THE PALLI KARMA-SAHAYAK FOUNDATION (PKSF) AS A REGULATOR OF MICROFINANCE INSTITUTIONS IN BANGLADESH

A THESIS

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EXECUTIVE SUMMARY

Over the last two decades, microfinance has become a popular vehicle for poverty reduction and economic development in Bangladesh. As the microfinance industry continues to experience high growth rates, and as concern about the need to protect the poor engaged in microfinance activities increases, the question of whether and how to regulate and supervise microfinance institutions (MFIs) also grows in importance.

On May 2, 1990, the Government of Bangladesh (GOB) established the Palli Karma-Sahayak Foundation (PKSF) as a not-for-profit financial apex organization. As an apex organization, PKSF's purpose is twofold: (1) to perform financial intermediation through the distribution of collateral-free loans with concessional rates of interest, financed by development banks and international donor agencies, to its partner organizations (POs) that perform grassroots microcredit operations and (2) to develop sustainable microcredit institutions.

PKSF has several characteristics that are thought to render it a good candidate as regulator. In Bangladesh, where access to credit is scarce and donor funds are decreasing, MFIs are obligated to comply with PKSF's strict reporting and performance standards to receive its credit. PKSF also has extensive experience appraising, monitoring and supervising diverse MFIs. PKSF has a highly qualified, professional staff that is trained in microfinance. In addition, PKSF's mission statement is encourages MFI product and process innovations and the expansion of new products. Finally, PKSF places great emphasis on building institutional development in order to strengthen its own capacity as an apex funding institution and the capacity of its POs, which promotes the sustainability of the industry.

However, there are some financial and non-financial costs that must be considered as part of this discussion. The administrative costs of registering all MFIs under one roof could force closure of MFIs and raise interest rates, hurting more of the poor who depend on their services. PKSF also may not be an effective regulator for local MFIs that do not receive or depend upon funds from PKSF or donor organizations for its operations.

On the other hand, the legitimacy and promotional benefits that would accrue to small locally funded MFIs may be great enough to attract funds and increase outreach to offset these initial costs. If PKSF compliance standards can serve as a benchmark for the financial health of deposit-taking MFIs, like a credit report, confidence in the sector would be expected to increase, thereby attracting more depositors and investors than there would have been if regulation reform had not occurred. Further research and investigation into quantifying the size and weighing the potential costs and benefits of regulation reform should be considered to determine the best course for implementation.

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List of Abbreviations

ADB	Asian Development Bank
ASA	Association for Social Advancement
BRAC	Bangladesh Rural Advancement Committee
BRDB	Bangladesh Rural Development Bank
BSA	Bank Supervisory Authority
CDF	Credit and Development Forum
CGAP	Consultative Group to Assist the Poorest
FY	fiscal year
GOB	Government of Bangladesh
IGA	income generating activity
MFI	microfinance institution
MF-NGO	microfinance-non-governmental organization
PKSF	Palli Karma-Sahayak Foundation
PO	partner organization
RLF	revolving loan fund
TNA	training needs assessment
USAID	United States Agency for International Development

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Currency Conversion

The Currency Unit of Bangladesh is the taka (Tk.)

Tk1.00 = US$0.0175

US$ 1 = Tk.57.00

I. Introduction

Over the last two decades, microfinance has become a popular vehicle for poverty reduction and economic development in Bangladesh. As the microfinance industry continues to experience high growth rates, and as concern about the need to protect the poor engaged in microfinance activities increases, the question of whether and how to regulate and supervise microfinance institutions (MFIs) also grows in importance. MFIs undertake nearly all types of commercial domestic banking activities to achieve their development objectives. They accept deposits from and extend credit to members. They raise capital from international donor organizations and private sources. However, since MFIs are not legally categorized as commercial banks in Bangladesh, their financial transactions are neither regulated nor supervised by the central bank. MFI operations are governed by weak, archaic laws, which apply to generic NGO activities.

While many MFIs have used this flexibility to reduce poverty and create employment through innovatively designed programs, efficient branch networks, and charismatic leadership, the members and lenders have relied solely upon the integrity of managers to avert fraud and mismanagement. However, for the future sustainability of the microfinance industry, there is a general and growing belief among stakeholders that the industry should be regulated.

On May 2, 1990, the Government of Bangladesh (GOB) established the Palli Karma-Sahayak Foundation (PKSF) as a not-for-profit financial apex organization. As an apex organization, PKSF's purpose is twofold: (1) to perform financial intermediation through the distribution of collateral-free loans, financed by development banks and international donor agencies, to its partner organizations (POs) that perform grassroots microcredit operations and (2) to develop sustainable microcredit institutions.

PKSF's success as an apex organization is thought to lie in the flexibility of its mandate and in its freedom from government bureaucracy. In addition, PKSF's close consultation with its POs, highly qualified and dedicated professional staff, solid management information system and accounting practices allow it to effectively monitor and supervise its POs. Furthermore, the financial leverage that PKSF wields as a creditor serves as a credible enforcement mechanism over its POs.

The objective of this study is to determine the feasibility of giving PKSF the additional role of national regulator for the microfinance sector in Bangladesh. This report will begin by discussing the current state of the industry and the regulatory environment for microfinance in Bangladesh. It will describe the motivation for creating an industry-wide regulator and set out what would be involved in giving PKSF this role. It will provide a brief overview of the desired benefits and feared costs associated with making PKSF regulator. It will then weigh the pros and cons of modifying PKSF to take on the additional role of regulator. Policy implications conclude the report.

II. The Microfinance Environment in Bangladesh

A. The History of Microfinance

Dr. Muhammad Yunus is credited with pioneering the concept of microfinance in Bangladesh in 1976. While teaching economics at the University of Chittagong, Dr. Yunus initiated a research program to design a framework that would bring the poor within a viable banking network.[1] He experimented with the idea of giving uncollateralized loans to poor families in a rural village. Through the Grameen Bank Project, he demonstrated that poor, asset-less and landless people were creditworthy and that lending to the poor could be an economically viable activity.[2] In 1983, the Grameen Bank Project was transformed into an independent commercial bank, known as the Grameen Bank. A decade later, Grameen Bank numbered 295 branches and credit worth 1.5 billion taka ($25.4 million) had been distributed amongst 230,000 borrowers in more than 5,000 villages."[3]

Following the success of the Grameen Bank, a number of existing Bangladeshi non-governmental organizations (NGOs), including the Bangladesh Rural Advancement Committee (BRAC) and Proshika, developed their own microfinance programs based on the Grameen model.[4]

B. The Socio-Economic Environment

Bangladesh is one of the most densely populated and poorest countries in the world. In 1999, the population of Bangladesh was 120.1 million people, and the

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[1] Gibbons, David, S, *The Grameen Reader*, 2nd ed. (Dhaka, Bangladesh: Grameen Bank, 1999), 11.
[2] Ahhmed, Mostaq, *Key to Achieving Sustainability: Simple and Standard Microfinance Services of ASA* (Dhaka, Bangladesh: Prominent Printers, 2002), 10.
[3] Gibbons, 26.
[4] Sinha, Sanjay, "Bangladesh: The Role of Central Banks in Microfinance in Asia." (Manila, Philippines: Asian Development Bank, 2000), 7.

population density was 868 people per square kilometer. The average income per capita is approximately US$370 per year and close to 47% of the population lives below the poverty line. The adult literacy rate for males was 59% and for females was 43%. Infant mortality rate is 73 deaths per 1,000 live births and 56% of children under 5 years old are malnourished. Although these figures have slightly improved over the last ten years, they indicate of the pervasiveness of poverty in Bangladesh.[5]

Some of the socio-economic factors that have contributed to the problem of poverty have also encouraged microfinance to thrive in Bangladesh. Poverty creates demand for microfinance loans in countries where there is a strong tradition of entrepreneurship, but access to credit remains severely restricted for the asset-less poor. Despite the immense poverty in Bangladesh, the poor have managed to find many profitable income generating projects in service-based businesses, including wireless telephone call centers, tea stalls, embroidery work, rickshaw transportation, etc. These businesses are generally easy to start and manage, provide services that are in always in demand (even by the poor) and generate a profit in a short amount of time. These factors ensure the success of the business, full repayment of the loan and the tendency of the borrower to renew or increase the size of his/her next loan. High population density increases the demand for these business services, which also contribute to the creation of a large microfinance market in Bangladesh.[6]

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[5] Asian Development Bank EDSD Poverty Database. Accessed on March 20, 2004. Available from http://www.adb.org/Documents/EDRC/Statistics/Poverty/Spi_ban.pdf

[6] Geetha, Nagarajan and Claudio Gonzalez-Vega, "The Palli Karma Sahayak Foundation (PKSF): An Apex Organization in Bangladesh." (Columbus, Ohio: Ohio State University, 1998), 5.

C. The Current Microfinance Industry

The emergence and performance of the more than 1,200 diverse MFIs operating across the country with an average membership growth of 16% per year suggests that there is a burgeoning microfinance market in Bangladesh. The socio-economic characteristics of Bangladesh as well as industry trends in microfinance raise important questions about the future design of the microfinance market. As competition increases, the size, structure and sources of funding will affect the viability of each MFI and the industry as a whole. The purpose of this section is to describe the characteristics of the diverse stakeholders that constitute the microfinance industry and the important implications that they may have on the design of regulation reform.

Borrower Profile

The profile of a typical microfinance participant is quite homogeneous across MFIs in Bangladesh, as most MFIs have adopted the selection criteria from the Grameen Bank model. The majority of borrowers are poor women, who represent 82% of microfinance clients. They are typically landless or have less than 0.5 acres of cultivable land. The clients are typically 30-35 years old, married with an average family size of 5.4 members. More than 50% of the clients live below the poverty line and earn an average monthly income of $50-$75. The literacy rate among borrowers tends to be quite low, as 65% percent of borrowers have never enrolled in school.

Outreach

The microfinance industry in Bangladesh has expanded enormously since the early days of the founding of the Grameen Bank. In 1996, the total outreach of MF-

NGOs was six million members, which increased to ten million in 1999 (a 167% increase) at an average growth rate of 16% per annum during this period.[7] According to the Credit and Development Forum (CDF), a Dhaka-based network organization devoted to research, advocacy and capacity building for microfinance, an estimated 1,200 to 1,500 non-governmental organizations (NGOs) currently perform microfinancial services in Bangladesh. The microfinance industry disburses an amount of US$1 billion in loans annually. [8]

The GOB estimates that 45% of the population or approximately 12.2 million families are poor (based on the total population of 130.2 million and an average of 4.8 persons per family). About 70% of poor households are currently reached by MFIs based on the latest government estimate of poor families and adjusting the active borrower data for client overlap (the percentage of clients borrowing from multiple MFIs at the same time is estimated at 15%) and membership by non-poor households (estimated at 10%).[9] In 2000, there were about 11 million members and 8 million [active] borrowers in different MFIs.[10]

Market Composition

Three main categories of organizations that provide microfinancial services in Bangladesh, including, (1) savings and credit cooperative societies, (2) the Grameen Bank and (3) MFI-NGOs. All three types of MFIs lend small short-term loans (ranging from $50 to $200) to individual entrepreneurs for income generating activities (IGA).

