finance & Planning-Sri Lanka, 2008).

However, literature on microfinance revealed that a broader classification of the microfinance institutions exists in Sri Lankan context such as; Individual and group-based “Informal Lending” , “Local/National NGOs including Co-operative Societies”, “International NGOs” , “Multilateral Agencies” (Aheeyar, 2007 cited Hospes et-al, 2002), “LCBs LSBs and LFCs” and the “Central Bank of Sri Lanka” (Balasooriya, 2012 & 2009) and Divineguma.

The institutional microfinance includes microfinance services which provided by both formal and semi-formal institutions (ADB, 2000 and Kelegama, and Tilakaratna. 2014).The microfinance sector of the country comprises a range of different institutions such as co-operative societies, NGO–MFIs, CBOs, development banks, and state programs which has a long history that dates back to the early 20th century. The pioneers of microfinance, thrift and credit co-operative societies (TCCSs) were started in 1906, Multi-Purpose Cooperative Societies (MPCSs) in 1957 and Co-operative Rural Banks (CRBs) with MPCSs, the Janasaviya Trust Fund in 1991 which converted as National Development Trust Fund (NDTF), the apex lending institution for the microfinance, the Regional Rural Development Banks in 1986, and the Samurdhi’s Savings and Credit Program in 1997 (Kelegama and Tilakaratna, 2014).

The formal microfinance sector in Sri Lanka comprises with LCBs, LSBs, LFCs & LLCs like Bank of Ceylon, Peoples’ Bank, National Savings Bank, Regional Development Banks and SANASA Development Bank, and with almost 900 branches. The semi-formal MFIs are the over 300 Cooperative Rural Banks (CRBs) with 1,196 outlets; approximately 8,500 thrift and credit cooperative societies (TCCS, or SANASA); 970 Samurdhi Banking Societies; about 200 NGO-MFIs(local and international); numerous government rural credit programs; pawnshops; and 4,000 or more post-offices to collect savings. Numerous informal, or non-institutional are available to provide such service. Some of the important ones are savings associations, rotating savings and credit associations, funeral benefit societies, traders, moneylenders, input suppliers, friends and relatives (Wiedmaier-Pfiste, and Wohlner, 2004; Colombage, u.d.; Ratwatte, 2012 c,; Aheeyar, 2007, and Central Bank of Sri Lanka, 2012 & 2014). However it was reported that microfinance institutions account only about 3% of the total assets of financial agencies and a number of government sponsored programmes conducted by banks, NGOs, and community organizations like the Thrift and Credit Co-operative Societies (TCCS), Samurdhi Banking Societies (SBS), Sarvodaya Economic Enterprise Development Services (SEEDs) and Co-operative Rural Societies (CRBs) (Kelegama, and Tilakaratna, 2014) for the benefit of poor and low income earners and the Divinaguma Banking Societies (DBS) established using tax payers money which converted using Samurdhi societies funds are the leading microfinance provider (Ratwatte, 2012 a) for the vulnerable people in Sri Lanka.

15,000 MFIs (Kelegama and Tilakaratna, 2014) / 16,400 MFIs (Ratwatte, 2012 a) are operating in Sri Lanka at the time of his study approximately 3,750 are not under any prudential financial regulation. Another estimate says that 14,000 MFIs active(Ratwatte, 2012 a), whereas 10,000 is active (GTZ Promis survey, 2007). However found 14,000 financial access points, defined as a bank, a cooperative branch, or a society where clients can deposit savings or withdraw loans (CGAP, 2006). Sri Lanka has a variety of options such as Money Lenders, Pawn Brokers, Non-Government Organizations, the Cooperative Rural Banks, the Divinaguma Banku Sangam (successor to the Samurdhi Banku Sangam), LCBs, LSBs, LFCs and LLCs, other MFIs, Seetu (Cheetu) groups (ROSCAs) to facilitate for microfinance services (Ratwatte, 2014 b) to the poor and the marginalized (Ratwatte, 2013).

Even though 16,400 MFIs (Ratwatte, 2012 a) or more than 14,671 (writer’s estimate) MFIs institutions exists in Sri Lanka as of 2017 the sector, in general, suffers weak governance, poor repayments, high transaction costs, recurring losses and deficiencies in regulation and supervision. On the other hand, amongst a large number of Microfinance Institutions, some promising public and private institutions are exist, and one of them, thrift and credit cooperatives/ Cooperative Rural Banks (under SANASA) have been successfully reaching out to many poor and rural families (Wiedmaier-Pfiste, and Wohlner, 2004). As noted earlier, though there is no single body to regulate and supervise MFIs, several Ministries, Departments, and Government Act control the operation of some of the MFIs (Galapattige, 2009). The regulatory requirements and standards of each of these regulatory bodies are different.

**What are the Laws related to Microfinance Sector in Sri Lanka?**

The laws and the legislative enactments applicable to MFIs are; Money Lending Ordinance, Pawnbrokers Ordinance, Companies Act, Banking Act, Finance Companies Act, Finance Leasing Act, Exchange Control Act, Cooperative Societies Act, Societies Ordinance, Voluntary Social Service Organizations Act, National Housing Act, Mortgage Act, Debt Recovery Act/ Debt Conciliation Ordinance/Recovery of Loans by Banks Act, Inland Revenue Act/ Value-Added Tax Act (Atapattu, 2009).

Atapattu, (2009) also highlighted that the issues related to the legality of mobilization of public deposits by unregulated institutions. As there was no Microfinance Act or law before 2016 especially for microfinance, MFIs generally carry on microfinance business within one of the following legislation structures; A company incorporated under the Companies Act, A Licensed Commercial Bank/Licensed Specialized Bank ("LCB"/"LSB"), A Licensed Finance Company LFC, A Licensed Leasing Company-LLC, A Co-operative Society, A Voluntary Social Service Organization ("VSSO"), A Society registered under Societies Ordinance, A Building Society, Statutes established by special Act of Parliaments.

The different types of legislation and registration practices for MFIs as follows; Guarantee Limited Companies , Private Limited Companies and Village Banks under peoples company under Companies Act, No 7 of 2007, The Divinaguma Banku Sangam under Divinaguma Act 2014 , TCCSs and CRBs under Co-operative Societies Law No. 5 of 1972 (amended); NGO MFIs (majority) and CBO under Social Service Organizations (Registration and Supervision) Act No. 31 of 1980 ("the VSSO Act"), Village Banks or CBO's under Societies Ordinance No. 16 of 1891 (amended), Regional Development Banks, Licensed Commercial Banks (LCBs) and Licensed Specialized Banks ("LSBs") (not exclusively microfinance only) under Banking Act No 30 of 1988 as amended by Banking Amendment Act No .30 of 1995; Licensed Finance/ Licensed Leasing Companies (LFCs/ LLCs) under the Finance & Leasing Act No. 56 of 2000 (Atapattu, 2009, Balasooriya, 2012 & 2009) and Microfinance no 06, 2016 (Democratic Socialist Republic of Sri Lanka, 2016).

NGOs involved in microfinance activities are registered under (i) the Companies Act No. 7 of 2007; (ii) the Societies Ordinance of 1891 (as amended by No 11 of 2005); and (iii) a Special Act of Parliament. Most of the small NGOs are registered under the Societies Ordinance the most complicated method to interpret but very simplest and easiest way to register. International NGOs (INGOs) operating in Sri Lanka are not required to be registered under any act but should sign a Memorandum of Understanding (MoU) with the Ministry of Policy Planning and Implementation or an agreement with the Director of External Resources and are not permitted to mobilize savings. TCCSs and CRBs are governed by the Co-operative Societies Act of 1972 and amendment of 1983 and 1992 and regulated by the Department of Co-operative Development. The co-operatives, such as the TCCSs and CRBs which allowed receiving deposits from their members and non-members (Kelegama, and Tilakaratna, 2014) are allowed to mobilize savings. Therefore different practices are being used according to their legislation, but the institutions mostly do the same Microfinance activities to poor people at large.