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[7] Ahhmed, 14.
[8] Sinha, 7.
[9] Charitonenko, Stephanie and S.M. Rahman, “The Commercialization of Microfinance: Bangladesh.” (Manila, Philippines: Asian Development Bank, 2002), vix.
[10] Ibid, 10.

These loans are generally unsecured, with simple weekly repayment structures and documentation requirements with a higher annual interest rate (at 20-30%) than most commercial banks (at 15%).[11]

Savings and Credit Cooperatives

A handful of savings and cooperative organizations (1.1% of all microcredit providers) currently operate in Bangladesh. Credit unions and savings cooperative associations are formal MFIs whose services are primarily limited to their members. Credit unions are co-operative societies that offer loans to their members out of the pool of savings that are built up by the members themselves. The unique ownership status (member run, owned and used) of credit unions restrict transactions to its members by requiring that they belong to a common bond. The common bond or interest is usually associational, occupational or residential.[12] Generally, more than half of its total funding for financial services is generated from its members' savings and share capital contributions.

A Commercial Bank: The Grameen Bank

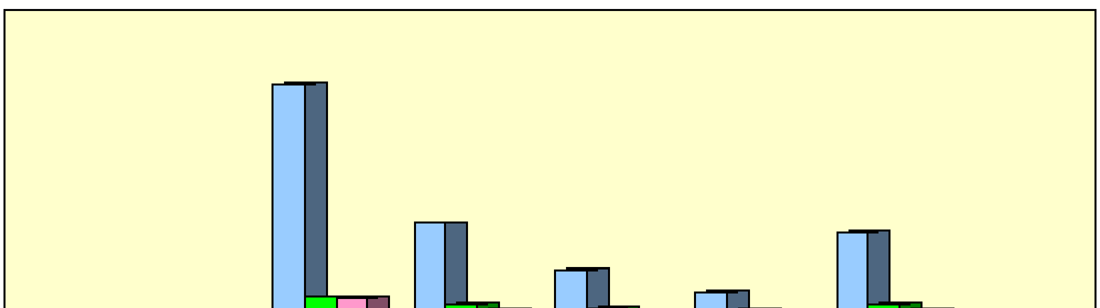
The Grameen Bank is a unique financial institution. It was created by a special act of Parliament, The Grameen Bank Ordinance 1983, as a commercial bank with the social mission of providing credit, with or without collateral security, to assetless and landless borrowers for any type of economic activity.[13] The Grameen Bank was started

[11] van Greuning, Hennie, Joselito Gallardo and Bikki Randhawa, "A Framework for Regulating Microfinance Institutions." (Washington, DC: Financial Sector Development Department, World Bank, 1998), 4.
[12] Ward, Ann-Marie and Donal McKillop, "The relationship between credit union objects and cooperative philosophies." (Belfast, Ireland: School of Management and Economics, Queens University Belfast).
[13] Ibid, 6.

with funds from the Bangladesh Bank, capital markets and concessional loans from international donors. Even though Grameen does not attract private capital with market rates of return and continues to receive substantial donor funding for its development activities, Grameen is operationally self-sufficient, which means its operating costs are covered more than 100 percent by internally generated revenues.[14]

The Grameen Bank employs 14,000 staff and conducts operations in 35,000 villages in rural Bangladesh. It currently has a membership of 3,260,598 clients. Since its inception more than two decades ago, Grameen has provided over $4 billion dollars in microloans. In 2002-03, it disbursed an amount of Tk. 18.5 billion (US $319 million) in loans. This year, it is expected to lend more than half a billion dollars.

Figure 1: Top Four MFIs in terms of Disbursement, Outstanding Loans and Savings (in billions taka)[15]



	G Bank	BRAC	ASA	PROSHIKA	Other MFIs
Disburs	154.11	61.74	30.45	16.53	55.55
Outstand	12.73	8.25	5.36	4.22	7.95
Savings	12	3.97	1.48	1.18	4.15

Source: Bangladesh Bank 2002

[14] Ahmed, Salehuddin, "Regulatory Framework for Microfinance Institutions: A Case Study of Bangladesh." (Dhaka, Bangladesh: PKSF, 1999), 15.
[15] Haque, Khandakar Muzharul and Lila Rashid, "Microfinance in Bangladesh." (Dhaka, Bangladesh: Bangladesh Bank, 2002), 3.

Microfinance-Non-Governmental Organizations

The vast majority of 1,200 plus microfinance organizations operating in Bangladesh are NGOs. Some MF-NGOs are structured as stand-alone institutions, while for other NGOs, microfinance operations are component programs that work in tandem with different social impact programs. About 35 NGOs are estimated to provide microfinance services exclusively.[16]

Many NGOs in Bangladesh are based on local initiatives, and some possess considerable experience in providing financial services. In June 2002, a total of 681 MF-NGOs were registered as members of the research institute, the Credit and Development Forum (CDF). Of this 46 NGOs were categorized as large MFIs (each with more than 15,000 active members). The majority of the NGOs are small in terms of the number of their clients and their volume of loans. About 74% of MF-NGOs have up to 3,000 members and only about 6.67% of MFIs have more than 100,000 members. Small and medium sized MFIs have reached 600,000 borrowers in disbursed loans, compared to the largest MFIs that have reached 12.7 million borrowers.

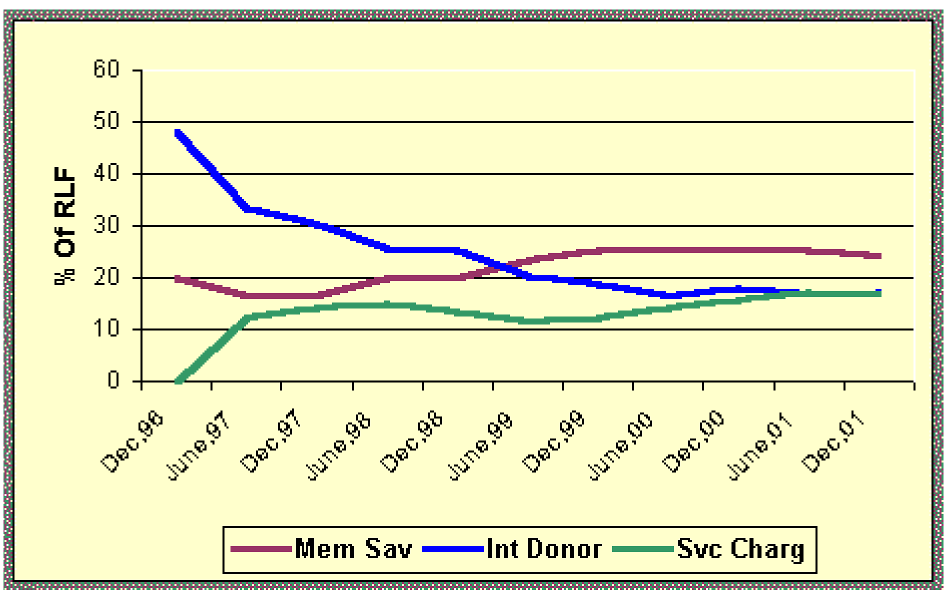
Most small NGOs have been in operation for less than a decade and incur relatively low administrative expenses, as they operate with low-pay staff structures. Small NGOs tend to have a lower loan recovery rate (95.22%) and are more likely to be dependent on external funds for growth, whereas large NGOs that have been in operation for more than two decades tend to have a higher average loan recovery rate (97.06%), professional management, abundant internal funds, and good access to external funds.

[16] Nagarajan et al., 8.

Sources of Funds

Sources of funds vary among MFIs as a result of differences in their access to various sources of capital for covering operational expenses and for providing micro loans. According to CDF, as of June 2002, sources of funding for the revolving loan fund (RLF) of the 681 MFIs it surveyed came from the following internal and external sources: members' savings (25.49%), PKSF (23.64%), foreign donations from international NGOs and international donors (17.04%) and interest payments from borrowers (16.59%).[17] Most MF-NGOs have traditionally received heavy support from foreign donors. However, as international donor funds are drying up and commercial sources of funds remain limited, MFIs have been increasingly on-lending funds from savings deposits and approaching PKSF for financial and technical support.

Figure 2: Trends in Sources of Funds, 1996 to 2001[18]



Source: Bangladesh Bank 2002

[17] *CDF Microfinance Statistics* (Dhaka, Bangladesh: Credit Development Forum, 2002), 4.
[18] The service charge is the interest rate on a loan. Accessed March 27, 2004. Available from http://www.bangladesh-bank.org/seminar/cpbdesh.html.

As MF-NGOs are legally restricted by the GOB from collecting savings deposits from the general public (with the exception of Grameen Bank), several larger, more stable MFIs such as BRAC and ASA have augmented their funding resources with member's savings deposits. According to *CDF Microfinance Statistics*, member's savings have exhibited an overall growth of 37.95%, increasing 14% from the previous year. In many Grameen-type group-lending programs, the members are required to deposit *forced* or *compulsory* savings (as little as 10 taka or 6 cents) on a weekly basis. The regularity of savings deposits and attendance of group meetings are additional preconditions for receiving credit. The savings are, in effect, used as cash collateral for loans. Historically, MFIs have not allowed members to withdraw any amount of their forced savings except when members decide to permanently leave the organization, since most MFIs have used the savings fund as an important source of their loan fund.[19]

Table 1: Source of Revolving Loan Fund of MFIs (percentages of total)[20]

Sources of Funding	**Dec., 1999**	**June, 2001**
Members savings	25.37	25.74
Service charge [21]	12.47	17.21
Foreign donations	19.11	17.43
Local banks	11.33	9.15
PKSF	23.81	23.50
Other sources	7.91	6.97
MFIs internal fund	(3.79)	(4.14)
Local donations	n.a.	n.a.
BRAC + Proshika + ASA (3 largest MFIs)	(0.27)	(0.49)
Number of MFIs borrowing from PKSF	122 (22.85)	119(20.00)
Number of MFIs included in survey	534	601

Source: CDF Statistics, Dec. 1999, June 2001

[19] Alamgir, Dewan, *Microfinancial Services in Bangladesh: Review of Innovations and Trends.* (Dhaka, Bangladesh: Credit and Development Forum, 1999), 18.
[20] Ahmed, Salehuddin, "Poverty and Microcredit: New Realities and Strategic Issues." (Dhaka, Bangladesh: Microcredit Operation Seminar, Bangladesh Bank), 5.
[21] The service charge is the interest rate on a loan.

Industry Structure

The structure of the microfinance industry is characterized by high market concentration due to domination of the market by a few large MFIs. In 2000, the four largest MF-NGOs, BRAC (28%), Grameen Bank (18%), the Association for Social Advancement (ASA) (11%), and Proshika (10%) covered about 67% of total outreach.