The Microfinance Act no 6 of 2016 enacted to provide the licensing, regulation, supervision of companies carrying on microfinance business; the registration of non-governmental organization as microfinance non-governmental organization; setting up of standard for the regulation and supervision of microfinance. However, the act doesn't cover micro-finance of any of followings (a) a licensed commercial bank or a licensed specialized bank; (b) a finance company; (c) a co-operative society; (d) a divineguma community-based bank and a divineguma community-based banking society; and (e) an entity formed in terms of the Agrarian Development Act (Democratic Socialist Republic of Sri Lanka, 2016)

**Why Regulation and Supervision of Microfinance Institutions are required?**

As far as the saver's point of view concern, the key motives of deposits are safety and security of such savings, easy and immediate access, and a positive real return. However, it is widely accepted that even though a large number of people have their savings in financial institutions, only a certain number of people would seek credit facilities at any given time. From the institutional point of view, the primary motive of saving is the low-cost of capital compared to other sources of funds. Therefore to develop a successful savings mobilizing strategy, following key areas need to be considered; Strong institution type, Good governance and well-organized structures, Demand-driven savings products with appropriate technologies, Management capabilities, Sound regulation and supervisory framework, and Cost analysis (Elser, Hannig, & Eschborn, 1999).

As explained above, the regulatory framework for MFIs in Sri Lanka is weak and fragmented one, under different institutions and laws. Most of the MFIs are not prudentially/ non-prudentially regulated, and no independent, competent, single regulatory authority for MFIs, Seetus, money lenders, and pawnbrokers (Ratwatte, 2014 b) or any other is available before 2016. Therefore most academics and professionals proposed a sound regulatory and supervisory framework for microfinance sector to ensure the financial soundness of MFIs and build confidence among stakeholders. Furthermore, many have argued for a robust regulatory framework for MFIs because a sound regulation and supervision ensure the sustainability of the industry and financial system stability of the country. The differences in standards of supervision of MFIs are questionable, and therefore the absence of single regulatory and supervisory body may create a disruptive environment (GTZ ProMiS & The Lanka Microfinance Association, 2010; Ratwatte, 2014 b; Kelegama and Tilakaratna, 2014). Therefore proposed a Microfinance Regulation and Supervision Authority for licensing, regulating, and supervising all NGO–MFIs, any cooperatives engaged in microfinance (Ratwatte, 2014 b; Kelegama, and Tilakaratna, 2014) and any microfinance institutions which are very vital to the stakeholders and the country.

Therefore a large no of positive arguments have placed in favour of proper regulation of microfinance institutions to (1) protect the country's financial system and small depositors; (2) address the consequences of growth and commercialization of the microfinance sector; (3) consumer protection against abusive interest rates; (4) entry of new providers and new credit delivery mechanisms in microfinance sector; (5) lessons learnt from the recent financial crisis; and (6) preventing fraud and financial crimes (Popovici, 2010).

As noted earlier, "microfinance" embraces not only a range of credit products for business purposes, for but also consumption smoothing, fund to social obligations, for emergencies, savings, money transfers, and insurance. Microfinance services delivered by the institutions that are registered with or licensed by a government called as "Formal" or sometimes "Semi-formal." Even though there are formal or semi-formal institutions, it is important to understand that most poor people widely use informal services, even when they have access to formal services (CGAP, 2012) due to many reasons (Modoran & Grashof, 2009).

**What is the relevant regulation for Microfinance?**

There are number of regulation methods available for microfinance institutions, but these usually may not suitable for all the countries and therefore regulatory definitions of “microfinance” should be carefully designed to meet the regulatory objectives and should not simply be drawn from general literature because even microfinance services same for all the countries but differs due to size, regulation, laws and many other factors. Their regulations of microfinance institutions should be defined as follows, a). Use of funds for the primary purpose of the loan, b). The maximum amount to be set for a customer on repayment ability, c). A degree of flexibility to a customer; d). The collateral requirement, e). Determining appropriate country-specific microfinance laws and regulations to improve the quality of microfinance services to clientele (CGAP, 2012).

As mentioned above there are many arguments for both prudential and non-prudential regulation on MFIs. When it comes to formal and even semi-formal MFIs, some types of prudential or non-prudential regulation is accepted without any doubt but for the unorganized non-formal MFI’s regulation is doubtful and have more critics. However the systemic risk, the cost of prudential regu¬lation and supervision, bearing the risk of loss, and effective supervisory capacity is the important areas in prudential regu¬lation and supervision. Because “systemic consequences” do not always imperil a country’s financial system but gives some bad impression to the society. However prudential supervision is costly for both the supervisor and supervisee as the issues of documentation, accounting, and technology. The other factor to be careful about is the “Capacity to supervise” the retail depositors because generally, they are not in a position to evaluate the management and condition of the banks that hold their funds. Therefore, in contrast, owners, lenders, and donors can and should supervise the MFIs which they are investing in (CGAP, 2012) for the benefit of invested money.

When a deposit-taking institution becomes insolvent or lacks adequate liquidity, the depositors are in trouble. In the case of a systematically large institution, its failure could undermine public confidence, and therefore the financial system system-wide damages. Prudential regulation involves the government in overseeing the financial soundness of these institutions and taking action when problems arise. However, “non-prudential” regulation or “conduct of business” does not involve monitoring or assessing the financial health of the regulated institution and therefore non-prudential regulation of MFIs tends to focus on absent extraordinary circumstances (CGAP, 2012).

**What type of Regulatory Framework (PRF) suitable for MFIs**

Prudential regulation involves the regulator setting guiding benchmarks and standards for compliance and verifying the compliance of institutions on core capital requirements, liquidity management, asset quality, solvency, governance, management and license issuance or revocation. Typically, prudential regulation should simply set rules and guidelines on acceptable behaviour and business practices in the operation of the financial institutions to protect the interests of clients and to monitor the institutions' activities. However, non-prudential regulation aims at ensuring that credit-only MFIs conduct their business in an orderly, transparent, and non-disruptive manner that is fair to the clients and non-prejudicial for the health of the rest of the financial sector (House, 2009).

Regulation is ‘prudential’ when it is explicitly aimed at protecting the financial system as a whole as well as protecting even the safety of small deposits in individual institutions. Therefore, prudential regulation involves the government in attempting to protect the financial soundness of the regulated institutions (CGAP, 2002). Further prudential regulations establish and enforce minimum standards for doing deposit-taking business in areas such as; Minimum capital requirements, Risk standards, Fit and proper requirements for directors and officers, Minimum liquidity requirements, Reporting and supervision requirements, and supervisors to conduct on-site inspections to ensure the regulations. So prudential regulation creates substantial barriers to the deposit-taking business besides through enforcement of prudent management of existing institutions (Porteous et al., 2010) but generally accepted understandings on microfinance, are that if an MFI does not accept deposits, prudential regulation is not required, even if accept deposits, exempting small community-based institutions which doesn't see much risk, Regulations which preclude existing financial institutions for microfinance as such in Uganda and Nigeria introducing new tiers of regulation to cater explicitly the microfinance institutions (Porteous, et al., 2010).

A Prudential Regulatory Framework (PRF) includes the law and the regulations or statutory instruments and typically prudential regulation such as: minimum capital requirements, maximum shareholder requirements, capital adequacy requirements, licensing requirements, benchmark for asset quality, limitations on risk exposure and insider lending, reserve and liquidity requirements, reporting requirements, sanctions and corrective actions and deposit insurance schemes (Pokhrel, u.d.) etc. Mostly microfinance regulation is focused on Non-Prudential Regulatory Framework (NPRF) than PRF and is not always required prudential treatment for MFIs due to structural and many other factors. Non-prudential or 'conduct of business' addresses regulatory issues of relevance to microfinance. These problems are; the formation and operation of microfinance institutions, consumer protection, fraud and financial crimes prevention, setting up credit information services, supporting secured transactions, policies with respect to interest rates, limits of foreign ownership, management, and sources of capital, tax and accounting issues, and a variety of crosscutting issues surrounding transformations from one institutional type to another (GAP, 2002). Still, there is no clear-cut justification for prudential regulation for MFIs, as most people believe a negligible risk in the sector. However, at the same time, an MFI can select ranges of choices for regulation like no regulation or self-regulation, hybrid approach, regulate under existing law or special law and prudential regulation or non-prudential regulation/ standards (Muganga, 2010). Regulation is viewed as the way to help free interest rates, provide a legal framework for savings collection, increase opportunities for foreign funding and create greater transparency in the industry (Hudak, 2012) for the benefit of stakeholders.

**Regulatory and Supervisory Framework for Sri Lankan MFIs**

The different categories of microfinance institutions are currently registered under various laws, but most of the institutions are not regulated or supervised according to prudential or even non-prudential standards other than LCBs, LSBs, LFCs and LLCs. Currently the Microfinance Act no 6 of 2016 enacted to provide the licensing, regulation, supervision of companies carrying on microfinance business ; the registration of non-governmental organization as microfinance non-governmental organization; setting up of standard for the regulation and supervision of microfinance but it doesn't cover microfinance of any of followings (a) a licensed commercial bank or a licensed specialized bank; (b) a finance company; (c) a co-operative society; (d) a divineguma community-based bank and a divineguma community-based banking society; and (e) an entity formed under Agrarian Development Act (Democratic Socialist Republic of Sri Lanka, 2016).