Flexibility and innovation in microfinance products and services are factors that have aided MFIs to face increasing industry competition. In the more populated villages that have multiple microfinance programs, MFIs are seeking new ways to respond to client demand by diversifying and expanding their product offerings to include larger individual loans, leasing, savings products, and microinsurance.[22] At the same time, some of the larger MFIs are slowing down their expansion in and pulling out of risky areas due to limited success, paving the way for small and medium MFIs to become major actors in these niche areas.

Description of PKSF [23]

The Palli-Karma Sahayak Foundation (PKSF) was established as an apex funding organization by the GOB in May 1990. According to Geetha and Gonzalez-Vega,[24] an apex funding institution, can be defined by the provision of its services, which include:

> (i) the wholesaling of loanable funds on behalf of donors and governments;
> (ii) the screening and certification of MFIs that fulfill certain eligibility criteria;
> (iii) the operation of loan-guarantee facilities; and
> (iv) institution-building support in the form of technical assistance and/or training of the staff of the retailing MFIs, and
> (v) the monitoring and supervision of MFIs.

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[22] Charitonenko et al., x.

[23] The description of PKSF in this section is based on the following three bibliographic sources: (1) "The Palli Karma Sahayak Foundation (PKSF): An Apex Organization in Bangladesh" by Geetha Nagarajan and Claudio Gonzalez-Vega, (2) the PKSF web-site: http://www.pksf-bd.org, and (3) the PKSF Annual Report 2002.

[24] Nagarajan et al., 1.

As an apex body, PKSF's main role has been the on-lending of funds from government and international agencies on highly concessional terms to individual NGOs engaged in microfinance. It also works to build up the retailing capacity of small and medium sized MFIs through providing technical assistance and staff training programs, and zero interest loans for capital equipment purchases.

PKSF has been an important facet of the microfinance landscape of Bangladesh for several reasons. First, it plays a quasi-regulatory role in that holds NGOs to performance standards as a condition for obtaining its loan funds.[25] An MFI must meet certain selection criteria to be elected and registered as a partner organization before it can receive PKSF loan funds. As a condition for receiving the funds, PKSF provides continuous strategic monitoring and supervision of the MFI. As the only national apex financial institution in Bangladesh, PKSF has become a significant, stable source of funding for its MFI POs. Inherent in the relationship between creditor and debtor, there is a powerful incentive for MFIs to meet its reporting and performance standards.[26]

Second, although it was established by the GOB, PKSF's legal structure as a non-profit organization allows it the flexibility and authority to establish linkages between MFIs, banks and donor organizations for mobilizing resources and managing its own budget. Third, being free from government bureaucracy, PKSF engages in advocacy work and lobbying on behalf of the microfinance sector. It also organizes workshops, seminars and international conferences and makes use of its organizational network as a conduit for information dissemination.

[25] Meagher, Patrick, "Microfinance Regulation in Developing Countries: A Comparative Review of Current Practice." (College Park, Maryland: IRIS Center, University of Maryland, 2002), 48.
[26] McGuire, Paul, B., John D. Conroy and Ganesh B. Thapa, "Getting the Framework Right: Policy and Regulation for Microfinance in Asia." (Australia: The Foundation for Development Cooperation, 1998), 8.

Industry Outlook

As international donor funds for microfinance continue to decline as a source of overall funding and MFIs push further into different areas of financial intermediation, many stakeholders believe that the future direction and impact of the microfinance industry in Bangladesh will depend largely on the development of a more effective regulatory and supervisory framework. Without proper regulation in place, an MFI remains limited in the kinds of functions it can perform and the sources of funding it may access. For example, as a commercial bank, the Grameen Bank has the ability to collect deposits from the general public, which provides an additional source of funds for on-lending that is currently unavailable to other MFIs in the industry. Since the Grameen Bank was created by a special act of Parliament, currently there is no regulation that allows for the transformation of NGOs into microfinance banks or for the creation of new ones. Many MFIs aspire to upgrade their savings activities and transform themselves into full-fledged financial institutions and it is estimated that approximately 300-350 MFIs have the potential to become financially sustainable in the near future.

As international donor funds continue to decline, there has been a strong upward trend in MFIs boosting efforts in mobilizing local resources by introducing various savings and credit products. NGOs are trying to become more responsive to client demands for diverse products. Clients currently complain that the loans that they receive fall short of their actual needs. This indicates that the market for microfinance is yet not saturated and that further industry growth can be expected. New products, such as microinsurance, are currently offered by 15% of NGOs. Unfortunately, there is no technical procedure for designing these products and actuarial tables are not used to set the premium. Most MFIs do not bother to determine the actual cost of the savings, credit or insurance instruments they are providing. Therefore, the rise of faulty, unregulated products on the market may cause confidence in microfinance sector to decrease.

In addition to funding difficulties, the lack of institutional and human resource capacity building may also place constraint on the future scalability and sustainability of MFIs. Small and medium MFI-NGOs, especially those operating in higher risk areas (e.g. isolated, ultra-poor) tend to be less experienced in the provision of microfinancial services, as few successful models currently exist.

III. The Current Regulatory Environment

The Bangladesh Bank (central bank) has been largely absent in the development of microfinance industry and has avoided interfering with the regulatory activities of MFIs. MFIs have had considerable freedom to operate and innovate due to the combination of government tolerance, lack of institutional capacity, and extremely high levels of donor funding and protection. With the exception of the Grameen Bank, NGO-MFIs are not subject to any official standards or prudential requirements.[27] Lack of clear regulation has implicitly discouraged MFIs from attempting to diversify their financial product offerings and to collect voluntary savings deposits. At the same time, it is also deemed responsible for the fraudulent activities of a number of fly-by-night MF-NGOs.

A. The Regulation of Cooperatives

Under the Cooperative Societies' Ordinance, cooperative societies are permitted to mobilize savings from the general public, though the registrar of cooperatives has little power, either preventative, or protective, and conducts minimal supervision. As a member-based, member-run institution, it is generally accepted that the members themselves are responsible for the monitoring and supervision of the cooperatives' functions, as they engage in these activities at their own risk.

B. The Grameen Bank Ordinance 1983

The Grameen Bank is the only MFI regulated by the Ministry of Finance through its own specialized charter called The Grameen Bank Ordinance 1983. The Ordinance requires licensing, monitoring and supervision requirements that are similar to those of commercial banks. But, in order to accommodate its social mission, Grameen has been

[27] Meagher, 29.

allowed special modifications in the banking laws.[28] The legal scope of its activities and its regulation requirements differ from regular commercial banks in several areas.

Scope of Activities. Like other MFIs, the legal status of Grameen Bank gives it the authority to provide credit without collateral securities in cash or in kind to landless persons for all types of income generating activities. Similar to other large MFIs, including BRAC, ASA and Proshika, Grameen also accept compulsory and voluntary savings deposits from members and borrows external funds from commercial banks against the security of its assets for the purpose of the bank's business. However, unlike all other MFIs, Grameen Bank is a prudentially regulated commercial bank and is authorized to mobilize savings deposits from the general public. It is also prohibited by the Bangladesh Bank from engaging in foreign exchange transactions.

Establishment of New Branches. The Grameen Bank must request approval from the Bangladesh Bank to open a new branch. The central bank prepares a brief feasibility study that evaluates the population demographics of the area. It also includes the opinions of local politicians and commercial bank officials. In practice, permission from the central bank has been a formality since no request has ever been denied.

Ownership Structure. Unlike most MFIs, the Grameen Bank is majority-owned and controlled by its shareholder-members. Muhammad Yunus designed the bank such that its ownership and control should remain in the hands of the very people it lends to. As soon as a borrow accumulates sufficient savings, she buys one (and only one) share in the

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[28] Charitonenko et al, 29.

Bank, which costs $3. Only the borrowers can buy shares in the bank."[29] Its borrowers currently own 92% of the Grameen Bank. The Bangladesh Bank owns the remaining 8% of the shares.

Governance Structure. Unlike other MFIs, Grameen Bank is directed by government appointed and shareholder-nominated members. The management of Grameen Bank is vested in a 13-member board of directors, which includes the chairman, who is appointed by the GOB. Nine of the twelve directors are nominated from the predominately female shareholder-members of different regional branches. Member-shareholders representatives are elected through a series of regional elections and serve three-year terms. While the Board appoints the Managing Director, the selection of candidates must be approved by the Bangladesh Bank. The Managing Director is an ex-officio board member with no voting rights. To date, the only Managing Director has been Dr. Muhammand Yunus, the founder of Grameen Bank.

Capital Requirement. The Grameen Bank was established with an initial capital base of US$2.5 million, with an additional paid-in capital of US$1.75, totaling to US$4.25 million, compared to US$3.25 million for the standard commercial bank in Bangladesh.

Compliance with Portfolio Risk Classifications.[30] Under revisions made to the Ordinance in October 2002, the Grameen Bank reports delinquency, loan loss provisions[31] and write-offs[32] to the Bangladesh Bank using the same measures as formal

[29] "Impact of the Grameen Bank on Local Society." Accessed on May 11, 2004. Available from http://rdc.com.au.
[30] Portfolio at Risk is the proportion of its total loans outstanding that have arrears of more than 4 weeks.
[31] Loan loss provisions are funds set aside by the bank's management in recognition of expected bad loans for the period.

banks. Grameen has two types of income generating loans: Basic and Flexible.[33] Grameen makes 100% provision for Basic income generating loans outstanding two years from date of first disbursement and 20% provision for all income generating loans outstanding one year from date of disbursement.[34] Flexible loans carry more risk than Basic loans and 50% loan loss provision is made for them.[35] These overdue loans are written off once they are two years past due.

Access to Bangladesh Bank Funds. Unlike regular banks, the Grameen Bank does not have access to central bank lines of credit. Instead, it is allowed to issue bonds and debentures that are guaranteed by the GOB.

Taxable Status. Effective January 1997, the Grameen Bank has been granted a tax exemption on income tax, super tax and business profit tax on the terms that the bank will establishes a Rehabilitation Fund and transfers thereto the entire amount of dividend declared and tax payable (but not actually paid over) by the Bank. The Rehabilitation Fund is utilized for the purpose of rehabilitation of members affected by natural disasters.

Weaknesses of the Ordinance

As a commercial microfinance bank, the Grameen Bank has both a social mission and a commercial motive. Under the Ordinance, Grameen must comply with prudential regulation requirements like regular commercial banks. However, as a MFI, it was

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[32] Write-offs are loans that the financial institution has removed from its books because of a substantial doubt that they will be recovered.
[33] Grameen clients start with a basic loan. If a borrower misses more several consecutive weekly payments, then the loan automatically gets restructured into a longer term Flexible loan.
[34] Accessed on May 11, 2004. Available on http://www.grameen-info.org.
[35] Gibbons, Davis, S, "Portfolio Quality at Grameen Bank." Accessed on May 11, 2004. Available from http://www.gfusa.org

allowed permission to adapt some of these requirements in order to accommodate its microfinance mission, creating some potential weaknesses in its regulation.