Even though Microfinance act is enacted, apart from the formal institutions such as LCB, LSB, LFC, and LLC for microfinance, there is no proper central or unique regulation and supervision mechanism to all the MFIs. Therefore the MFIs are lies in a fragmented and complicated structure which hasn't a single body to regulate and supervise. The regulatory requirements and standards of each of these regulatory agencies are different and therefore complicating the current standard regulatory framework (Galapattige, 2009) for LCBs, LSBs, LFCs and LLCs by the Central Bank of Sri Lanka. However, every institution providing microfinance facilities should be subject to prudential or non-prudential regulations (Pouchous, 2012) for the benefit and interest of general public in Sri Lanka and also the safety of the economy.

As explained and mentioned above in this article the multiple regulatory systems in Sri Lanka can be described; a). The CBSL empowered by the Monetary Law Act and other agency functions of CBSL empowered by the Exchange Control Act, Banking Act, Finance Companies Act, Finance Leasing Act, Local Treasury Bills Ordinance and Registered Stocks & Securities Ordinance and Payment and Settlement Act; b). The Securities and Exchange Commission (SEC) regulates stock exchanges, securities clearing & depository systems, stock brokers/dealers, unit trust management companies, investment managers, margin providers, stock underwriters and credit rating agencies under the Securities and Exchange Commission Act; c). The Insurance Board of Sri Lanka regulates insurance companies and brokers under Regulation of Insurance Industry Act; and d). Co-operatives Department, Social Services Department and Samurdhi Authority Department or Divineguma regulate differently. Further, the CBSL works closely with the other financial regulators to ensure that the components of the financial system are regulated and supervised effectively (Pokhrel, u.d.).

**Available Infrastructure for Microfinance Sector in Sri Lanka**

The poor microfinance services offered by MFIs are seriously threatening the sustainability of the industry and their outreach to poorer households, micro and small entrepreneurs (Perera, u.d.). At present, regulation and supervision of the microfinance sector in Sri Lanka occurs within a fragmented and complicated structure (Galapaththige, 2009) as explained several times and no specifically separate microfinance regulation currently exist in Sri Lanka (Perera, u.d.).

However, the financial system consists of 24 Licensed Commercial Banks (LCB) and 9 Licensed Specialized Banks (LSB), 48 Licensed Finance Companies (LFC) and Licensed Leasing Companies (LLC). LCB and LSB consist of over 6,400 bank branch network, and around 2,500 ATMs with other banking outlets and LFC and LLC have more than 1,000 branch network (CBSL 2014). The Divineguma Banku Sangam or Samurdhi Banking Societies (SBSs) have 1,042 Banking Societies and over 34,000 village level societies (Kelegama, and Tilakaratna, 2014). Since 2002, the regulatory framework and practice of bank supervision have been strengthened (ADB 2009) to be survived in the healthy global financial system. The CBSL initiated risk-based supervision and has introduced new risk management and governance requirements for authorized institutions. Also, in 2002 the capital adequacy requirement was increased to 10% (CBSL 2012) of risk-weighted assets, according to the Basel Committee recommendation and further developed Basel II with modest strengthening measures (ADB 2000). MFIs can be divided into non-bank MFIs and banks (Galapaththige, 2009). At the same time, Sri Lanka's microfinance sector has done well even though a lack of proper regulatory structure. The formal financial system is made up of commercial and specialized banks, finance companies and leasing companies. Institutions relevant to microfinance including rural development banks, the SANASA Development Bank, Samurdhi Bank Societies, various rural cooperatives, the Thrift and Credit Cooperatives of the SANASA movement and assorted NGOs, altogether representing over 9000 separate outlets or branches (Hudak, 2012)

The Bangladesh Microcredit Regulatory Authority (BMRA) is very fruitfully and efficiently regulates Bangladeshi MFIs. Considering all their country-specific factors, BMRA has divided MFIs in to 5 categories based on the borrower size such as;