In most commercial banks shareholders monitor the performance of management to ensure that their actions are properly aligned with the overall goals of financial institution. In the case of Grameen, although member-shareholders control 92% of the bank (the remaining 8% is controlled by GOB), each member is allowed to own only one share of Grameen stock. With over 2.4 million shareholders, it becomes physically impossible for members to directly participate in shareholder meetings or wield any real power over management, as they are unable to sell or trade their share.

Despite the poor quality of supervision of the Bangladesh Bank (as observed by the Bangladesh Bank's continued capital infusions to the four largest failing government banks with high levels of non-performing loans), commercial banks in Bangladesh adhere to the international standards of the Basle Core Principles of Banking Supervision. The Grameen Bank Ordinance, however, makes only minimal provisions for prudential regulation, leaving most decisions on capital ratios, liquidity ratios, loan loss provisioning, and reserve funds to the discretion of the Bank's board. Although the Ordinance does call for higher capital requirements than regular commercial banks, there are no on-going capital adequacy or liquidity ratio requirements to insure that the initial capital is actually preserved.

Despite these regulatory weaknesses in the Ordinance, the Grameen Bank is, nevertheless, formally regulated and supervised under the purview of the Bangladesh Bank and the Ministry of Finance. By default of its special legal and formal commercial bank status, Grameen falls outside of the discussion for the pressing need for the creation of new microfinance regulation.

C. The Regulation of MF-NGOs[36]

As MF-NGOs are neither categorized microfinance commercial banks as Grameen Bank, nor as non-bank financial institutions under the Financial Act of 1993, they are not regulated by the Bangladesh Bank or by any other government agency. Registration is not even mandatory for all NGOs, but most register for the sake of legal recognition. Only those NGOs receiving or applying for foreign funds are required by law to register with the NGO Affairs Bureau (NGOAB). As of December 1999, about 1,429 NGOs registered with NGOAB out of 19,000 existing NGOs in Bangladesh.

There are two parts to the legal framework that govern NGOs in Bangladesh. The first part manages the act of incorporation (i.e., acts under which NGOs are incorporated and given a legal identity). These laws and acts relate to the formation, management structure, and the responsibilities and liabilities of NGOs, which include the Societies Registration Act 1861, Trust Act 1882, Cooperative Societies Act 1925, and Companies Act of 1913 (amended in 1994).

The second part of the legal framework manages the laws and ordinances for the regulation of the relationships of such associations with the government. The laws of the second group are the Voluntary Social Welfare Agencies (Regulation and Control) Ordinance 1961, Foreign Donations (Voluntary Activities) Regulation Ordinance 1978 (amended in 1982) and Foreign Contributions (Regulation) Ordinance 1982.

[36] Accessed on April 22, 2004. Available from http://search.com.bd/banglapedia

The registration requirements for MFIs are simple and non-specific to microfinance. To be registered under these Acts, NGOs must generally have a memorandum of association and rules and regulations, or some similar document, covering such matters as the name of the organization, objectives, membership, management committee and organizational structure. In addition, government agencies require an annual report and financial statements.

IV. The Consensus for Regulatory Reform

Over the last six years, there has been a growing perception among key players in microfinance industry that several benefits would flow from the creation of a new regulatory framework. There has been considerable on-going debate among stakeholders about this issue. In November 1998, the main actors in the microfinance industry, including representatives of MFIs, the Bangladesh Bank, government agencies, research institutions and PKSF, participated in a "Workshop on Appropriate Regulatory Framework for NGO-MFIs," hosted by the Credit Development Forum. Through this participatory forum, the representatives concluded that the numerous, diverse, unenforceable laws, which govern currently govern microfinance activities in Bangladesh, were largely irrelevant and restrictive of future industry expansion.

In June 2000, the Microfinance Research and Reference Unit (MRRU), a steering committee headed by the Governor of the Bangladesh Bank, was set up to draft legislation for a new legal and regulatory framework specific to microfinance. The 11-member committee includes representatives from the Finance Ministry, the Social Welfare Ministry, the NGO Affairs Bureau, The Grameen Bank, PKSF, a large NGO, a small NGO, CDF and the Bangladesh Bank. The committee decided that ensuring transparency and accountability of MF-NGOs would be the main objectives of this policy. A technical committee of MRRU, headed by PKSF's Managing Director, outlined several possible design choices for the regulatory framework in a report, which is currently being reviewed by the GOB.

As recently as November 2003, the GOB announced to the Bangladesh media, "the urgency of the creation of a regulatory commission to oversee the expanding microfinance operations under a uniform, legal framework".[37]

A. Policy Objectives of Regulatory Reform

At the national policy level, there is a perception that several benefits would flow from the regulation of the microfinance sector in Bangladesh. These benefits are expected to improve the coverage and the level of protection of depositors and investors and the financial system as a whole. They also aim foster the sustainability of the MFI sector by creating a legal enabling environment that promotes the diversification of new product and service offerings and increases MFI access alternative sources of funding. This section describes the main policy objectives that policy makers hope to achieve from the regulation of microfinance.

First and foremost, it is expected that regulation reform will improve the protection of depositors and investors though several different channels: (a) improve the quality of the standards that MFIs must meet; (b) improve the coverage of all institutions through the creation and enforcement of standards; (c) create greater reporting uniformity, so that consumers can make educated comparisons; and (d) assist MFIs to build institutional capacity in order to better manage their funds and risks.

By improving the uniformity and the quality of the standards that MFIs are required to meet, it is expected that regulation will increase transparency and good governance of MFI operations. The current ambiguities and inconsistencies in the definitions of MFIs and the types of activities allowed under the existing acts, laws and

[37] "Microcredit-Saifur," United News of Bangladesh, November 12, 2003.

ordinances make the current regulation difficult for the GOB to enforce and easy for MFIs to manipulate. The laws that currently govern MFIs were created with the intention of regulating NGOs, not financial institutions, and do not contain provisions that address special regulatory issues concerning MFIs operations.[38] At present, only those MFIs who opt to register or request donor funds are required to produce financial statements. But, since the data are only collected annually they cannot be used for regular and timely supervision. Enforcement has also been compromised by the fact that government agencies are not staffed with personnel that are knowledgeable in microfinance. There is a felt need that the laws needs be fine-tuned through the necessary statutory modifications so that MFIs are able to function with a clean legal basis.[39] The new legislation would aim to address these issues by clearly laying out guidelines for incorporation, governance structure, reporting and capital requirements, and performance standards that would be specific to different categories of microfinance organizations.

The standardization of reporting requirements for MFIs is also expected to increase transparency and reduce the opportunity for fraud and mismanagement. It will allow for the comparability of reported figures across MFIs, which will allow consumers and investors to make more educated decisions about their choices. Clients could use the information to compare interest rates and fees to determine the most competitive credit or savings options for them.

Regulation is expected to protect depositors and investors by placing precautionary measures on an institution to ensure the safety and sustainability of the financial system as a whole. "Systemic risk is the probability that cumulative losses will

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[38] McGuire et al., 7.

[39] *Proceedings of the Workshop on Appropriate Regulatory Framework for NGO-MFIs*. (Dhaka, Bangladesh: Credit and Development Forum, 1998), 7.

occur from an event that ignites a series of successive losses along a chain of institutions or markets comprising a system. Since larger MFIs are closely intertwined financially with other financial institutions, holding deposit balances at banks, and lending funds and technical support to smaller MFIs, a failure at one major MFI is believed to be more likely to spillover to other MFIs."[40] Graham Wright supports the need for regulation as a means of preventing systemic risk. He states:[41]

> "In Bangladesh at present, despite many examples of the loss of precious savings of the poor (usually through both benign incompetence but occasionally through criminal intent), there is no regulatory no insurance mechanism to safeguard all the savings being mobilized. There is a clear need for the MFIS and others interested in the need for the well-being of the microfinance industry in Bangladesh to be proactive in developing regulations and depository protection schemes."

In addition to man-made scandals, commonly occurring natural disasters in Bangladesh may also cause systemic risk, as many depositors to suddenly draw down their life savings from their open access savings accounts. MFIs must be equipped to respond to such a demand for funds in order to maintain their clients' confidence in the institution. According to a study conducted by Wright on the rural MFI, BURO Tangail, "the poor (quite rightly) take time to develop confidence in a MFI and its ability to repay savings. They like to see loans being made available on demand and to test the withdrawal facility to ensure that it operates as advertised. Banking is all about confidence."[42]

By assisting MFIs to build institutional capacity in order to better manage their funds and risks, it is expected that regulation will lead to the development of a more

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[40] Hughes, Jane E. and Scott B. MacDonald, *International Banking Text and Cases*, (Boston, MA: Addison Wesley, 2002), 235.
[41] Wright, Graham A.N., "Moving the Mountains: Savings as a Human Right in Bangladesh." (Kampala, Uganda: MicroSave-Africa, 1998), 13.
[42] Wright, 11.

sustainable industry. Most MF-NGOs in Bangladesh are not very cost-conscious and financial data are not readily available as they are seldom produced.[43] Providing technical advisory services and financial management training to MFI administrators and loan officers will not only help MFIs to meet their regulatory requirements, but will also improve their prospects for long-term growth and sustainability.

A second major benefit that is expected to come from regulation reform is the creation of an enabling environment that supports the diversification and economies of scale of new products without creating undue risk. Savings and insurance products, especially voluntary open access savings accounts[44], contractual savings agreement schemes,[45] microinsurance and pension plans are an immense benefit both to the poor and the MFIs that service them. Currently, the rigidity of the ordinances and acts limits NGO capacity to respond to the client demand in a flexible way that encourages industry growth. For instance, due to the lack of depositor protector schemes, MFIs continue to require substantial locked-in, compulsory savings from clients as a means of maintaining *de facto* loan guarantee reserves. Years of enforced group savings have allowed larger MFIs to develop a huge capital fund for their lending operations. As a result, MFIs have reluctantly pushed into voluntary savings products for fear that allowing open access withdrawal of those savings would result in massive outflows of funds as the members used these large balances—possibly in preference to taking loans.[46] Especially in a country like Bangladesh, where the clients are susceptible to macroeconomic factors,

[43] Rahman, S.M., "Commercialization of Microfinance in Bangladesh Perspective." (Dhaka, Bangladesh: Credit Development Forum), 2001.
[44] Open access savings accounts or "current accounts" allow the client to make withdrawals at any time without penalty.
[45] Contractual savings agreements (CSA), commits clients to save a specified amount, every specified period, for a specified number of periods in return for a pre-determined pay out on successful completion of the CSA.
[46] Wright, 11.

including high inflation, urbanization, and frequent natural disasters, MFIs remain cautious in offering such products without the proper regulation in place. According to The Consultative Group to Assist the Poorest (CGAP) despite these advantages, the expansion of savings services to the poor remains possibly the greatest challenge in microenterprise finance.[47]

Lastly, it is expected that regulation will encourage more investment into the microfinance sector. Regulation would serve to boost investor confidence in MFIs that meet compliance and to assist MFIs to access alterative sources of funding for their capital requirements and loan funds. Compliance would to raise the bar on performance standards for all MFIs thereby, credibly signaling the financial health of the organization to private investors, international donor agencies and commercial banks. Private investors could use financial statements to create a sort of informal credit report to determine which MFIs are healthy and sustainable and they may be less reluctant to directly fund NGOs, provided that regulation is enforced.

B. The Cost and Benefits of Regulatory Reform Across the Economy

The regulation of microfinance is expected to impact stakeholders in the microfinance industry differently. This section will lay out the costs and the benefits of regulatory reform that many proponents of reform believe would be distributed among economic actors in the Bangladeshi microfinance sector.

Members

Benefits:

Regulatory reform is thought to improve the level of protection of depositors. The standardization of financial reporting requirements and the enforcement of standards

[47] Wright, 1.

are expected to increase the transparency and the comparability of the data, reducing opportunities for moral hazard, fraud and mismanagement. It would also allow of consumers to make more educated financial decisions. Members would also benefit from a wider selection of innovative products offered by MFIs. It is believed that overall participation and outreach of microfinance activities would rise due to increased confidence in the system, greater consumer choice and improved competition between MFIs.

Costs:

Regulatory compliance may cause MFIs to incur higher administrative costs and be forced to raise their interest rates on loans and lending fees. Increased administrative costs could potentially curtail outreach to higher risk or vulnerable groups. Members in more isolated regions may also face fewer options among MFIs, due to gradual industry consolidation.

Small and Medium Microfinance Institutions

Benefits:

Small and medium MFIs may have much to gain from the legitimacy granted through regulation. Regulatory compliance may compel MFIs to improve the financial management of their organization, in order to signal financial stability to potential clients and investors. The standardization of financial reporting requirements and the enforcement of standards would increase the transparency and the comparability of the data, reducing opportunities for moral hazard, fraud and mismanagement. It is expected that financial credibility may serve to level the playing field for external funds as small and medium MFIs compete with larger, more established MFIs for access to donor or private funds. In addition, client overlap (the act of borrowers taking multiple loans from different MFIs) is expected to decrease.

Costs:

Increased administrative costs incurred by regulation compliance are expected to put a strain on profit margins, outreach and sustainability of MFIs. It may also lead to mission drift as MFIs phase out of the industry or collapse because they cannot meet the requirements.

Large Microfinance Institutions

Benefits:

As international donor funds for microfinance continue to decline as a source of overall funding and large MFIs will now rely more freely on the collection of voluntary savings deposits, regulation is expected to establish mechanisms to safeguard the savings deposits of members. This is intended to have a direct positive impact on the ability of large MFIs to rapidly and safely expand their capital requirement and loan fund needs. As a result these MFIs may gradually decrease donor dependency and become self-sustaining. Eventually, larger MFIs may transform into microcredit banks. In addition, client overlap (the act of borrowers taking multiple loans from different MFIs) is expected to decrease.

Costs:

As these large MFIs are already subjected to strict monitoring and supervision by PKSF, the costs of regulation compliance are expected to put little strain on profit margins, outreach and sustainability of MFIs. However, larger established MFIs who have been operating freely may face more bureaucracy and control under the new regulation.

The GOB

Benefits:

Regulation reform is hoped to foster the growth and the sustainability of the microfinance industry, which will improve the overall welfare of its poor citizens. Increased access to financial tools for managing income and businesses will provide the poor with more economic choices and decision-making power and raise their standard of living. Employment opportunities of the poor may increase. The spillover effects of the increased transparency and governance of the microfinance sector of microfinance may lift Bangladesh's economic profile and bring in more foreign capital inflows into the country.

Costs:

Laying off or retraining government agency staff to regulate the microfinance sector will be a huge political and economic challenge. The GOB is the largest employer in the country and it is likely that civil servants will protest.

Donors, Investors

Benefits:

With effective regulation in place, donors may reduce monitoring and supervision costs, thereby increasing the likelihood of lending to new kinds of organizations and projects. For example, donor funds may be better utilized in large-scale projects that may impact microfinance such as strengthening the role of the central bank.

Costs:

Donors may not agree with the standards enforced by the new regulator and may go ahead and still fund unsustainable MFIs on their own.[48]

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[48] Banking with the Poor Newsletter. No. 13. July 1999. Accessed on February 21, 2004. Available on http://www.bwtp.org/newletters/news13.htm

V. A Proposal for Making PKSF the Regulator

A. Key Characteristics of PKSF that Would Make it a Good Regulator

Based on the benefits that policy makers hope to achieve from regulation reform, there are several key characteristics of PKSF that are thought to render it a good candidate as regulator.

PKSF's Extensive Experience in Appraising, Monitoring and Supervising MFIs

PKSF has more than twelve years of experience in collecting and digesting accounting information from over two hundred diverse microfinance POs. It devotes a considerable amount of resources to appraising, monitoring and supervising partner organizations to ensure that each one meets its standard criteria before receiving new funds.[49] The highest governing body within PKSF, The General Board, developed strict policy guidelines that it uses to effectively manage its MFI partner organizations.

Before an MFI can be selected as a partner organization, it undergoes a rigorous screening process that has it has perfected over the years. PKSF follows clear guidelines in determining the eligibility of its partner organizations, which are based on an assessment of following seven characteristics: (1) organizational structure, (2) reputation of the organizer, (3) management quality, (4) capacity/ efficiency of the staff, (5) area of operation and activities, (6) past performance, and (7) status of the Management Information System). PKSF uses these common criteria to accept POs on the basis of their focus on the target clientele, the robustness of their governance and management structures, their experience in microfinance and their record in collecting loans.[50] PKSF has a rating system for five categories of POs. These determine the maximum loan that

[49] Ahmed, 17.
[50] Nagarajan et al., 23.

the PO can obtain from PKSF. The system is very complex with 139 indicators covering the following areas: viability of borrowers, institutional viability and financial and economic viability.[51]

As an organization that provides collateral-free, concessional loans to MFIs, monitoring and supervision are integral parts of PKSF's activities. Every PO is systematically required to submit monthly and quarterly statements that specify information about loan disbursements and repayments, savings collected and invested, management, and repayment to PKSF. POs are also monitored for the attendance rate of their borrowers at group meetings, their financial performance, their staff performance, their cost of operations, their income, their effectiveness in the expansion of activities and their utilization of PKSF funds.[52] PKSF actively follows up on these reports during its visits to POs at least four times a year and through its annual audits.

PKSF's Successful Human Resources Policy

PKSF has well-developed policies regarding human resources management. PKSF recruits graduates of high academic standing, which has contributed to the quality of the services delivered, the working culture within PKSF and the advisory role played by PKSF. Besides the job security guaranteed by government employment, the salaries and benefits received by PKSF staff are higher than those paid by regular government employers and large NGOs. This policy was designed to attract, train, and retain highly qualified candidates for long-term career development at PKSF. According to Claudio Gonzalez-Vega, "These attractive remunerations act as efficiency wages, a structure of incentives that has been found [elsewhere] to promote staff behavior compatible with

[51] McGuire et al., 11.
[52] Nagarajan et al., 25.

sustainability."[53] Properly motivated and trained personnel are expected to more productive and reliable employees.

If these policy guidelines could be extended to the entire microfinance sector, it is expected that the regulatory coverage of MFIs across the industry would increase due to PKSF's ability to efficiently appraise, monitor and supervise MFIs. It is also expected that the current duplication of different government agency efforts would be eliminated.

PKSF's Significant Experience in Capacity Building for MFIs

PKSF places great emphasis on building institutional development in order to strengthen its own capacity as an apex funding institution and the capacity of its POs.[54] Its institutional development activities include program outreach, loan absorption capacity of the POs, supervision and monitoring, financial management and control, personnel policy including human resource development, and sustainability of the microcredit program, etc.

Over the last decade PKSF has prepared a number of policy guidelines and standards for its POs and for the microcredit sector. PKSF reviews its policies and programs continuous basis and adjusts them accordingly to meet changing requirements. PKSF plans to expand its policy program and to develop standards for best practices in microcredit lending. As of June 2003, PKSF prepared 20 major policy guidelines and standards. Examples of these, include the following topics: Guidelines on the Management of Savings; Guidelines for Avoiding Overlapping; Guidelines for

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[53] Nagarajan et al., 18.
[54] "Microcredit Operation." (Dhaka, Bangladesh: Palli Karma-Sahayak Foundation). Available from http://www.pksf-bd.org.

Performance Standards and Categorization of POs; and Policy for Loan Classification and Debt Management Reserve, etc.

PKSF also regularly conducts a highly customized training program for PO and PKSF staff. PKSF has developed 22 training modules in response to information received from PKSF Training Need Assessments (TNA).[55] A new dimension in the training program has been developed to accommodate spot training (quick, need-based) for PO staff.

PKSF also offers on-site technical assistance during their regular intensive field visits, which has been found very effective in improving the efficiency of POs. In addition, PKSF established a Pre-PKSF program to fund and develop small locally based NGOs, which do not yet qualify as PKSF partners, but have the potential to do so.[56]

PKSF's Mission Statement to Support Innovation and Product Diversity

As a leading stakeholder of the microfinance sector, PKSF plays a crucial role in initiating, undertaking and supporting innovative products, processes and technologies that promote employment creation and poverty alleviation. Stated in its 2002 Annual Report, PKSF clearly illustrates its commitment to supporting an enabling environment for MFIs.[57] PKSF's objectives are as follows:

- To assist the poor by diversifying and strengthening their survival strategies to enhance their security and give them access to assets and rights. Increased choice and independence will augment the self-respect of the poor.

- To be a promoter and stimulator of innovative ideas and methods and to encourage, promote and assist efforts, which that focus on new technologies for employment creation and productive activities for poverty alleviation.

[55] PKSF Annual Report 2002, 33.
[56] PKSF Annual Report 2002, 31.
[57] PKSF Annual Report 2002, 1.

- To initiate, undertake and promote research activities directed towards poverty alleviation and employment generation; to establish and support research and training institutions; to grant stipends, scholarships, fellowships for such research activities; to organize seminars, workshops, conferences; and to undertake publication of reports, periodicals, monographs, bulletins, journals, books, etc. in furthering the objectives of the PKSF.

Due to its international reputation as a successful apex institution and its connection to major international donors and development banks, PKSF has the ability to harness opportunities, innovations and technologies for the Bangladeshi microfinance sector.

PKSF's Ability to Effectively Enforce its Contracts

PKSF's quality of the General Body, Governing Board and staff, its strict and transparent criteria in the selection and monitoring of partner organizations, and credible threats to successfully enforce its contracts with POs have allowed PKSF to build an excellent reputation as an apex funding body.[58]

PKSF has several mechanisms that it employs, on an as-needed basis, to enforce its contracts with MFIs, including peer pressure and publicity of delinquent MFIs at NGO meetings. Over the past twelve years, PKSF has ejected 17 microfinance POs from its lending program due to fraudulent activities and mismanagement. The consistency and reliability of enforcement mechanisms also serves to build the confidence of the public in PKSF MFIs.