Very Small 1-10,000, Small- 10,001-50,000, Medium- 50,001- 100,00, Large- 100,01- 1,000,00 and Very Large- over 10,000,00.Therefore a positive impact on the client in building their confidence on MFI can be seen, but meanwhile, the savings rate of licensed MFIs are higher than the unlicensed MFI due to the cost of procedural activities (Chowdhury, 2014). Apart from Bangladesh MFI regulation, Nepal is unique among many developing countries having a particular regulatory framework for MFIs. According to the Bank and Financial Institutions Act (BAFIA) of Nepal, there are four categories of banks supervised by the Nepal Rastra Bank, the Central Bank of Nepal: i.e. Commercial Banks (Class A), Development Banks (Class B), Finance Institutions (Class C) and Microfinance Development Banks (Class D). There are also the FINGOs, which are registered under different legislation (Hudak, 2012).

Like the Nepal Rastra Bank, the Central Bank of Sri Lanka regulates and supervises LCB, LSB, LFC, and LLC. In Sri Lanka, a large number of organizations exist to serve the poor and low-income earners in different niche markets. Therefore in general, MFIs can be grouped into four categories based on their regulatory and supervisory mechanisms, i.e., 1.Licensed Commercial Banks (LCBs), Licensed Specialized Banks (LSBs), 2.Non-bank Finance Institutions (NBFIs), 3.Cooperatives and NGO-MFIs and 4.Other MFIs. LSBs and NBFIs are registered and regulated by the Central Bank of Sri Lanka (CBSL) while Cooperatives are regulated and supervised by the Department of Cooperative Development (Wijesiri et al., 2015).

**Conclusion to Regulate Microfinance Institutions in Sri Lanka**

The requirement is now to understand the industry of microfinance, their clientele, registration authorities, and legality of the entity perfectly to regulate the same accordingly. The regulatory mechanism for microfinance sector proposed in Microfinance Act 2016 is fairly good as there is no ready-made strategy suitable to regulate the industry nevertheless need to verify whether the regulation gives proper attention to whole microfinance industry due to the differences in laws, policies, legal and legislative system, structural frameworks, and bottlenecks and drawbacks etc. Earlier it was believed that the strategy for MFI regulatory mechanism enveloped whole industry but realized that it is not as expected. Therefore firstly regulator need to understand what institutions are to be supervised, what the institutions are to be potential institutions, which will undergo lesser supervision, which is to be monitored and follow-up and which are to be upgraded or downgraded to provide better service and maintain healthy and sound microfinance system. Finally, no supervision required for the institutions which cannot consider as microfinance institutions but need to be issue guidelines and restrictions in handling microfinance activities confining them to only member activities to avoid any social distresses. Therefore few layers can be proposed as follows;

I. MFI Tier 1: The institutions generate returns which greatly help to the development of the financial system, serve a vast and well-diversified client base, and have an experienced management team in place. They are always in the financial system and supervise by Central Bank of Sri Lanka but to be provided proper guidelines to conduct microfinance activities not mixing their other core business into the microfinance activity. The institutions are LCBs, LSBs, LFCs & LLCs who are involved in microfinance and need not to them supervise separately than the Central Bank Supervision.

II. MFI Tier 2: The institutions generate significant returns to the society, serve a medium to the large-scale and well-diversified client base, and have an experienced management team. In reg¬ulatory terms, their potential has largely been realized. The institutions are Divinaguma Banku Sangam or Divuneguma Banking Societies (DBS) earlier Samurdhi Banking Societies (SBSs), Thrift and Credit Co-operative Societies (TCCS), Sarvodaya Economic Enterprise Development Services (SEEDS) and Co-operative Rural Societies (CRBs), Multi-Purpose Cooperative Societies (MPCSs), National Development Trust Fund (NDTF), National NGOs, International non-governmental organizations and Multilateral Agencies etc.

III. MFI Tier 3: The medium or smaller but budding MFIs that have to be developed as a viable business model to a significant extent and recommend to develop further in regulatory terms to become an of¬ficially recognized financial institution in their countries. The institutions belong to this category are guaranteed limited companies, private limited companies, International Non-Government Organizations (INGO) and Non-Government Organizations (NGOs) MFIs, National NGOs including Co-operative Societies or Multilateral Agencies, etc.