Its reputation has the positive spillover effect of increasing investor confidence in the MFIs associated with PKSF. Since it is well known that PKSF POs are subject to strict monitoring and supervision as a pre-requisite for accessing its highly demanded concessional loan funds, it is assumed that these MFIs are more likely to be safer investments than non-PKSF affiliated MF-NGOs. PKSF's integrity as an organization

[58] Nagarajan, 46.

also lends itself to serve as a sort of informal ‘credit rating agency’ for its MFIs. In this way, PKSF’s regulatory approval of an MFI may assist MFIs to reach out and access funds from formal financial markets.

PKSF compliance could eventually become a benchmark for the health and stability of MFIs. With the wealth of financial data that PKSF collects from MFIs, it could regularly produce and publish an informal credit rating that is based on the current performance of each deposit-taking MFI. PKSF could possibly serve as a bridge between small and medium-sized MFIs with strong credit ratings and private investors, capital markets and commercial banks.

B. Practical Steps for Making PKSF into a Regulator

Certain changes to PKSF’s rights and responsibilities must be instituted before it can be transformed into the role of regulator and achieve the five main national policy objectives of regulation reform. PKSF must first be given the authority to perform the duties of regulator, including the registration of all MFIs; monitoring and supervising of member deposit-taking MFIs; the production and publication of MFI credit ratings. It will also be authorized to punish offending MFIs by prohibiting them from taking members’ savings, lowering their credit ratings, withdrawing their registration, and/ or rejecting new requests for loans. Despite its expanded role as regulator, PKSF will remain a government-owned organization that is autonomous in its operations and maintain its current governance structure.

Legislating New Rights and Responsibilities for PKSF

For PKSF to serve as the national regulator, the Parliament of Bangladesh must create a new ordinance or enactment specific to MFIs, such as a Microfinance Institutions Act (MFI Act). This act would allow the GOB to formally recognize MFIs as legal entities, which provide limited financial services with the objective of poverty alleviation. "The MFI Act" would include the following provisions:

(i) Under the new act, MFIs are exempt from the existing legislation.

(ii) The GOB recognizes the legal status of MFIs as a legal entity providing limited financial services with the objective of poverty alleviation.

(iii) MFIs are categorized according to the types of activities performed and the corresponding risks associated with each activity. Each category of MFI has a unique regulatory status with corresponding conditions for registration, licensing, capital requirements, and form of external regulation, if necessary.

(iv) MFIs are required to meet certain licensing and capital requirements in order to mobilize voluntary savings deposits from non-members, as these MFIs are subject to prudential regulation and supervision.

(v) PKSF will remain a government-owned organization that is autonomous in its operations. PKSF will maintain its current governance structure, composed of the General Board and the Governing Board, with representation from MFIs, the Bangladesh Bank, the GOB, universities and research institutes.

(vi) The new act gives PKSF the authority to regulate MFIs in Bangladesh. It dictates all the functions that must be performed by the apex regulatory body, including:

a) The registration of all NGOs that engage in microfinance activities.
b) The strategic monitoring and supervision of voluntary open access deposit-taking MFIs.
c) Intervention in conflicts, irregularities, and other problems faced by NGOs.
d) The practice of compulsion and punishment of offending NGOs.
e) The development and regular revisions of The Code of Conduct/ Norms for all MFIs are necessary for on-going supervision.
f) The mobilization of funds for qualifying MFIs.
g) Acting as a guarantor or collateral security agent or informal 'credit rating agency' for those qualifying MFIs that seek to mobilize credit from formal financial markets.
h) Advocacy and lobbying for the microfinance sector.
i) The organizing of workshops, seminars, and issue related meetings.
j) Making publications and documents and serve as a conduit for information dissemination.

(vii) The Code of Conduct/ Norms must be drafted by the apex body and included as part of the MFI Act. The Code would incorporate user-friendly norms and preventative guidelines in the place of a formal regulatory framework for banking and financial services. In the case of commercial bank regulation, the Code of Conduct is more likely to take the form of the Basle Committee on Banking Supervision's 'Core Principles for Effective Banking Supervision', which is a comprehensive set of voluntary core principles for effective banking supervision and a compendium of existing Basle Committee recommendations, guidelines and standards.[59] The Code would place the following requirements on member organizations:[60]

a) The creation of a strong and capable board of directors that establishes sound program interventions, financial and risk management policies and holds management accountable for implementing those policies effectively is essential to good governance. The evaluation of potential board members should involve background checks on banking and microfinance experience, personal integrity and relevant

[59] Basle Committee on Banking Supervision, "Core Principles for Effective Banking Supervision." (Basle, Switzerland, 1997), 2.
[60] Ahmed, 16.

skill. The members of the governing board should have reputational or equity stake in the MFI, which ensures depositors that they have strong incentives to watch MFI management closely to make sure their performance is consistent with the health of the organization.[61]

b) A standard accounting system that is transparent and universally acceptable enables a supervisor to obtain a true and fair view of the financial condition of the MFI and the profitability of operations. It is the duty of the MFI to publish its financial statements on a regular basis to reflect this condition.[62]

c) The practice of effective internal control and an extensive internal audit function ensures that the operations of the MFI are conducted in a prudent manner in accordance with strategies established by the MFI's board of directors; that transactions are only entered with appropriate authority; that assets are safeguarded and liabilities are controlled; that accounting records provide complete, accurate and timely information; and that management is able to identify, assess, manage and control the risks of the business.[63]

d) The practice of effective mechanisms for depositor protection. This includes such practices as keeping the voluntary savings deposits of MFI clients in an earmarked account in a licensed bank, to avoid liquidity risk; allowing MFIs to mobilize voluntary deposits from their members only and not from the general public; establishing and maintaining a Depositor's Protection Fund for the purpose of mitigating risk of its depositors, to which an MFI shall credit not less than 5% of annual profit after taxes; and taking member's savings deposits until the balance of deposits equals 75% of their outstanding loan funds.

e) The use of an efficient and effective Management Information System (MIS) will allow adequate information flow regarding MFI operations at all times. There should be a system in place for the collection of information at the member, group and branch level, for proper management and monitoring of the MFI.

f) The use of effective financial and operational performance standards of MFIs to improve the operations of MFIs and increase the sustainability of the sector as a whole. In general, there are three approaches to maintaining effective financial and operational standards of MFIs in Bangladesh: (1) Second-tier institutions that are

[61] Christen, Robert Peck and Richard Rosenberg, "Regulating microfinance—the options." *Small Enterprise Development*, Vol. 11, No. 4, December 2001.
[62] Basle Committee on Banking Supervision, 7.
[63] Basle Committee on Banking Supervision, 29.

major lenders can create strong enough incentives for retail MFIs to meet their standards. (2) The establishment of standardized performance and reporting standards for MFIs through self-regulation,[64] (3) The formation of an independent credit rating agency that would publish assessments of MFIs.[65]

g) The contracting of high quality, regular external audits by professional auditors who are knowledgeable and competent in microfinance is a means of safeguarding MFIs against fraud and mismanagement.

System of Self-Regulation

As regulator, PKSF would operate within a self-regulatory system.[66] Self-regulation may take a wide variety of forms, ranging from a voluntary Code of Conduct to which all MFIs agree to adhere, to a rigorous licensing system administered by an apex body and backed by the force of law. Effective self-regulation is rooted in good governance, an efficient management system, effective supervision and internal control supported by a Code of Conduct and proper built-in incentives for MFI to meet these standards. According to Graham Wright, effective self-regulation requires that individual MFIs strengthen their institutions and share financial information on a consistent basis. Wright suggests that self-regulation is only possible if the following three elements are combined with transparent disclosure:[67]

(i) An independent board with the technical expertise and authority to hold management accountable;

(ii) well formulated and properly implemented internal control and risk management policies, and

[64] 'Self-regulation' is defined as arrangements under which the primary responsibility for monitoring and enforcing prudential norms lies with a body that is controlled by the organizations to be supervised.
[65] Sinha, 60.
[66] 'Self-regulation' is defined as arrangements under which the primary responsibility for monitoring and enforcing prudential norms lies with a body that is controlled by the organizations to be supervised.
[67] Wright, 15.

(iii) high quality auditors who are educated about microfinance.

In the case of Bangladesh, under a self-regulatory framework, PKSF would continue to perform its functions as an apex institution, including capacity building, screening, monitoring, and supervising and lending to MFIs.[68] However, PKSF would operate as a bargaining agent, whereby it would monitor the system of self-regulation, and award MFIs that meet regulatory standards a positive credit rating.

In order for self-regulation through PKSF to be effective, there are factors that must be considered. PKSF must have the majority of MFIs under its jurisdiction and sanctions for non-compliance must be enforced.[69] PKSF would need to expand its management capacity to include the entire microfinance sector. It would be responsible for registering all MFIs, but limit its monitoring and supervising to member-based voluntary deposit-taking MFIs and its current POs. PKSF would also need to develop cost-effective methods for off-site and on-site supervision that are suitable to the operating procedures of MFIs. PKSF will need to reinforce the self-regulatory system with some legal or quasi-legal system of incentives or compulsion for MFI, including prohibiting it from taking members' savings, lowering its credit rating, withdrawing its registration, and/ or ejecting it from the lending program.

Defining Classes of MFIs and Differentiated Regulations

According to the MFI Act, MFIs would be categorized by the risk level of the types of activities that they performed. The following table, Table 1:

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[68] Sinha, 59.
[69] van Greuning, Hennie, Joselito Gallardo and Bikki Randhawa, "A Framework for Regulating Microfinance Institutions." (Washington, DC: Financial Sector Development Department, World Bank, 1998), 16.

Table 1: Regulatory Thresholds of Activities by Type of Microfinance Institution

MFI Type	Activity that Determines Regulatory Status	Proposed Form of External Regulation if Required	Regulatory Agency
CATEGORY A MFIs			
Type 1 Basic Nonprofit NGO-MFI	Making microfinance loans not in excess of grants and concessional loans.	None—Registration with PKSF.	PKSF
Type 2 NGO-MFI with limited deposit-taking from members	Taking minor deposits, e.g. forced savings or mandatory deposit schemes, from microfinance clients in community.	None –-Exemption or exclusion provision from banking law; compulsory registration with PKSF.	PKSF
Type 3 Incorporated MFI accepting voluntary, open-access deposits from members	Taking limited deposits and minor deposits from members (e.g. daily savings, voluntary savings contractual savings and time deposits).	Registration as a corporate legal entity and authorization from PKSF; maintain savings deposits as a ratio of outstanding loans or Depositor's Protection Fund.	PKSF
CATEGORY B MFIs			
Type 4 Specialized Bank, Deposit-taking Institution, or Finance Company	Taking limited deposits (e.g. daily savings, voluntary savings contractual savings and time deposits).from the general public beyond minor deposits. Microfinance activities more extensive than NGOs but operations not on scale of licensed banks.	Registration and licensing by Bank Supervisory Authority with a limitation provision (e.g., savings & fixed deposits, smaller deposits-to-capital multiple, higher liquidity reserves, limits on asset activities and uses).	Bank Supervisory Authority of the Bangladesh Bank
Type 5 Licensed Equity Bank	Non-restricted deposit-taking activities, including generating funds through commercial paper and large-value deposit-substitutes, from the general public.	Registration and full licensing by Bank Supervisory Authority as a mutual-ownership or equity bank; compliance with capitalization/ capital adequacy requirements, loan loss provisioning and full prudential regulations.	Bank Supervisory Authority of the Bangladesh Bank

Source: World Bank 1998

Regulatory Thresholds of Activities by Type of Microfinance Institution,[70] was adapted from a table featured in a 1998 World Bank study by Hennie van Greuning, Joselito Gallardo, and Bikki Randhawa presents the entire spectrum of the possible legal forms of MFIs.

Each category is organized by the scope and risk of the activities performed by MFIs.[71] This framework proposes that different categories of MFIs will be subject to different forms of regulation based on the level of risk of their activities. For instance, Type 1, basic non-profit NGOs that provide microcredit services, and Type 2, non-profit NGOs with compulsory deposit-taking schemes and microcredit services, are required to be registered with PKSF, but do not require constant monitoring and supervision. Type

[70] van Greuning et al., 4.
[71] Table 1 is based on the Regulatory of Thresholds of Activities by Type of Microfinance Institution table from the World Bank report by van Greuning et al.

3, MFIs, which provide microcredit services, compulsory savings schemes and limited voluntary open-access savings instruments, would be subject to registration, monitoring and supervision by PKSF. Type 4, specialized banks, deposit-taking institution, or finance companies would be subject to registration and licensing by the Bank Supervisory Authority (BSA) of the Bangladesh Bank (central bank). Type 5, licensed equity banks, which are equivalent to regular commercial banks, would be subject registration and full licensing by the BSA of the Bangladesh Bank.

This framework is designed for MFIs to self-determine the activities and the level of risk they are willing to bear. For instance, prudential regulation and supervision are only required for MFIs in Category B with higher thresholds of risk, on the basis that it would be unrealistic for any agency to supervise every MFIs currently operating in Bangladesh.[72]

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[72] Sinha, 55.

VI. PKSF as Official Regulator

In order for national policy makers to determine the size of the costs and the benefits attributed to PKSF as official regulator of the microfinance industry, it is first necessary to understand the impact that regulation reform will have on MFIs with varying levels of pre-existing internal and external control. We can differentiate these MF-NGOs in three ways: (1) PKSF funded partner organization MFIs (2) donor funded MFIs, and (3) locally funded MFIs.

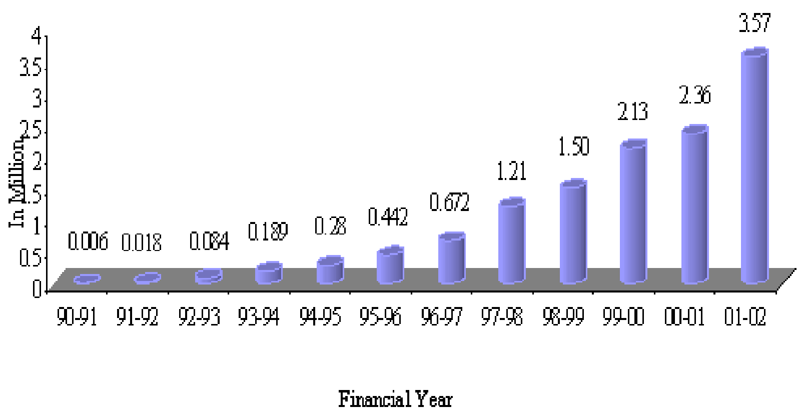
PKSF Partner Organization MFIs

Over the last ten years, PKSF has developed efficient, standardized procedures for collecting monthly information on changes in clientele, savings, loans, disbursement, and recovery and for conducting on-site visits and annual audits. These factors have historically reduced the chance of fraud and mismanagement from occurring, thereby strengthening the microfinancial system. Over the last twelve years, there have been 17 incidences where PKSF, has suspended disbursements of funds to its POs.[73] Compliance failure of these MFIs was caused by a variety of acts, including fraudulent activities, poor management, disagreements between the MFIs's governing board members, and employment crisis in the respective locality of the MFI.[74] In most cases, PKSF has the ability to bring POs before court on charges of fraud and mismanagement under the contract of law. PKSF also can initiate litigation under the Public Demands Recovery Act, which was recently amended in Parliament.[75]

[73] Kader, Fazlul. Consultation. April 30, 2004.
[74] Uddin, Khawaza Main, "NGOs Fail to Benefit Their Poor Members." New Age Business, July 13, 2003. Available on http://www.bangla.net
[75] Kader, Fazlul.

In terms of costs, there would not be many incurred among PKSF partner organizations after PKSF is authorized to regulate the microfinance industry. PKSF will continue to screen, monitor and supervise and lend subsidized loan funds to the same MFI POs provided that they remain in good standing. According to the Bangladesh Local Consultative Group of Donors on Finance, the present system works very well and costless. "With PKSF now lending to all but a handful of the medium and large MF-NGOs, there is *de facto* supervision by PKSF, including monitoring of what have now become the standard financial and performance indicators."[76] The outreach of PKSF affiliated MFIs was 3.57 million members in FY 2000-01 or about 29% of all microfinance members.

Figure 3: Number of Borrowers of PKSF (in million)

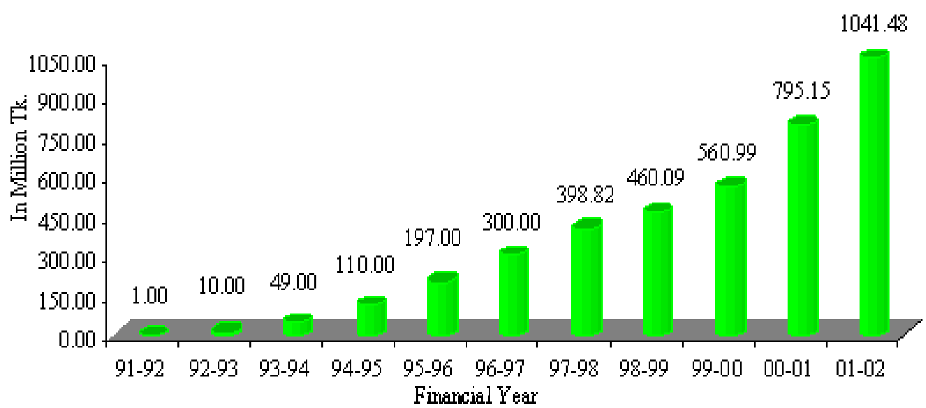


There are few additional benefits to be gained by POs since they already benefit from PKSF's capacity building and technical advisory services, which has enabled them to function rather efficiently. One small potential benefit could be that international donor agencies start to channel the funds that they have traditionally given to individual MFIs to

[76] "Joint Donor Strategy on Microfinance." Vol. 1.-Summary Draft. (Dhaka, Bangladesh: Bangladesh Local Consultative Group of Donors on Finance, 2002) 24.

PKSF. In doing so, it is assumed that PKSF will increase its power as a primary lender over more MFIs. However, this is unlikely to happen as PKSF feels it already has an adequate number of POs that are capable of maintaining a desired level of outreach.[77] PKSF has been conservative in accepting loan applications from MFIs, requiring those accepted to have at least 400 clients organized in groups that regularly mobilize savings. Recovery rates of 95-98% are required, depending on the age of the institution.[78]

Figure 4: Annual Loan Disbursement of PKSF (Tk. in Million)[79]



In 2001, PKSF disbursed only 76% of the amount it had budgeted for lending to small MFI. It disbursed 85% of the total amount that it had budgeted for lending to the three largest MFIs. With PKSF as regulator, it is expected that the number of POs that PKSF accepts each year will not be affected.

Donor Funded MFIs

With PKSF as regulator, it is expected that some administrative costs will be incurred as donor formatted financial statements and procedures are adjusted to match PKSF reporting requirements and performance standards. However, the costs are

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[77] Kader, Fazlul.
[78] Meagher, 48.
[79] http://www.pksf-br.org

expected to be low, since donor programs already place comprehensive reporting requirements on MFIs. Donors have spent a significant amount of time with MFIs building their capacity to regularly collect financial information, it is expected that the task of adapting this information to PKSF standards will not be too onerous.

There are also few benefits, as donors are also known to do a thorough job of monitoring and supervising their MFI recipients. According to Patrick Meagher, "under the World Bank program, PKSF imposes somewhat more stringent performance criteria, and large MFIs must maintain minimum equity of $240,000, a maximum debt-equity ratio of 2.5 to 1, a client base of at least 100,000 borrowers, and a loan recovery rate of 95% or higher."[80] However, donors may benefit from reducing the administrative paperwork that they have to submit for each MFI, as they may opt to provide funds directly to PKSF rather than on-lend them to individual MFIs.

Locally Funded MFIs

Local MFIs tend to be small in membership size and operate across a small geographic area. These MFIs can be further sub-divided into two main categories: (1) MFIs that only provide credit services and (2) MFIs that collect savings deposits from members in addition to providing credit services. Local credit-only MFIs are required to register with PKSF, whereas, local deposit-taking MFIs are required to be both registered and authorized by PKSF to mobilize voluntary savings deposits among its members.

The cost of subjecting all deposit-taking MFIs to regulation and supervision under PKSF is expected to be incredibly high. In general, the administrative costs of monitoring and supervising MFIs are likely to be quite expensive given their smaller

[80] Meagher, 48.

asset base, the labor-intensive process of checking a much larger number of accounts and the decentralized organizational structure of MFIs. For example, the costs of supervising a medium-sized MFI with 10,000 members could range from 1% to 5 % of assets, whereas the cost of supervision of a commercial bank is estimated to be about $1 to $1,000 of assets supervised.[81] If the MFI is not able to fully absorb these costs then they may be passed on to its members.[82] The pure administrative costs of registering over 1,000 plus MFIs that are currently are not required to submit/ maintain any sort of financial statements may be prohibitively expensive. Major investments in institutional capacity building and human resources training would be needed to overhaul the majority of these MFIs in the current system. In an analysis of MFIs in Bangladesh, the World Bank (1996) noted that accounting, management information systems and external audit policies and standards that were adopted by small and medium MFIs needed to be substantially upgraded.[83] An international survey of MFIs conducted by Sustainable Banking for the Poor (1996) found that numerous MFIs did not have accurate accounting systems and were not operating on a sustainable basis. The authors asked: "If some managers of microfinance are unable to answer questions about their own costs without the help of outside experts, how can they be expected to run sustainable institutions?"[84]

Most small local unregulated MFIs have low administrative expenses, as they operate with low-pay staff structures. A sudden increase in administrative costs associated with making locally funded MFIs PKSF compliant may have direct negative repercussions on the poor they are trying to benefit. These costs may cause MFIs to raise

[81] Christen et al., 6.
[82] Ibid.
[83] McGuire.
[84] Sinha, 49.

their interest rates to cover their operations, which may force closure of MFIs operating in underserved areas or cause members of the poor to self-select themselves out. In Bangladesh, the central bank president has stated that one of the main objectives of regulation ought to be to restrain the 'exploitative' interest rates charged by some MFIs.[85] Higher interest rates may cause the GOB to impose interest rate controls that may undermine the possibility of sustainable microcredit and discourage the outreach of poorer customers.