IV. MFI Tier 4: The smaller and may be weak MFIs that are to become the officially recognized financial institution but needed to be monitored and to be upgraded either to the upper category to giving more recognition or downgraded to lower category refraining any microfinance activity. Self-Regulatory supervision on this institution and periodical reports to the authority is required to take necessary actions on them. The examples for this category are guaranteed limited companies, private limited companies, International Non-Government Organizations (INGO) and Non-.Government Organizations (NGOs) MFIs, National NGOs, and Multilateral Agencies, etc.

V. MFI Tier 5: The smaller, unorganized and even weaker to be handled microfinance activities neither viable businesses nor regulatory terms to become an of¬ficially recognized financial institution status in the country. This category of institutions is neither required supervision nor any microfinance activity and therefore required restrictions on them in handling any microfinance activity other than the social events among the membership of their entity. The examples for such are the institutions registered as money lenders, general merchants, pawnbrokers, Seetu (Cheetu) groups (ROSCAs), village death donation societies, building societies, voluntary social service organization, women's groups and registered societies, etc.

**Recommendation for a Viable Microfinance Industry in Sri Lanka**

The Microfinance industry, effective instruments which are available to satisfy the financial needs of the less privileged low-income rural and urban community is to be regulated appropriately to safeguard the institutions as well as its clientele. Therefore, the establishment of relevant law and authority for Microfinance is already started but reviewing the possibilities of establishment of the competent authority to give umbrella coverage is needed. Because the inability to cater the low income rural and urban community by formal institutions due to many inherited/ structural reasons, MFIs are existed to provide the services by filling the gap of credit to poor. Therefore, the supervision of MFIs must be available and also it should do properly to protect the interests of low income rural and urban community. Therefore, the governments should take necessary steps to maintain the healthy level in these institutions to facilitate and stimulating a viable and sustainable microfinance sector for the growth of small economies in the country. Therefore recommends introducing appropriate layers to MFIs in Sri Lanka as mentioned in the article. Even though the LCBs, LSBs, LFCs & LLCs are involved in microfinance they need not be supervised separately than the Central Bank Supervision but need to follow the regulations or guidelines stipulated to microfinance sector rather than using the cumbersome process to poor people who indeed need support to startups or run their small enterprises. It is recommended to provide proper guidelines to LCBs, LSBs, LFCs & LLCs to conduct microfinance activities because microfinance is not their core business. The institutions such as Divinaguma Banku Sangam or Divuneguma Banking Societies (DBS), Thrift and Credit Co-operative Societies (TCCS), Sarvodaya Economic Enterprise Development Services (SEEDs) and Co-operative Rural Societies (CRBs), Multi-Purpose Cooperative Societies (MPCSs), National Development Trust Fund (NDTF), National NGOs, International non-governmental organizations and Multilateral Agencies etc. who are registered under different authorities need to be reported to the relevant authority with regard to the activities of microfinance and need to follow the stipulated regulations or guidelines to microfinance. Also, a proper guideline needs to be provided to them to handle their activities systematically as they serve small/ medium enterprises who are not much educated in any manner.

The medium or smaller category such as guarantee limited companies, private limited companies, International Non-Government Organizations (INGO) and Non-Government Organizations (NGOs) MFIs, National NGOs including Co-operative Societies or Multilateral Agencies, etc. needs to regulate or at least monitored by the appropriate authority. Further recommended to develop good regulatory and guidelines to recognized officially enabling them to go for either local or foreign funds for their activities. The institutions which are smaller in size, unorganized and even weaker to be handled microfinance activities such as money lenders, general merchants, pawnbrokers, Seetu (Cheetu) groups (ROSCAs), village death donation societies, building societies, voluntary social service organization, women's groups and registered societies etc. are not recommended to consider or identify anyhow as microfinance institutions. Therefore it is recommended to apply restrictions on them in handling any microfinance activity which comes under any relevant laws other than the social activities among the members of their entity for the benefit of the society.

Further, recommends giving sufficient time to reorganize the institution's activities enabling them to survive in the microfinance industry without creating any problem to the industry. Also, recommends government or the authority to take necessary steps to expand the access to financial services is to uplift the level of the poor or low-income people where the gaps of such access exist due to the limitation of activities of microfinance institutions who are not capable enough to continue their activities.

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