The benefits of regulation may be nonexistent for small local MFIs. If locally funded MFIs that do not receive or depend upon PKSF as a source of funding may not have strong enough incentives to comply with PKSF as a regulator. In this case the cost of compliance would far exceed any direct benefits, unless PKSF had the authority to penalize non-complying MFIs. Regulation reform may force small local deposit-taking MFIs to forego the provision of savings instruments or to shut down if they cannot meet PKSF's authorization requirements.

On the other hand, there may be other potential benefits to be gained if small MFIs can receive promotional benefits from meeting PKSF compliance measures. Registration with PKSF may serve as a credible sign of the health of the organization and the integrity of the management. This informal 'credit rating' system may build the confidence of potential borrowers and investors (or donors). According to the Executive Director of the Bangladesh Bank, "Most of them do not practice proper bookkeeping and accounting policies, lack professionalism in financial transactions, therefore, training and capacity building in accounting and financial management, plus greater transparency is essential not only to make them attractive to the donors but to also enable them to tap

[85] Christen et al., 7.

commercial markets and banks."[86] Credit ratings can help create linkages to between MFIs and formal commercial banks. "Smaller MFIs could be strongly encouraged to play the role of brokers between the banks and the borrowers. The banks bear the credit risk by lending to the borrowers and share a part of its spread with the MFIs".[87] Aside from the promotional benefits, if small MFIs can improve their institutional capacity to meet compliance, they may also grow into more stable and sustainable MFIs. In the future they may expand their coverage and the range of services they can provide, increasing their sources of funding and outreach.

[86] Haque et al., 7.
[87] Haque et al., 8.

VIII. Policy Recommendations

The purpose of this final chapter is to extrapolate how PKSF would achieve effective and economical microfinance regulation in Bangladesh. The goal of this section is to briefly suggest some of the functions that the main MFI stakeholders could perform to ensure that PKSF becomes a successful regulator while encouraging future growth of the microfinance sector.

Suggested Measures for PKSF:

- PKSF should continue its role as creditor and capacity-builder as it assumes the additional responsibilities of regulator. PKSF should remain consultative and NGO-friendly organization. Establishing close professional relationship with its POs enabled PKSF to properly assess and address the capacity building needs of its MFI POs and put them on a path towards sustainability.
- PKSF should publish its informal credit ratings of voluntary open access deposit-taking MFIs. A credit rating service compliments the idea of the self-regulation. The ratings would measure performance, rather than the extent to which MFIs meet regulation. The credit ratings would reward institutions that are financially healthy. The credit ratings would be used by all funding agencies, including second-tier institutions, donor agencies, and commercial lenders and would provide powerful incentives for compliance.
- PKSF should create benchmarks for reporting and performance standards for the industry based on PKSF policy guidelines. Reliable standards will reinforce depositor trust and investor confidence in the microfinance system.

Suggested Measures for Donors:

- Donors should provide technical assistance and training to PKSF and the GOB on legal and regulatory frameworks to help PKSF build its institutional and professional capacity to transition into the role of regulator for the entire industry. Donors should support PKSF's position as a creditor and as regulator by not supplying funds to those MFIs, which PKSF deems negligent, poorly managed or engaged in fraudulent activities.
- Donors should provide capacity building and policy development assistance for the general banking sector. Donors should aim to strengthen financial institutions, including the Bangladesh Bank. The new regulation will allow a new class of microfinance banks (similar to the Grameen Bank) that must be prudentially regulated and supervised by the Bangladesh Bank.
- Donors should support an enabling environment that encourages commercial banks to develop their capacity to lend to MF-NGOs. Promote linkages between commercial banks and MFI as a means of accessing more commercial sources of funds. Such bridges are mutually beneficial. As donor funds decline, access to commercial funds will allow small and medium to scale-up operations without relying solely on donor funds.
- Donors should support the creation of microfinance banks and the involvement of regulated commercial banks to become involved in microfinance activities. Banks may have a number of advantages over specialist MFIs as regulated institutions. Banks have well-established administrative and accounting systems that are able to track a large number of transactions. Bank ownership structures

that include private capital tend to encourage sound governance structures, cost-effectiveness and profitability, all of which lead to sustainability. Banks can rely on their resources of funds, deposits, and equity capital and are not obligated to depend on scarce donor resources. As prudentially regulated institutions, banks can also offer a wider variety of products, especially savings deposits that are attractive to microfinance clients.

- Donors should support the innovation of products and procedures that will advance the concept of microfinance. By designing products that meet the evolving needs of clients, an organization can build client loyalty and increase profit. An institution using innovative approached will generally incur higher costs that an institution replicating an existing model, reflecting higher costs and a greater degree of risks involved.[88] For example, life insurance for the poor is fairly new product on the market. However, many NGOs do not have the resources or capability to develop systematic procedures to determine the cost of the product. Mere rule of thumb is being used in premium setting. Often times, MFIs do not even test products before they are launched on the market. More innovative products and methods may generate positive externalities that are adopted by other MFIs in the market. Donors should specifically use seek to support NGOs that bring these contributions to market.

Suggested Measures for MFIs:

- MFIs should work with PKSF to build up management capacity to meet reporting and performance standards. MFIs that do not meet basic operational standards are

[88] McGuire et al., 8.

unlikely to achieve significant to outreach the poor on a sustainable basis. MFIs should enroll their staff in PKSF training programs for management and accounting, as necessary.

- MFIs should also work to increase cost efficiency and keep administrative costs low. In this way MFIs are able to maintain a profit spread, while keeping interest rates low. MFIs that decrease operational costs may reduce dependency on scarce donor funds and improve access to alternative funds as a result of better a credit rating.
- MFIs should also look for opportunities to with donors to develop innovative financial and non-financial products that cater to different client groups, including microfinance graduates and the ultra-poor.

<u>Suggested Measures for the Bangladesh Bank:</u>

- The Bangladesh Bank should start building up staff knowledge of the microfinance sector. It should begin building capacity of the supervising authority to prudentially regulate microfinance banks.
- The Bangladesh Bank should also take a more active role in encouraging linkages between MFIs and the commercial banking sector by documenting and publicizing successful case studies of banks that have engaged in microfinance and issuing clear guidelines that banks can follow.

<u>Suggested Measures for the GOB:</u>

- The GOB should support legislation such as an MFI Act, which flexibly regulate the microfinance industry and increases the protection of depositors and investors;

creates an enabling environment for diverse products and services; supports MFIs to collect savings deposits from members; and allows for the establishment licensed microfinance banks.

- The GOB should support legislation that encourages regulated commercial banks to offer innovative financial services that reach poor clients. Create an enabling environment for banks to develop their capacity to lend to MF-NGOs.
- The GOB should work with donor organizations to maintain an enabling macroeconomic policy environment and an adequate legal, regulatory and supervisory framework for microfinance. The GOB should focus on maintaining stable economic growth and containing inflation. A sound macroeconomic policy will further lower market risks and interest rate premiums.
- The GOB should work with donor organizations to develop targeted grant-based approaches to reach the ultra-poor and the poor that may lose access to microfinancial services, after a possible industry consolidation caused by regulation reform.

VII. Suggested Areas for Further Research

There are additional areas of research that fall outside the scope of this paper that policymakers will need to address in order to determine the optimal course of action for the actual implementation regulation reform. The task is to find cost-effective ways of improving the protection of depositors and investors, while at the same time encouraging MFIs to stay innovative and avoiding burdensome regulation which restricts their efficiency and effectiveness. As this debate continues, the following questions should be considered:

1. How will regulation be implemented? Will it be phased in over several years? Which types of MFIs will be regulated first? Will large MFIs eventually be converted into microfinance banks?

2. How will PKSF allocate its capacity building services to the new MFIs? Which MFIs will receive priority treatment?

3. What specific requirements (for example, number of members, geographic outreach, repayment rate, type of clients) should be met to ensure that MFIs are able to safely collect deposits from members?

4. What course of action will PKSF be able to take against locally-funded, non-PO MFIs?

5. Should PKSF manage credit ratings or should a separate entity be created to take on this function?

As policy makers calculate and weigh the size of the financial and non-financial costs and benefits of different paths to implementation, the following questions should be considered:

1. About how many small, medium and large MFIs are estimated to meet these registration and/ or prudential type requirements? How many have the potential to be sustainable in the future?

2. How many MFIs will leave the microfinance industry due to compliance failure? How much of the poor will be worse off if these MFIs are forced to close?

3. How large will administrative costs be for PKSF to simply register all MFIs?

4. How large are the administrative and capital costs of monitoring and supervising all MFIs that mobilize voluntary savings deposits from members in addition to monitoring and supervising POs?

5. How many microfinance banks could the Bangladesh Bank feasibly regulate?

6. How well is PKSF expected to regulate locally funded MFIs? How large will the benefits be from the expansion of new financial products? How much more funding would be attracted to the field, once the industry is regulated? Will these benefits exceed the administrative costs for compliance?

IX. Conclusion

The microfinance sector in Bangladesh has experienced enormous growth over the past two decades, improving the lives of millions of poor families everywhere. This remarkable growth can be partly attributed to the GOB's hands-off approach towards regulation. In recent years, however, the sector has expanded to the point where MFIs can no longer safely push into other areas of financial intermediation without regulation, causing the future growth and sustainability of the microfinance industry to be jeopardized.

Over the past 14 years, PKSF has earned an international reputation as a case study for the most successful apex financial institution. PKSF's history of collecting standardized financial information from MFIs; monitoring and supervising MFIs; developing the institutional and human resource capacity of MFIs; and acting as a credible enforcer, has naturally lent itself to the role of national regulator for the microfinance industry.

The advantages and disadvantages of transforming of PKSF into the role of official regulator vary across stakeholders in the microfinance sector. PKSF partner organizations will have very few costs and benefits to regulation, as they are already receiving the benefits of being regulated by PKSF. Donor funded MFIs tend to have small costs and fewer benefits as they are already fairly effectively controlled by international donor agencies. However, the administrative costs of overhauling and implementing regulatory reform are expected to be quite significant for small locally funded MFIs. At the same time, the non-financial costs of closing down the unsustainable MFIs that serve the poor may also be significant, if the poor lack other options. On the other hand, the legitimacy and promotional benefits that would accrue to small locally funded MFIs may be great enough to attract funds and increase outreach to offset these initial costs. If PKSF compliance standards can serve as a benchmark for the financial health of deposit-taking MFIs, like a credit report, confidence in the sector would be expected to increase, thereby attracting more depositors and investors than there would have been if regulation reform had not occurred. Further research and investigation into quantifying the size and weighing the potential costs and benefits of regulation reform should be considered to determine the best course for implementation.

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